National Association of Insurance Commissioners & The Center for Insurance Policy and Research

MEMORANDUM

To: States considering joining the Nonadmitted Insurance Multi-State Agreement and updating laws and regulations to conform to the Nonadmitted and Reinsurance Reform Act of 2010

From: NAIC Legal Division

Date: 1 December 2010

Re: NRRA Implementation Considerations

NRRA Implementation Considerations

The Surplus Lines Implementation (EX) Task Force is nearing completion of its work on the Nonadmitted Insurance Multi-State Agreement (NIMA) as the recommended approach for implementing the surplus lines provisions of the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA). While NIMA provides one means of implementing those NRRA provisions concerning surplus lines premium tax collection, allocation and distribution, states should also consider the extent to which they need to amend their laws to allow for full participation in NIMA and to otherwise conform to the NRRA.

This memorandum is prepared for the purpose of assisting states in identifying those areas of their surplus lines laws that may need to be amended or updated. States should conduct a thorough review of their surplus lines laws in the event there are state-specific issues that need to be addressed. This memorandum is divided into two parts: (1) those changes that may be necessary to participate in NIMA, and (2) those changes that may be necessary otherwise to conform state law to the NRRA. In those places where the memorandum provides examples of statutory language, states will need to adapt any such language to the existing format and convention of their insurance codes. The examples included herein are provided for illustrative purposes only.

Statutory changes that may be considered to enter into and implement NIMA

1. Enabling language to permit the state to enter into NIMA

Because participation in NIMA requires states to share tax revenues they are authorized to collect under the NRRA as the home state on a nonadmitted insurance placement, states will likely require statutory authorization to enter into NIMA and participate fully in NIMA. Statutory language similar to that enacted by Texas to authorize its comptroller to enter into an interstate agreement or compact for surplus lines tax collection is one option:

> The comptroller may enter into a cooperative agreement, reciprocal agreement, or compact with another state to provide for the collection of taxes imposed by this state and the other states on insurances taxes that may be due the states and this state based on a standardized premium allocation adopted by the states under the agreement. The comptroller may also enter into other cooperative agreements with surplus lines stamping offices located in this state and other states in the reporting and capturing of related tax information. In addition, the comptroller may enter into cooperative agreements with processing entities located in this state or other states related to the capturing and processing of insurance premium and tax data. Tex. Ins. Code Ann. § 229.002.

Another approach may be the following:

> For the purposes of carrying out the Nonadmitted and Reinsurance Reform Act of 2010, the commissioner [or other state official] is authorized to enter the Nonadmitted Insurance Multi-State Agreement in order to facilitate the collection, allocation and disbursement of premium taxes attributable to the placement of nonadmitted insurance; provide for uniform methods of allocation and reporting among nonadmitted insurance risk classifications; and share information among states relating to nonadmitted insurance premium taxes.

2. Add definition of "home state" to surplus lines law

States may consider codifying the definition of "home state" that is ultimately included within NIMA. Codifying a commonly accepted definition of "home state" will help to ensure states are operating from a mutual understanding of which state will be the "home state" for a nonadmitted insurance placement and reduces the potential for conflicts among states as to which jurisdiction is the home state in a transaction.

3. Statutory authorization to collect and disburse taxes based on a single home state rate as well as the rates of other states.

The below language is a modified version of Section 5.F.(1) of the NAIC Nonadmitted Insurance Model Act, which concerns surplus lines taxes. (A related section concerning taxes on independently-procured insurance follows. States may also need to consider whether additional sections requiring the payment of taxes should be similarly modified.) Possible modifications to Section 5.F.(1) are highlighted. The modifications are intended to (a) provide for the payment of surplus lines taxes on 100% of the gross premiums of a surplus lines policy, (b) compute the sum of taxes to be paid based on a formula that incorporates the home state's tax rate as well as the tax rates of other states where a portion of the risk or exposure on the policy is located, (c) authorize participation in the clearinghouse established by NIMA for the purpose of collecting, allocating and disbursing taxes to other participating states, and (d) provide for the reversion to the home state of any taxes that otherwise would be allocated to a state that does not participate in NIMA.

