



## The Chairman's Corner

by Richard C. Lambert, CPCU, ARM



Welcome to our new world of insurance! This market will go down as one of the most difficult "hard" markets ever. The implications of all the hits we have taken in the past year are going to be felt for some time to come. For agents and brokers, this just raises the bar on the challenges we have always faced for our customers. Hopefully, you will find the articles in this and future newsletters helpful.

Let me bring you up to speed on what is going on with our Agent & Broker Section Committee. We have literally gone through a metamorphosis in the last six months. More than half of our 17 member-committee is new to their role, including this writer and your newsletter editor, **Chris O'Donnell, CPCU**. We have an energetic group that wants to contribute to the needs of the CPCU Society, as well as those of the section members.

One of the biggest and most important thing going on is the enhancement to the CPCU Society web site platform. Each section has its own area that is currently being developed. **Marianne Franken, CPCU**, has been our liaison to this web site construction since the inclusion of the sections for their input and coordination. She will be coordinating the content of the Agent & Broker portion of the web site. At our meeting held during the Leadership Summit in May 2002, **Rich Gerrond, CPCU**, joined her as co-liaison. Our plans call for up-to-date information flowing through the site, with the formation of a chat room in the near future. Although the web site is open to all CPCU Society

members, we are researching how to have an area segmented specifically for our section members only. Why not take a few minutes to search through the CPCU Society web site and see how this effort is progressing? Stay tuned, as this concept will raise the level of communication for us.

Other areas our committee is discussing include:

- How do we increase the value of the section to our members?
- How do we involve new designees in the section?
- How do we contribute to goals of the CPCU Society's Strategic Plan?
- What will be timely topics and seminars for the 2003 Annual Meeting?
- What articles, authors, and other information do we want to include in future newsletters?

Hopefully, you will agree that we are trying to continue the progress made by the prior members of our committee. We would welcome any feedback you may have for us.

In this newsletter is an article authored by **Kathleen J. Robison, CPCU, CPIW**. I have known her for a number of years now. This article is an excellent representation of what getting involved in the CPCU Society means to her. For those of us who have volunteered, the contacts developed have been invaluable. I can only stress Kathy's last paragraph. Volunteering to serve may seem like just one more thing on that incredibly long to do list, but it is worth it!

In the remainder of the newsletter you will find two additional articles of interest. The first is an article by **Laura S. Danoff, CPCU**, on "Working Effectively with Wholesalers." This is followed by a reprint of a speech given by Michael Phillipus of RIMS to a Senate Subcommittee on Insurance Regulation and Competition in the 21st Century. I hope you find both of them interesting. ■

# What National Service Means To Me

## *Why One Gets Involved*

by Kathleen J. Robison, CPCU, CPIW

In my continuing CPCU Society service role, I attended our 2001 CPCU Society's Annual Meeting and Seminars and assumed new duties as a member of the CPCU Society's Board of Governors representing the sections. To say that it was a proud moment for me would be an understatement. In the room there were friendships that were begun and nurtured through several years of CPCU Society meetings and endeavors. Outside of the room there were many scores more of CPCU Society friendships developed over my 16 years as a CPCU. Friendships where we freely shared our knowledge, gave each other advice, asked each other advice, worked on projects together, helped each other through downsizing, through job and employer changes, through hard markets and soft markets; these friendships were cultivated when we were mentored, and then when we became the mentors.

And to think it all began October 1985 in St. Louis when I received my CPCU designation. It turned out I received a lot more than the designation. I was so impressed by the vast insurance knowledge present at the general session, the President's Panel, the many seminars, the speakers, the attendees, and everyone's willingness to warmly share their knowledge. I ended the meeting just knowing that I had to become involved; I had to really belong to this "family" somehow.

Initially I became involved because I wanted the multifaceted insurance knowledge that this group possessed. Knowledge is a key to success. Over the years my fellow CPCUs also shared with me the many other keys one also needs to succeed. So I joined the CPCU Society, the local CPCU Society's Claims Section and chapter, and now the Board of Governors.

