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Director McRaith:

The National Association of Professional Surplus Lines Offices (NAPSLO) appreciates the opportunity to provide comments to the Federal Insurance Office (FIO) as it prepares its report to Congress on how to modernize and improve the system of insurance regulation in the United States.

Overall, NAPSLO believes the nation's 160-year old system of state based insurance regulation has worked well in protecting consumers and overseeing the solvency of the nation's insurers. There is no better proof of the effectiveness and value of the current insurance regulatory structure than performance of the country's state regulated insurers during the recent financial crisis. While commercial and investment banks, securities firms, mortgage banks and government sponsored enterprises, such as Fannie Mae and Freddie Mac, which were subject to federal regulatory supervision, frequently found their solvency in jeopardy and in many cases required an injection of federal taxpayer dollars to stay afloat, America's insurers were the bastion of financial quiescence.

NAPSLO strongly supports the state based system of insurance regulation, and believes any federal policy regarding insurance regulation continue a course aimed at strengthening state insurance regulation and coordinating the efforts of federal agencies with state regulatory systems.

Even with the outstanding track record of state insurance regulation, NAPSLO recognizes that times change, technology advances, public policy goals are altered and business practices are modified such that if any system of regulation is to retain its vibrancy and effectiveness, it must be continually monitored and assessed in light of the ongoing shifts in the environment impacting regulated entities. This evaluation is the purpose of the FIO report to Congress and NAPSLO offers its comments for use by the FIO in regard to modernization of the current regulatory system as it relates to the surplus lines insurance market and the wholesale insurance distribution system.

About NAPSLO
NAPSLO is a national trade association representing the surplus lines industry and the wholesale insurance distribution system. NAPSLO is unique among insurance trade groups in that it represents both surplus lines producers and surplus lines insurers. Both categories of surplus lines organizations are voting members in the association and their representatives serve on the NAPSLO Board of Directors.

The NAPSLO membership consists of approximately 400 wholesale brokerage member firms, 100 company member firms and 200 associate member firms. NAPSLO member firms operate over 1,600 offices representing approximately 15,000 to 20,000 individual brokers, insurance company professionals, underwriters and other insurance professionals in 50 states and the District of Columbia. NAPSLO also has 12 active committees on which representatives of each membership category serve.

NAPSLO's associate membership class includes organizations that are domiciled outside of the United States, which actively participate in the United States surplus lines market as producers, markets and reinsurers of NAPSLO member brokers and companies. The vast majority of these associate members are located in United Kingdom with some domiciled in Bermuda.

NAPSLO members are dedicated to the wholesale surplus lines distribution system. Consequently, NAPSLO member brokers do not generally deal directly with consumers. Rather, they work with retail agents and brokers whose clients are unable to secure the needed insurance through licensed insurers that write standard risks. In this regard, the surplus lines companies that belong to NAPSLO are dedicated to and serve NAPSLO member wholesale brokers and the wholesale surplus lines distribution system. These companies have found the wholesale distribution mechanism to be the most effective method of delivering their specialty insurance products to the consumer.

Since it was founded in 1975, NAPSLO has become the authoritative voice of the surplus lines industry. Acting as a source of information, NAPSLO spends a significant portion of its resources gathering and providing information to regulators, members, other segments of the insurance industry, the media and the public about the surplus lines industry. NAPSLO is routinely called upon to explain the vital role surplus lines insurance and the wholesale distribution system plays for consumers. NAPSLO members play an important role in the economy by insuring hard to place risks and creating new insurance products in response to the needs of an ever-changing social, business and insurance environment. NAPSLO provides educational programs to its members and the industry, and works with regulators and legislators and their staffs on legislation and regulation affecting the surplus lines industry.

Role of the Surplus Lines Industry
The surplus lines market plays an important role in providing insurance for hard-to-place, unique or high capacity (i.e., high limit) risks. With the ability to accommodate a wide variety of risks, the surplus lines market acts as a supplement to the admitted market. Often called the "safety valve" of the insurance industry, surplus lines placements fill the need for coverage in the marketplace by

insuring those risks that are declined by admitted insurance carriers. According to A.M. Best[1], 2010 surplus lines premium volume was nearly $32 billion and represents a vast number of insureds who, without the surplus lines market, would have a difficult time obtaining insurance, if they were able to secure it at all.