> *Based on Section 5.F.(1) of Nonadmitted Insurance Model Act:*
>
> In addition to the full amount of gross premiums charged by the insurer for the insurance, every person licensed pursuant to Section 5H of this Act shall collect and pay to the commissioner [or other state official] a sum based on the total gross premiums charged, less any return premiums, for surplus lines insurance provided by the licensee pursuant to the license. Where the insurance covers properties, risks or exposures located or to be performed both in and out of this state, the sum payable shall be computed based on (a) an amount equal to [insert number] percent on that portion of the gross premiums allocated to this state pursuant to Paragraph (4) of this subsection, plus (b) an amount equal to the portion of the premiums allocated to other states or territories on the basis of the tax rates and fees applicable to properties, risks or exposures located or to be performed outside of this state pursuant to Paragraph (4) of this subsection, less (c) the amount of gross premiums allocated to this state and returned to the insured. The tax on any portion of the premium unearned at termination of insurance having been credited by the state to the licensee shall be returned to the policyholder directly by the surplus lines licensee or through the producing broker, if any. The surplus lines licensee is prohibited from rebating, for any reason, any part of the tax.
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> The commissioner [or other state official] is authorized to participate in the clearinghouse established through the Nonadmitted Insurance Multi-State Agreement for the purpose of collecting and disbursing to reciprocal states any funds collected pursuant to clause (b) above applicable to properties, risks or exposures located or to be performed outside of this state. To the extent that other states where portions of the properties, risks or exposures reside have failed to enter into a compact or reciprocal allocation procedure with this state, the net premium tax collected shall be retained by this state.

4. Statutory authorization to collect and disburse taxes based on a single home state rate as well as the rates of other states for independently-procured insurance.

The below language, which is based on Section 6.B of the Nonadmitted Insurance Model Act, is intended to bring taxation for independently-procured insurance in conformity with the above-suggested changes for surplus lines taxes. Possible modifications to the existing model law language are highlighted in yellow.

Based on Section 6.B of Nonadmitted Insurance Model Act:

> Gross premiums charged for the insurance, less any return premiums, are subject to a tax at the rate of [insert number] percent. At the time of filing the report required in Subsection A of this section, the insured shall pay the tax to the commissioner, who shall transmit the same for distribution as provided in this Act. Where the insurance covers properties, risks or exposures located or to be performed both in and out of this state, the sum payable shall be computed based on (a) an amount equal to [insert number] percent on that portion of the gross premiums allocated to this state pursuant to Section 5F(4), plus (b) an amount equal to the portion of the premiums allocated to other states or territories on the basis of the tax rates and fees applicable to properties, risks or exposures located or to be performed outside of this state pursuant to Section 5F(4).
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> The commissioner [or other state official] is authorized to participate in the Nonadmitted Insurance Multi-State Agreement for the purpose of collecting and disbursing to reciprocal states any funds collected pursuant to clause (b) above applicable to other properties, risks or exposures located to be performed outside of this state. To the extent that other states where portions of the properties, risks or exposures reside have failed to enter into compact or reciprocal allocation procedure with this state, the net premium tax collected shall be retained by this state.

5. Authorization to establish blended tax rate to participate in NIMA

Participation in NIMA requires the state to establish a single rate applicable to all lines of nonadmitted insurance and encompassing all applicable taxes, fees and assessments. The purpose of this requirement is not to impose or require new taxes but is to ensure that the person submitting relevant transaction information will benefit from the ease of applying a single rate to risk located in a state. States participating in NIMA will likely need to establish the rate of taxation through which the state can be "made whole" in moving from a system of differing rates across lines of business and differing levels of state and local assessments. It is not clear whether states presently have the authority to combine existing taxes, fees and assessments into a single rate applicable to that state. In order to establish the authority to set a single blended rate, states may consider language similar to the following:

> In order to participate in the Nonadmitted Insurance Multi-State Agreement, the commissioner [or other state official] is authorized to establish a uniform, statewide rate of taxation applicable to lines of nonadmitted insurance subject to the Agreement. This rate shall encompass all existing rates of taxation, fees and assessments imposed by this State and any political subdivision hereof, and the commissioner [or other state official] shall document the method by which the statewide rate is calculated. The commissioner [or other state official] is authorized to receive any monies obtained through the clearinghouse established through the Agreement for the collection and disbursement of such funds on behalf of any agency or political subdivision of this State and shall transfer monies to any agency or political subdivision in proportion to the inclusion of any rate of taxation, fee or assessment in the statewide rate.

6. Authorization to adopt the Allocation Schedule to be utilized in implementing NIMA

There may be some states for which adoption of a common allocation schedule is subject to legislative approval or administrative procedures. Moreover, Section 5.F.(4) of the Nonadmitted Insurance Model Act currently presumes that a state receives only those taxes attributable to risk located in that state and that the allocation schedules attached to the model regulation will be utilized. The following language is intended to provide the authorization to utilize NIMA's Allocation Schedule. States may consider the extent to which this or similar language may replace or amend statutes based on Section 5.F.(4).

> The commissioner [or other state official] is authorized to utilize [or adopt] the Allocation Schedule included in the Nonadmitted Insurance Multistate Agreement for the purpose of allocating risk and computing the tax due on the portion of premium attributable to each risk classification and to each state where properties, risks or exposures are located.

