



**Surplus Lines
and
Residual Markets:
Maintaining the Public's
Right to Freedom of Choice**

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SURPLUS LINES & RESIDUAL MARKETS: MAINTAINING THE PUBLIC’S RIGHT TO FREEDOM OF CHOICE

Introduction

Over the past three decades, various states have created residual market mechanisms for certain insurance coverages in order to assure that insurance buyers in the state have markets for these insurance coverages. For the most part, these residual markets were initiated in mandated lines of insurance such as automobile liability and workers’ compensation. In addition, residual markets have been established in some states for non-mandated but “essential” lines of insurance such as medical malpractice and property coverages through FAIR plans.

There are three types of residual markets. The first type is an “assigned risk” plan in which licensed insurers are compelled to accept, in an equitable proportion to the company’s market share, random assignments of those risks unable to be placed in the voluntary market. The second type of residual market is that of an involuntary “joint underwriting association” (JUA) whose members are those companies licensed in the state to write a similar type of business to that of the joint underwriting association. The members of the JUA share in the losses generated by the association’s risks. The third type of residual market is the reinsurance facility. A reinsurance facility is established in order to allow insurers that are forced to take assignments or “bad risks” an opportunity to reinsure those risks with the facility. Thus, losses incurred by these “forced placements” are absorbed by the reinsurance facility.

Residual markets form a back-stop to admitted and nonadmitted companies that make up the voluntary market by providing a market of last resort.

In recent years some states have proposed regulations requiring that before business can be placed with a nonadmitted carrier, a “declination” from the applicable residual market must be obtained. Since residual markets were essentially designed to “take all comers,” the requirement that a declination be obtained from a residual market before the risk can be placed in the surplus lines market places the voluntary surplus lines market behind involuntary residual markets in its ability to accept risks rejected by the licensed market. The result of the proposed regulations would be that many insureds, who might otherwise be able to obtain their coverage through the voluntary surplus lines market, must now be “forced placed” into one of the state’s residual market plans.

The National Association of Professional Surplus Lines Offices (NAPSLO) believes that the policy of placing the surplus lines market behind the residual markets discounts the important and traditional role the surplus lines market plays in providing insurance for hard to place risks. Moreover, such a policy denies insureds the freedom of choice to either accept a surplus lines placement or opt for coverage through a residual market plan. In addition, this policy does a disservice to the licensed market that must subsidize risks that are placed in residual markets at fixed rates.

Legal Basis

The legal argument for the proposition that the surplus lines market must stand behind the residual markets is, in most cases, predicated on the fact that a residual market constitutes an “authorized” carrier or insurer that is available to all agents and brokers in the state. Therefore, the residual market must be contacted and must decline the risk as part of the “diligent search/effort” requirement which surplus lines laws place upon the surplus lines broker.

A careful examination of both the structure of residual markets and their statutory/legal authorization, however, does not support this conclusion. “Authorized insurers,” for the most part, are those insurance carriers that are licensed and/or chartered by the states. To obtain this status, these carriers must meet minimum capital and surplus requirements, conform to a number of statutory procedures and, in general, be solvent insurance companies with sufficient financial resources. Assigned risk plans and joint underwriting associations, which form most of the residual markets in the various states, are neither licensed insurers nor are they incorporated under the laws of any state. Therefore, they do not meet the legal requirements to be an authorized insurer. In effect, residual markets simply offer insurance through legislative mandate and do not meet the requirements of an “authorized insurer.”

If state legislatures meant to include residual markets within the definition of authorized carriers, they would have done so. It is clear that in the states that have established residual markets, their legislatures have consistently avoided including residual markets in the definition of authorized insurers. Legislatures are well aware of the purpose of residual markets and created them for the specific purpose of being a market of last resort; not to supplant the state’s voluntary surplus lines insurance market.

In addition to problems with the legal basis of placing the surplus lines market behind residual markets, there are a substantial number of public policy considerations that make such a requirement contrary to the best interest of the state’s citizens.

Residual Market Population Should be Reduced Not Expanded

The public is best served when the population of residual markets is reduced, not expanded. Therefore, sound public policy dictates that state insurance department procedures should encourage, not discourage, the use of all voluntary markets before a risk is placed in a residual market.

By implementing policies that restrict the use of the surplus lines market, the state insurance department increases the residual market population. This exacerbates an existing incentive that licensed companies have for not writing or expanding their business in the state. This further reduces available markets and weakens competition.

For example, when the surplus lines market is restricted, a licensed carrier will find that an increased marketshare also means a higher residual market assessment. Consequently, the prospect of having the financial benefits from expanded writings eliminated by residual market assessments dampens an insurer's desire to expand market presence. Moreover, increased residual market assessments may hasten a company's withdrawal from a market or limit its product offerings when market conditions become difficult.

Hence, citizens are better served if the policy of the insurance department is directed at encouraging surplus lines carriers to write the difficult risks that are rejected by the licensed market rather than restricting the activities of the surplus lines carriers.

Subsidies

By forcing business into the residual markets that would otherwise be placed with nonadmitted carriers through the surplus lines mechanism, the state increases the amount of subsidy that licensed companies must pay. Residual markets, because they "take all comers," have very little, if any, incentive to efficiently underwrite risks. These markets may also lack the expertise to effectively consider difficult risks. Surplus lines companies, on the other hand, are a part of the voluntary market and have substantial underwriting expertise. Therefore, it is most likely that a surplus lines company could profitably write a book of business that if written by the residual market, would result in a loss — a loss that the licensed carriers would have to absorb.