Surplus lines companies are able to cover unique and hard-to place risks because, as nonadmitted or unlicensed insurers, they are not required to comply with rate and form filing regulations that apply to admitted insurance carriers. As a result of this flexibility, surplus lines insurers are able to react to market changes and accommodate the unique needs of the insureds that are unable to obtain coverage from admitted carriers.

Risks typically written in the surplus lines market fall into three basic categories: (1) non-standard risks, which have unusual underwriting characteristics; (2) unique risks for which admitted carriers do not offer a filed policy form or rate; and (3) capacity risks where an insured seeks a higher level of coverage than most insurers are willing to provide.

Examples of the types of risks commonly insured by the surplus lines market include:
- Coastal property coverage;
- A developer re-building homes and businesses in hurricane-prone areas;
- A sports celebrity that wants to insure his or her legs or hands;
- A school district building a new high school;
- A non-profit association that seeks to provide food, medical care and education to the Third World;
- A research lab working on a promising, yet unproven new drug;
- A law firm specializing in intellectual property work;
- Earthquake coverage; and
- High layer casualty coverage, among many others.

The surplus lines market is particularly important in introducing new products to the market in an efficient manner. New and innovative products, and processes and procedures for which there is no loss history are difficult, if not impossible, to price or rate for insurance purposes. Surplus lines insurers are uniquely qualified to cover these emerging risks because they have developed this expertise through decades of experience.

Surplus Lines Regulation

While the surplus lines market is regulated differently than the admitted market, in order to provide the flexibility necessary to cover the hard-to-place risks, it is a regulated marketplace. Each U.S. based (domestic) surplus lines company[2] is licensed (admitted) in at least one of the 50 states or other U.S. jurisdiction and must fulfill the solvency requirements of that state or jurisdiction. Thus, as with admitted insurers, the surplus lines insurer's state of domicile becomes the financial solvency regulator of that insurer.

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[1] A.M. Best 2011 Special Report, U.S. Surplus Lines—Market Review, pg. 2

[2] According to the A.M. Best 2011 Special Report, Surplus Lines—Market Review, 69% of the surplus volume in 2010 was written by U.S. based surplus lines insurers and 18.3% was written by the Lloyd's market.

Insurers based outside the United States, known as alien insurers, represent a substantial portion of the surplus lines market writing about 20 percent of the U.S. surplus lines premium annually. Lloyd's of London writes between 85 and 90 percent of the alien surplus lines market each year with the bulk of the remaining premium being written by insurers based in the United Kingdom.

The solvency regulation of alien surplus lines companies is the responsibility of the insurer's domiciliary jurisdiction or country. To assist the states in determining the financial soundness of alien surplus lines insurers, the National Association of Insurance Commissioners (NAIC) in the early 1960s established its International Insurers Department (IID), which assumed the responsibility of reviewing and vetting the financial condition of alien insurers wishing to enter the U.S. surplus lines market. Those alien companies that met the IID standards were placed on the NAIC Quarterly Listing of Alien Insurers. The role and importance of the IID and NAIC quarterly list was expanded by the recently enacted Nonadmitted and Reinsurance Reform Act (NRRA) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-204),[3] in that no state can prohibit a surplus lines broker from placing insurance with any alien carrier listed on the NAIC Quarterly Listing of Alien Insurers.

In addition to the solvency regulation of the surplus lines insurer's domiciliary state or country, the surplus lines insurer must meet eligibility standards in order to insure risks through any state through a licensed surplus lines broker. Prior to the enactment of the NRRA, approximately two-thirds of the states required that an eligible surplus lines insurer be placed on a list of eligible surplus lines insurers. The basic eligibility criteria focused on a minimum amount of capital and surplus, which ranged from $15 million to $45 million. States that did not compile an eligibility list had similar minimum capital and surplus requirements for surplus lines insurers. A.M. Best has reported the solvency record of surplus lines insurers has been historically equivalent to the admitted marketplace, with the surplus lines market recording no insolvencies over the past seven years.[4] This is indicative of today's strong and effective solvency and capital regulation regime by the states.

While solvency regulation is the purview of the surplus lines insurer's domiciliary state, the actual surplus lines transaction is regulated through a licensed surplus lines broker. It is the licensed surplus lines broker that is responsible for: (1) selecting an eligible surplus lines insurer; (2) reporting the surplus lines transaction to insurance regulators; (3) remitting the premium tax due on the transaction to state tax authorities; and (4) assuring compliance with all the requirements of the surplus lines codes.