In 1987 the senior executives of the insurance company where I was practicing my profession set a goal of reducing legal expenses. (Some things never change.) Now one could mandate that all attorneys reduce their hourly rate; one could review the attorney bills very carefully; one could set up an in-house counsel unit, etc. but I found

there were many varied approaches to achieving this goal. After careful review with the staff and the facts, I began to formulate a plan. I wrote down the issues and the plan in detail. At conclusion, my review indicated that the plan would also make a very good article. Just that morning I had received the *Claims Section Quarterly* and the editor, Ken Brownlee, CPCU, was asking for articles. So I sent my legal cost reduction article in and Ken printed it. Was I ever proud. He even called me and we began to discuss various claims issues. He encouraged me to write further articles and we soon became professional claims friends. After a year he took me on as assistant editor, taught me the ropes of publishing a quarterly newsletter, and then promoted me to editor of the *Claims Quarterly*. This Society service, while time consuming, gave me the opportunity to continue to improve my writing skills, focused me on continually being aware of the "hot" breaking claims topics, and getting up the nerve to solicit and convince knowledgeable insurance professionals to write articles. Each quarter with the publication of the *Claims Quarterly* my professional skills continued to develop. And, my network of insurance professional friends continued to grow.

I met John DiLiberto, CPCU, at a national claims executive meeting. He belonged to the Claims Section and was on the national Claims Section Committee. As we discussed claims issues John suggested that I become a committee member. With John's recommendation I added Claims Section Committee service to the editor job. Now I got to work face to face with 18 dynamic claims professionals from all over the country. Some worked for large insurance carriers, some for smaller ones, some worked for themselves. Some worked in workers comp, property, casualty, independent adjuster service, SIU. All were committed to producing high-quality educational seminars and symposia across the country for CPCU claims professionals. Now we had the opportunity to plan, organize, market, and present information



**Kathleen J. Robison, CPCU, CPIW, is a member of the Greater Detroit Chapter, and is a Claims Section Member.**

*She is also serving on the Board of Governors representing the sections.*

on claims issues across the country. The Claims Section sponsors one seminar at each Annual Meeting. These seminars had to have top-notch speakers on a very timely topic and be of interest to a wide range of insurance professionals, not just claims. I learned how important a budget and a market plan are for a seminar/symposium to succeed. The group also taught me the importance of teamwork. No one person could do it by himself/herself. Teamwork is a very important key to success. And, my network of insurance professional friends continued to grow.

The Claims Section Committee meets twice a year, at the Mid-Year Meeting and the CPCU Society's Annual Meeting and Seminars, along with all the other CPCU committee meetings. This gave me the opportunity to interface with non-claims insurance professionals at lunch, at breaks, in the hallways, etc. I learned the depth of the Society's volunteer leaders—how many there were and how varied the backgrounds that were necessary to do all the Society work that benefited the total membership. We freely shared our insurance knowledge base from the differing viewpoints. We worked on projects that required cross-discipline approaches such as the transition to the Society's new governance structure and the formulation of the new five-year strategic plan. And, my network of insurance professional friends continued to grow.

While serving as a Claims Section Committee member I met Wayne Browne, CPCU. Wayne Browne has a deep commitment to CPCU and to claims. He constantly encouraged and supported the group on taking new challenges. He willingly shared his knowledge and resources to make things happen such as the study of "CAT Impacts on Claims Staff and Managers," and creating templates for symposia making it easier to put one on around the country. His actions were continuously teaching me how to improve my coaching and mentoring skills. Wayne's enthusiasm was very contagious and before I knew it he had me involved in a number of national claims endeavors. One endeavor was following Wayne into the position of Claims Section chairman. Through this Society assignment I had the opportunity to practice and improve upon my planning and facilitation skills. Since the section chairmen met

frequently, I was able to learn in more detail the structure and function of other CPCU Society sections. And, my network of insurance professional friends continued to grow.