Statutory and administrative changes that may be considered to bring state law in conformity with provisions of NRRA unrelated to subject matter of NIMA

While NIMA is focused on preserving the existing system of premium tax allocation, the NRRA makes other changes affecting surplus lines regulation. Similar to issues associated with premium tax allocation, the NRRA establishes certain

regulatory requirements that will apply to surplus lines insurance. Some of these requirements will go into effect regardless of whether states take uniform nationwide action. States should review the following areas of their surplus lines laws in order to determine whether to amend such laws to be consistent with the NRRA. In the event states choose not to amend their statutes, inconsistent state laws may be subject to preemption pursuant to the NRRA.

1. Regulatory authority

The NRRA establishes the principle of home state deference with respect to surplus lines regulation and taxation. While the NRRA permits states to agree on a nationwide system for premium tax allocation and otherwise work together to achieve uniformity in certain areas, Section 522 enshrines home state deference into federal law. Pursuant to Section 522(a), the placement of business "shall be subject to the statutory and regulatory requirements solely of the insured's home State." Additionally, Section 522(c) provides that, with respect to certain provisions of the NRRA, state laws or measures that "appl[y] or purport[] to apply to nonadmitted insurance sold to, solicited by, or negotiated with an insured whose home State is another State shall be preempted with respect to such application."

This memorandum has already described certain provisions of state laws that will need to be revised to participate in NIMA. The Nonadmitted Insurance Model Act does not include a general section on the scope of the law. For those states where the surplus lines law includes a statement of the law's scope, states may consider modifying their statute to clarify that such law will only apply to those placements of nonadmitted insurance where that state is the home state of the insured. Concurrent enactment of NIMA's definition of "home state" may further assist in providing nationwide clarity about the determination of an insured's home state on a given placement.

2. Insurer eligibility requirements

Without the establishment of uniform nationwide nonadmitted insurer eligibility requirements, Section 524(1) of the NRRA requires states to adhere to Sections 5.A.(2) and 5.C.(2)(a) of the NAIC Nonadmitted Insurance Model Act relating to eligibility requirements for nonadmitted insurers domiciled in other U.S. jurisdictions. Section 524(2) prevents states from prohibiting surplus lines brokers from placing business with non-U.S. carriers included on the NAIC's Quarterly Listing of Alien Insurers. Therefore, state requirements that differ from the limitations of the NRRA may be subject to preemption. In the absence of amending state law to enact presently-undeveloped uniform nationwide requirements or choosing not to enforce requirements that would be subject to preemption, states may consider amending the appropriate statutes or regulations to conform to Section 524 of the NRRA. The following language is based on Section 5.C of the Nonadmitted Insurance Model Act, with possible changes highlighted. Included is proposed language authorizing the commissioner to participate in a multi-state initiative to establish nationwide, uniform eligibility requirements for U.S.-based carriers:

Based on Sections 5.A and 5.C of Nonadmitted Insurance Model Act:

A. Surplus lines insurance may be placed by a surplus lines licensee if:

. . .

(2) Each insurer is authorized to write the type of insurance in its domiciliary jurisdiction; . . .

. . .

C. A surplus lines licensee shall not place coverage with a nonadmitted insurer, unless, at the time of placement, the surplus lines licensee has determined that the nonadmitted insurer:

(1) Has established satisfactory evidence of good repute and financial integrity; and

(2) Qualifies under one of the following subparagraphs:

(a) Has capital and surplus or its equivalent under the laws of its domiciliary jurisdiction which equals the greater of:

(i) (I) The minimum capital and surplus requirements under the law of this state; or

(II) $15,000,000;

(ii) The requirements of Subparagraph (a)(i) may be satisfied by an insurer's possessing less than the minimum capital and surplus upon an affirmative finding of acceptability by the commissioner. The finding shall be based upon such factors as quality of management, capital and surplus of any parent company, company underwriting profit and investment income trends, market availability and company record and reputation within the industry. In no event shall the commissioner make an affirmative finding of acceptability when the nonadmitted insurer's capital and surplus is less than $4,500,000;

(3) For an insurer not domiciled in the United States or its territories, the insurer is listed on the Quarterly Listing of Alien Insurers maintained by the NAIC International Insurers Department.

(4) [Insert state-specific requirements for non-US insurers not on IID quarterly listing]

D. The commissioner [or other state official] is authorized to enter into a cooperative agreement or interstate agreement or compact to establish additional and alternative nationwide uniform eligibility requirements that shall be applicable to nonadmitted insurers domiciled in another state or territory of the United States.