One of the most significant regulatory requirements imposed by state surplus lines laws is that a surplus lines broker must complete a diligent search of the admitted markets. A diligent search represents the attempt to find the coverage from admitted insurers before a policy is placed in the surplus lines market. The standard to fulfill the diligent search requirement can vary from state to

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[3] This law was signed by President Obama on July 21, 2010 with an effective date on July 21, 2011, or one year from the date it was approved.

[4] A.M. Best 2011 Special Report, Surplus Lines—Market Review, pg. 28

state, but generally, three companies licensed to write the kind and type of insurance must decline a risk before it can be placed in the surplus lines market.

The licensed surplus lines broker in each state is also responsible for providing the insured with a written statutory notice regarding a surplus lines transaction. Every state requires a notification to the insured party in a surplus lines transaction that discloses: (1) the surplus lines policy is not covered by the state guaranty fund; and (2) the insurance is placed with a surplus lines company that is not subject to many of the state's regulations.

As the sole regulated entity in a surplus lines placement, the surplus lines broker must hold a surplus lines license. Every state, as a part of its surplus lines law, requires the issuance of a surplus lines broker license.

Fourteen states have created surplus lines stamping offices.[5] More than two-thirds of the national surplus lines premium flow through these stamping offices, which were formed by surplus lines brokers as a form of self-regulation to foster and facilitate compliance with the unique regulatory requirements applicable to surplus lines transactions. Stamping offices provide oversight, information and assistance to brokers conducting surplus lines transactions, which offers the public an additional level of protection.

Modernization Efforts and the NRRA

Historically, surplus lines regulation has been described as arcane and complex because the regulations governing a surplus lines transaction differ from state to state. As the economy modernized, more multi-state policies were required and surplus lines regulations became more onerous because of inconsistent and conflicting requirements from state to state.

Congress, at the urging of the industry and some regulators, acted in 2010 to modernize surplus lines regulation by enacting the NRRA. The purpose of the NRRA was to bring efficiency, clarity and uniformity to the regulation of surplus lines insurance by creating a modern and efficient framework by which the states would regulate surplus lines insurance.

As part of this modernization effort, Congress established a home state framework for the regulation and taxation of surplus lines insurance, as well as to: (1) create uniform, nationwide eligibility requirements for surplus lines insurers; and (2) provide easier access to the surplus lines market for large commercial purchasers of insurance. Congress expressed its intent that states establish uniformity in the regulatory process, particularly in the manner in which surplus lines premium is taxed by the states.

Although Congress provided a preemption provision in the NRRA, the legislation contains no other federal enforcement provisions to assure the states implement the NRRA in the manner Congress intended. Congress left it to the states to implement and enforce the NRRA legislation in the clear, efficient and uniform manner Congress intended.

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[5] The states with stamping offices are Arizona, California, Florida, Idaho, Illinois, Mississippi, Minnesota, Nevada, New York, Oregon, Pennsylvania, Texas, Utah, and Washington.

The surplus lines industry's primary goal for regulatory modernization is the creation of simple and uniform guidelines adopted nationwide enabling the industry to continue serving as the "safety valve" of the insurance industry. Congress provided this framework with the passage of the NRRA, and NAPSLO is working hard to ensure that Congress's intent is upheld as the states implement the provisions of this law.

Home State Approach
Since the NRRA became law in July 2010, 43 states have enacted NRRA implementation legislation. Unfortunately, the states have not acted to implement the legislation in a consistent, much less uniform, manner. As a result, rather than creating the simple, efficient, uniform and modern system Congress intended with the NRRA, the states are evolving toward a complex system of surplus lines regulation and taxation that presently diminish, and may completely eliminate, the intended benefits of the NRRA for the surplus lines industry.

For example, Congress provided in the NRRA that "No State other than the home State of an insured may require any premium tax payment for nonadmitted insurance." The clear intent of this provision is that surplus lines brokers are to remit the tax due on a surplus lines transaction to only one state, which was defined as the insured's home state. The NRRA intended for the broker to use the insured's home state tax laws and tax rate. The home state is defined in the NRRA as the state where the insured's principal place of business is located or if the insured is an individual, the state where the insured has his or her primary residence.

Instead of including definitions of home state of the insured in their NRRA implementation legislation as Congress defined these terms in the NRRA, a number of states have created their own unique definitions of home state and principal place of business. Some state have gone beyond the language Congress used in the NRRA and have adopted parts of the definitions of home state and principal place of business that were included in one of the two tax sharing agreement proposals that have been created.