At the end of my Claims Section chairman term, the Society leaders decided that it was time I step outside of claims. I was asked to serve on the Budget & Finance Committee. Since money always interests me, I gladly accepted. This group was definitely not claims. This group really knew its way around a balance statement and a calculator. I too, began studying the Society's finances in detail. This gave me a deeper appreciation for the varied functions and tasks that the staff is required to perform in order for the Society to function in an effective and efficient manner. Once again there was a free sharing of information. And, my network of insurance professional friends continued to grow.

Now my service begins on the Board of Governors. In this role I represent along with Larry Klein, CPCU, and John Twomey, CPCU, the sections. John W. Reynolds Jr., CPCU, 2001-2002 Society President, has stated that "the Board is going to move very rapidly to increase Society visibility efforts and career enhancing programs for this year. We are going to look very closely at how we can access knowledge and information and deliver it to our members in a variety of ways, via the Annual Meeting and Seminars, continuing education workshops and symposia, and the Internet." I personally encourage all section members to share their thoughts on how they feel this can, and should, be accomplished. Please e-mail me at [kjrobison@voyager.net](mailto:kjrobison@voyager.net).

The learning and sharing experiences will continue along with the ever-increasing network of professional CPCU friends. Join in the sharing, fill out an application for national service and submit it for consideration! You can find the application for national service on the CPCU Society's web site at [www.cpcusociety.org](http://www.cpcusociety.org) or you can discuss this further with your chapter president. Please, feel free to contact me with any questions at all. ■

# Working Effectively with Wholesalers: The Care and Feeding of Your New Best Friends

by Laura S. Danoff, CPCU

Enjoying the hard market? Whether it's your first or you've been through this before, one thing is certain—you're accessing the E&S/wholesale marketplace more than you've needed to in the past 12 or so years. And guess what? So is everyone else. Of course intellectually you understand this, but that voice inside your head is saying, "Who cares about everyone else? I just want to make sure *my* stuff gets quoted." And that's the purpose of this article—to assist you in working that marketplace effectively so that your submission gets to the top of the stack and gets quoted, which is no mean feat in a very odd market.

The article will cover four areas:

1. What is a "wholesaler"?
2. How do you know which one to use?
3. Preparing the submission
4. Reviewing the quotation

This is going to be a very pragmatic article, because if you're going to take the time to read it, it should contain information that can be put to work immediately. In fact, I'm going to begin by talking about the one commodity no one can create more of—time.

Even if you were in the business in the mid-80s for the last hard market, this one is very different for a number of reasons. The following did not exist in the mid-80s, or if they did, few had access to them:

- fax machines
- voice mail
- overnight mail (it existed, but you needed three levels of upper management to sign off before you could use it)
- cell phones
- pagers
- computers
- e-mail
- the Internet

Imagine this: back then, you could actually be inaccessible because you were *away from your desk, or out of the office!* The underwriter couldn't quote the risk yet

because the submission was *in the mail*.

These wonderful inventions that have made our lives so much easier have also created a greater sense of urgency and immediacy, because people feel there are no excuses to not having a quote because after all the information was e-mailed, overnighted, faxed, so why can't I have my quote *now*? These devices have created a whole new concept of "*now*"—communication is instantaneous, so expectations have become greater.

This is one of the realities of the current marketplace. Here are some others: fewer markets due to insolvencies, lowered Best's ratings, or what I like to call "dietary declinations," as in "I'd like to write this but we've lost our *appetite* for this class of business; less capacity; higher prices, more stringent underwriting guidelines; treaty and facultative reinsurance setting prices and terms; standard company underwriters who have been in the industry a short time and have not been trained for a hard market. The E&S/wholesale marketplace was created to respond to all of those realities, and its participants are used to working with a sense of urgency. So let's see what makes up this marketplace. Just by understanding who does what should make it easier for you.