3. National insurer producer database

Section 523 of the NRRA provides that participation in the national insurance producer database of the NAIC for the licensure of surplus lines brokers and renewal of their licenses will be required to collect licensing fees for surplus lines brokers as of July 21, 2012. The National Insurance Producer Registry presently serves as such a database. In the event states require statutory authorization to participate in this database, states may consider the following enabling language:

> For the purposes of carrying out the provisions of the Nonadmitted and Reinsurance Reform Act of 2010, the commissioner [or other state official] is authorized to utilize the national insurance producer database of the NAIC, or any other equivalent uniform national database, for the licensure of an individual or an entity as a surplus lines producer and for renewal of such license.

Alternatively, Section 7.G of the NAIC Producer Licensing Model Act includes language that may provide an existing basis for participation in NIPR and may be adopted by states that have not done so:

> G. In order to assist in the performance of the insurance commissioner's duties, the insurance commissioner may contract with non-governmental entities, including the National Association of Insurance Commissioner (NAIC) or any affiliates or subsidiaries that the NAIC oversees, to perform any ministerial functions, including the collection of fees, related to producer licensing that the insurance commissioner and the non-governmental entity may deem appropriate.

4. Home state broker licensing requirements

Section 522(b) of the NRRA provides that only the insured's home state may require a surplus lines broker to be licensed to sell, solicit or negotiate nonadmitted insurance with respect to that insured. This paragraph does affect the requirement that states extend reciprocity to non-resident surplus lines brokers pursuant to the NARAB provisions of the Gramm-Leach-Bliley Act. Section 522(b), however, will affect requirements that a broker be licensed in every state where a portion of the risk is located in a multi-state placement. Accordingly, states may consider amending provisions in their surplus lines laws to clarify that licensure is required only where the state is the home state of the insured. The following language is based on Section 5.H.(1) of the Nonadmitted Insurance Model Act, with proposed additions highlighted:

Based on Section 5.H.(1) of Nonadmitted Insurance Model Act:

H. Surplus Lines Licenses

(1) For insureds whose Home State is this state, a person shall not procure a contract of surplus lines insurance with a nonadmitted insurer unless the person possesses a current surplus lines insurance license issued by the commissioner.

5. Exempt commercial purchasers

Section 525 of the NRRA provides that surplus lines brokers seeking to procure or place nonadmitted insurance on behalf of an "exempt commercial purchaser" are not required to satisfy any diligent search requirements where certain conditions are present. Section 527(5) defines those "exempt commercial purchasers" to which this provision would apply. Section 5.A.(3) of the NAIC Nonadmitted Insurance Model Act includes a requirement that a diligent search of admitted carriers be performed. State laws vary with respect to establishing the requirement of the diligent search and any required number of declinations before the coverage may be placed with a nonadmitted insurer. Therefore, states seeking to conform their diligent search laws to NRRA's exempt commercial purchaser provision will need to tailor relevant statutory language to the specific provisions in their surplus lines law. In developing state-specific language, states may consider the following:

A. A surplus lines broker is not required to make a due diligence search to determine whether the full amount or type of insurance can be obtained from admitted insurers when the broker is seeking to procure or place nonadmitted insurance for an exempt commercial purchaser provided:

(1) The broker procuring or placing the surplus lines insurance has disclosed to the exempt commercial purchaser that such insurance may or may not be available from the admitted market that may provide greater protection with more regulatory oversight; and

(2) The exempt commercial purchaser has subsequently requested in writing for the broker to procure or place such insurance from a nonadmitted insurer.

B. The term 'exempt commercial purchaser' means any person purchasing commercial insurance that, at the time of placement, meets the following requirements:

(1) The person employs or retains a qualified risk manager to negotiate insurance coverage.

(2) The person has paid aggregate nationwide commercial property and casualty insurance premiums in excess of $100,000 in the immediately preceding 12 months.

(3) (a) The person meets at least one of the following criteria:

(i) The person possesses a net worth in excess of $20,000,000, as such amount is adjusted pursuant to clause (b).

(ii) The person generates annual revenues in excess of $50,000,000, as such amount is adjusted pursuant to clause (b).

(iii) The person employs more than 500 full time or full time equivalent employees per individual insured or is a member of an affiliated group employing more than 1,000 employees in the aggregate.

(iv) The person is a not-for-profit organization or public entity generating annual budgeted expenditures of at least $30,000,000, as such amount is adjusted pursuant to clause (b).

(v) The person is a municipality with a population in excess of 50,000 persons.

(b) Effective on January 1, 2015 and every five years thereafter, the amounts in subclauses (i), (ii) and (iv) of clause (a) shall be adjusted to reflect the percentage change for such 5-year period in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.