The creation of numerous and different definitions of home state or principal place of business among the states introduces ambiguity into, for the broker, the process of determining the one state to which the tax is to be paid and by which the placement transaction will be regulated. The multiple definitions of home state and principal place of business are not consistent with the intent of the NRRA. NAPSLO continues to encourage the states to develop and implement one definition of home state and principal of business, consistent with the NRRA, on a nationwide basis.

Surplus Lines Taxation
Congress took a major step toward clarifying and simplifying the tax remittance process for surplus lines brokers by establishing the home state approach in the NRRA. Unfortunately, as the states have begun to implement tax sharing systems in connection with the NRRA, some of the states have counteracted the intended beneficial reforms of the home state approach to surplus lines premium tax remittance. As a consequence, the premium tax remittance and reporting

requirements in the post-NRRA environment could be, in practice, just as complex, difficult and costly as the process that existed prior to the NRRA. This is because of tax sharing compacts or agreements that have been implemented in a complex and inconsistent manner.

It is important to note NAPSLO has not opposed the sharing of tax revenues among states. However, NAPSLO believes any tax sharing system must be: (1) clear, simple and uniform; (2) based on the use of readily available information, including data collected and required specifically to support the underwriting process; and (3) based upon input from surplus lines licensees. NAPSLO has been and continues to be strongly opposed to any tax compact or agreement that increases the reporting burden on purchasers of nonadmitted insurance or the brokers who serve them, and strongly opposes any tax sharing system that requires the creation of data for the sole purpose of allocating taxes.

The problems arising from the implementation of the tax sharing systems are three-fold.

1. Two potential compact models have been created. The Nonadmitted Insurance Multi-State Agreement (NIMA) was developed by the NAIC, and the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) was developed by the National Conference of Insurance Legislators (NCOIL). This creates the reality of at least three separate methods for the remittance and reporting of surplus lines taxes to the states: (1) a home state only approach; (2) the NIMA approach; and (3) the SLIMPACT approach. NAPSLO is very concerned the NIMA and SLIMPACT approaches will employ different requirements, procedures, forms and tax allocation methodologies.

2. At least one of the compact models, NIMA, employs a tax allocation methodology that is complex and burdensome. The NIMA allocation methodology contains a detailed allocation formula that would require a substantial amount of state-specific data to be collected by the surplus lines broker from the insured. The NIMA allocation system would also require the broker and the insured to provide information for the allocation of casualty insurance policies that is not normally used in the underwriting process or currently gathered by the broker in the normal course of business. NAPSLO has aggressively raised concerns regarding the complexity and additional burdens of the NIMA allocation approach since NIMA's allocation methodology was first released.

3. Some states have modified their surplus lines tax laws to tax the portion of surplus lines premium allocated to other states at the other states' tax rates. Some states require the use of the other states' rates even in circumstances where they are not participating in either NIMA or SLIMPACT. This creates a matrix for tax allocation and reporting purposes, within a number of states, which is difficult and costly to administer and, in NAPSLO's opinion, is inconsistent with the intent of the NRRA.

The implementation dates of NIMA and SLIMPACT are undetermined at the present time, and NAPSLO members continue to be very concerned with the widely diverse guidance for the reporting, allocation and remittance of surplus lines taxes subsequent to the July 21, 2011 effective date of the NRRA.

The Kentucky Compromise

In August 2011, the Kentucky Insurance Department proposed a workable tax allocation methodology (the "Kentucky compromise"), which was considered by the surplus lines industry and national broker and company trade associations to be a vast improvement over the NIMA allocation methodology. The nine states that currently form SLIMPACT have agreed to this allocation approach for SLIMPACT upon commencing its operations.

NAPSLO believes the Kentucky compromise is a vast improvement over the current NIMA allocation methodology, primarily because it is consistent with industry practices existing prior to the NRRA. In an October 19, 2011 letter to the NIMA states, NAPSLO and nine other broker and company trade associations urged the NIMA states to abandon the NIMA allocation methodology in favor of the Kentucky compromise. In November 2011, NAPSLO further outlined its concerns regarding NIMA's allocation methodology to the NIMA states during their meeting in conjunction with the NAIC 2011 Fall National Meeting, and it has been reaching out to NIMA state leaders to continue to outline the NAPSLO membership's concerns since that time.