## What Is a "Wholesaler"?

Traditionally, the term "wholesaler" referred to an excess and surplus lines broker, which is a *broker* who acts as an intermediary between the retail agent/broker and the non-admitted marketplace. However, some E&S brokerage firms also operate as managing general agents (MGAs), so I'll cover that as well.

The important thing to remember is that a wholesale broker is a *broker*, and as such does not have underwriting or binding authority with the companies he or she places business with. If the E&S firm also has MGA contracts, they do have underwriting, binding and policy issuing authority within the stated guidelines of the





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For details about that and other seminars, please go to [www.LSDanoff.com](http://www.LSDanoff.com).

MGA contract; however, these days some MGAs might have less underwriting authority or more items that are Home Office Referrals as the market continues to harden.

## Some Important Facts About Wholesalers

1. They're human—just like you!
2. They have the access and clout with the markets you need.
3. They know what to ask for and what to look out for when it comes to specialty coverages/forms.
4. They have more business to work on than they can possibly get to.
5. Their *markets* have more business to work on than they can possibly get to.
6. If they are E&S *brokers*, their office will not be the last stop for your submission.

Knowing these facts, what can you do to work effectively with wholesalers?

1. They have the same pressures and frustrations that we all do! If you show that you understand and appreciate that, they'll go the extra mile for you.
2. They act as your negotiating partner with these important markets, so furnish them with all the information they need in order to get the best deal for your insured.
3. There are some markets that work with both wholesalers and retailers, but if it's a market or coverage that you're not familiar with, it makes more sense for you to leverage your time and your clout by using the wholesaler because he or she has the current market/coverage knowledge.
4. Your goal is to make sure that of all the business they have to work on, *yours* is one that they *will* get to. Your goal is to make it as easy as possible for them to work on it. Back to the "human being" thing: if it looks like too much work, it will get set aside (i.e. receive the Kiss of Death).
5. Your goal is also to make sure that when your submission gets to the markets, the underwriters can actually read the application and supporting information. If it's faxed too many

times . . . (see above Kiss of Death).

6. What happens to your submission when it reaches the wholesaler? It gets sent *someplace else*. So allow for that additional time. Each market may require different information or special supplementary applications, so be aware that you may need to supply this in order to get each one to quote. It's not the wholesaler being difficult—it's the wholesaler trying to get coverage for your insured, and special supplementary applications are a hard market reality.

How do you know which one to use?

### Questions to ask:

1. What's your experience with this particular coverage?
2. How's the market for this coverage? What should I expect?
3. Are my premium/coverage expectations realistic?
4. What markets will you be approaching [get a list]?
5. What information will you need in order to obtain a quote? [Note: in a softer market I inserted the word "quickly."]
6. *How many copies of this information will make it easier for you to market this?* [Note: they'll love you for this.]
7. What's the time frame for obtaining a quote?

### Preparing the submission:

1. Use a one-page cover letter recapping the Coverage, Limits, Exposures, *brief* Description of Ops (*never* say "see attached"—you'll never see your quote if your submission looks like too much work) including the web site address if applicable, anything "ugly" (better to deal with it up front than have it change an indication later) and listing the Attachments. This will allow your submission to be quickly qualified and let the wholesaler determine which markets to approach. It also makes it easier to get the account out to markets who can review it quickly and see if it's something they can do or not. After all, isn't it better to receive a

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declination sooner rather than the day you thought you'd have a quote to present?

2. Ask yourself the following basic questions:
  - a. Can I read this?
  - b. Will it survive faxing?Remember: the wholesaler is not the last stop for your submission. If you faxed the app to your insured who faxes it back to you, you then fax it to the wholesaler who faxes it to markets, just how legible will the stuff be when it gets to the one person who really needs to read it?
3. Fact: your insured has more than one copy of the brochure hanging around his or her place of business. Get as many copies of the brochures as your wholesaler needs in order to get originals to underwriters. The less photocopying the wholesaler has to do, the quicker your account goes out to markets.