The subsidies that licensed companies must pay to support residual markets impact rates across the entire customer base of the licensed

market. This subsidy increases the cost for all customers regardless of individual loss history.

Therefore, it is in the best interest of the public and the licensed market to allow surplus lines carriers to stand on an equal footing with residual markets.

Surplus Lines Carriers/Full Service Carriers

As voluntary carriers, nonadmitted insurers accepting surplus lines business are full service insurers wishing to write insurance that qualifies for surplus lines placements. As a consequence, surplus lines insurers are sensitive to the needs of both the insureds and producers. Such sensitivity may not be found in residual markets. Moreover, these carriers together with the insured's agent or broker have the capacity and resources to service the policy once it is written.

For example, surplus lines carriers can provide agents and brokers with same day quotations and same day binders. Residual markets, for the most part, are not equipped to provide this type of quick response to submissions and effect needed coverage. Moreover, the surplus lines carrier, as a member of the voluntary market, can offer to the insured broader forms and higher limits as well as loss control services. Residual markets are narrow and rigid in their product offerings and cannot provide needed flexibility with the "insurance" they write.

Residual markets, for the most part, are restricted in the coverage they can provide and must write to specific mandated limits on both property and casualty coverages. Therefore, insureds that are forced into residual markets, but want broader coverage or higher limits than the residual market can offer, have to obtain two coverages — one from a residual market and one from a surplus lines insurer — in order to fulfill their insurance needs. Such an approach is not only cumbersome and costly but could also create unintentional coverage

gaps. A surplus lines company could write the coverage for one premium and issue one policy rather than forcing the insured to incur the cost and problems of obtaining two or more separate policies.

In simple terms, the commitment to service and the flexibility of coverage offered through the surplus lines market makes that market more attractive to buyers than residual market coverage. Therefore, insurance buyers should be allowed the opportunity to evaluate the coverage and service differences that exist between the surplus lines market and residual market. Rather than having their coverage “forced placed” into a residual market, consumers should have a **choice**

Taxes

Premiums received for risks placed in the surplus lines market are subject to a surplus lines tax in every state. This tax is equal to or exceeds the premium tax imposed upon licensed domestic and foreign carriers. Business placed in the residual market is often not subject to state tax. Consequently, the more business that is directed away from the surplus lines market and forced into residual markets, the more the state reduces its tax revenue. The state does not benefit in any way by curtailing the use of the voluntary insurance market at the cost of much needed tax dollars.

Solvency

Some state regulators have justified the implementation of procedures that favor residual markets over surplus lines markets by arguing that surplus lines solvency regulation is insufficient to allow risks to be placed with surplus lines markets when residual markets are available.

Such an argument is contrary to the facts. In reality, U.S. based surplus lines insurers must meet the same capitalization, investment and other solvency standards in their state of domicile as all other insurers domiciled in that state. Alien insurers domiciled outside the United States must establish a substantial trust fund in the United States. They also must meet capitalization and other requirements of the

NAIC's Nonadmitted Insurers Information Office (NAIIO) or meet eligibility requirements that establish significant solvency related conditions as a prerequisite to accepting risks from the state on a nonadmitted basis. In addition, in some states professional surplus lines brokers can be held liable for placing coverage with nonadmitted insurers that became insolvent. This makes surplus lines brokers vigilant in their evaluation of nonadmitted companies in which they place business. As a consequence, the vast majority of property/casualty company insolvencies over the past 20 years have involved admitted insurers — not nonadmitted surplus lines insurers. The simple fact is that there is no evidence that surplus lines insurers pose a greater threat of insolvency than licensed insurers. There is, therefore, no reason to eliminate the surplus lines option for the consumer.

Conclusion

It is poor public policy to eliminate the use of the voluntary surplus lines insurance mechanism which is specifically designed to provide insurance for hard-to-place and difficult risks. The surplus line mechanism pays its fair share of taxes and offers flexibility and service to policyholders. The public would be better served if the surplus lines market was allowed to operate on an equal basis with residual markets and the consumer was offered the choice between the two markets when the admitted market is unable to write the coverage. Freedom of choice in a competitive market is a far superior approach for servicing the consumer than forced placement in a government mandated "pool."

NAPSLO serves the Excess and Surplus Lines Insurance Industry

The National Association of Professional Surplus Lines Offices, Ltd. (NAPSLO) is a national trade association representing the surplus lines industry and the wholesale insurance marketing system.

Founded in 1975, NAPSLO has become the authoritative voice of surplus lines. Acting as a source of information, NAPSLO communicates to regulatory bodies, other segments of the insurance industry, the media and the public the vital role surplus lines plays in the insurance industry.

In addition, NAPSLO provides other important services to its constituency and the industry, including educational programs, financial data and legislative information.

The NAPSLO logo is inscribed with the Latin phrase "Uberrima Fides," which means "in the utmost good faith." This serves as a symbol of the professionalism, integrity and purpose of the association and its members.

National Association of Professional Surplus Lines Offices, Ltd.

6405 North Cosby, Suite 201 • Kansas City, MO • 64151

Phone: 816-741-3910 • FAX: 816-741-5409

www.napslo.org