If both NIMA and SLIMPACT states were to use the same allocation formula, the consistency of approaches in these 21 states would at least eliminate the possibility of two tax sharing systems with inconsistent allocation methodologies. The adoption of inconsistent tax allocation and reporting systems among the states is contrary to the intent of the NRRA and unacceptable to the NAPSLO membership. At the present time, the NIMA states have not agreed to any change in their tax allocation methodology, which continues to be of great concern to the NAPSLO membership and many other national broker and company trade associations.

Taxation at Home State Tax Rate

NAPSLO believes Congress intended, upon enactment of the NRRA, for each state to collect surplus lines taxes pursuant to its own laws and at its own tax rate. If the state so elected, the NRRA allows the state to share that tax revenue with the other states through a compact or other procedure.

However, a number of states have enacted tax laws, as part of their NRRA implementation effort, that impose tax on the portions of surplus lines premium for risks in other states at the other states' tax rates. The calculations are expected to include the other states' fees and assessments, which complicates the calculation of taxes and makes it difficult to prepare insurance quotes for clients. These laws make it very difficult for insureds, brokers or regulators to ultimately determine the total tax due.

For example, several states require that, if the state is the home state for the transaction, a tax be charged on portions of surplus lines premium representing portions of the risks in other states at the tax rates of the other states. However, some states will only share this portion of the tax with states in a reciprocal tax sharing system. Thus, if a risk is insured with Florida as the home state and portions of the risk are in Mississippi, Texas, Louisiana and Nevada, the tax must be appropriately allocated, by the broker, to five different states, with the total tax determined by applying the separate tax rates of these states to each state's allocated portion of the premium. The current tax rates are 5.0% for Florida, 4.0% for Mississippi, 5.0% for Louisiana, 4.85% for Texas and 3.5% for Nevada, with many of these states imposing fees and assessments that would also be applied to the allocated premium. The taxes would be shared with Mississippi, Louisiana, and Nevada, because they are reciprocal states participating in the NIMA agreement with Florida. However, Florida would keep the Texas portion of the tax since Texas is not a reciprocal state.

Some states have enacted surplus lines tax laws that require tax be charged at other states' rates on portions, if any, of surplus lines premium attributable to risks located in a state participating in a reciprocal tax sharing system. For portions of the risk in states not participating in a reciprocal tax sharing system, the tax rate of the home state would be utilized for such risks, and the home state would keep such portion of the tax.

Some states have adopted tax laws that impose surplus lines tax on the premium or risks located in other states at the other states' tax rates, but the home state currently would not share such tax revenue with the other states because the home state is not participating in any reciprocal tax sharing system.

The NRRA enforcement provision prohibits any law, regulation, provision or action of any state other than the home state that attempts to collect its taxes. Moreover, the NRRA did not envision that the home state approach to surplus lines tax collection would involve numerous permutations of assessment and surplus lines tax allocations, creating a complex matrix of variables brokers and insureds would use to calculate and remit taxes. The system of surplus lines tax collection being created by the states in connection with tax sharing systems simply runs counter to the clear, efficient and uniform approach to surplus lines regulation and taxation intended by Congress with the NRRA.

NAPSLO continues to encourage the states to revisit their NRRA implementation laws and revise them where necessary to ensure the regulation of the surplus lines market and the allocation and reporting of surplus lines taxes is consistent with the Congressional intent of the NRRA.

Conclusion

In enacting the NRRA, Congress has taken a great step toward modernizing surplus lines regulation. If the promise of the NRRA is to be fully realized, the states must take steps to implement the NRRA in a manner consistent with its intent.

To do this, the state tax sharing systems must not create a reporting system for brokers and insureds that rival in complexity and burdens the dysfunctional system it replaced. NAPSLO has three key recommendations to facilitate the implementation of the NRRA as Congress intended:

1. Every state intending to participate in a tax sharing system should adopt the Kentucky compromise.

2. All states, as the home state whether it participates in a tax sharing system or not, should utilize their tax rate as the basis for tax assessment and collection of taxes on surplus lines placements with multi-state risks.

3. States should establish uniformity in the definitions of home state, reporting forms, and requirements and procedures for the reporting and remittance of surplus lines tax revenues among states participating in tax sharing systems.

NAPSLO appreciates the opportunity to provide our comments to the FIO, and offers its support to the FIO as it prepares its report to Congress on how to modernize and improve the system of insurance regulation in the United States.

Sincerely,

Robert T. Sargent President	David E. Leonard Co-Chair, NAPSLO Legislative Committee	James C. Drinkwater Co-Chair, NAPSLO Legislative Committee	Brady R. Kelley Executive Director