## **Reviewing a quote from a wholesaler:**

1. Is it a quotation or just an indication?
2. Admitted or Non-admitted?
3. Minimum Earned Premium?
4. Get copies of policy forms and endorsements.
5. "Subject to"—in a hard market, they really mean it! Get all items prior to binding if that's a subjectivity.
6. Is it subject to placement of facultative reinsurance? That means that coverage may not be able to be bound, or that the pricing and/or terms could change. It also means you have to allow for additional time for the reinsurance to be placed.
7. Did they any words out? (joke)

## **In closing, here are my Top 10 Ways to Work Effectively With Wholesalers:**

1. Know who the markets are, find out who does what.
2. Know more than one person at a market—people go on vacation, they go out on appointments, they go to conventions, they leave!
3. Recognize that everyone is under

pressure and has no time.

4. There's a finite number of times a document can be faxed and still be legible.
5. The highest quality submissions from completeness and legibility standpoints have the best chances of getting quoted.
6. Let the wholesaler know what your time deadlines are.
7. Constantly follow up with the wholesaler to see where your submission is in the food chain.
8. Go where you've built a strong relationship over a period of years if possible. More than one market has said that underwriters are "triaging" submissions, i.e. going through the stacks and pulling out submissions from "A-List" clients to work on first.
9. Allow as much time as possible. Traditionally, wholesalers are used to being contacted at the last minute and will make your sense of urgency their own, but things are taking longer these days. Underwriters are being told to underwrite to a profit (what a concept!) and there are more steps to be taken.
10. Remember that your wholesaler is your negotiating partner and work with him or her to get all of the information the underwriters will need. In a hard market, there are no shortcuts.

Above all, recognize that the wholesale market is a worthy and valuable marketplace and is there to assist you and your clients when the market gets hard. In the 22 years I was an E&S broker, the thing I liked most was the "good faith" aspect of the business—that we were all there to solve problems for insureds, along with the underwriters' expertise and ability to get things done when the rest of the marketplace was saying "no."

And you know, just like your mother told you: always remember to say "please" and "thank you." You'll be surprised how much that will be appreciated (and who knows, it may even get your submission moved up closer to the top of the stack). ■

# Insurance Regulation and Competition for the 21st Century

**Editor's note:** *This article is a statement given by Michael D. Phillipus of the Risk and Insurance Management Society before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Committee on Financial Services, United States House of Representatives, Richard Baker, Chair, June 4, 2002.*

*RIMS would like to acknowledge the efforts of Dick Bouhan (National Association of Professional Surplus Lines Offices) for his assistance in preparing the section on surplus lines.*

**G**ood 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 twenty-first 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 twenty-first 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.<sup>1</sup>

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 its 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.<sup>2</sup>

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.<sup>3</sup> Of the total number of captives, 678 were organized in the United States. According to the 1999 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.<sup>4</sup>
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.

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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 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.<sup>5</sup> The federal authorizing statute was approved originally in 1981 to address the inability of companies to purchase product liability insurance.<sup>6</sup> 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.<sup>7</sup>

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.<sup>8</sup>

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 managers 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 35 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

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# Insurance Regulation and Competition for the 21st Century

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market has been as good as, or better than, the admitted market for the last thirty years.<sup>9</sup>

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 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.<sup>10</sup> 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

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.<sup>11</sup> 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 twenty-first 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 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 nationwide 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 as 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 twentieth century regulatory system in the U.S. cannot adequately compete in the twenty-first 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.

## Endnotes

1. *Risk Retention Reporter*, May 2002.
2. ARM 54, "Essentials of the Risk Management Process," and ARM 56, "Risk Finance," American Institute for CPCU.
3. *2000 A.M. Best Captive Directory*.
4. *Risk Financing*, International Risk Management Institute, Inc., Dallas, TX.
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.
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.
10. A.M. Best Company (September 2001), *Op. Cit.* p. 12.
11. *State Board of Insurance, et al. v. Todd Shipyards Corp.*, 370 U. S. 451 (1962).

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