THE E&S Empire Express

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ELANY

FBI—FEDERAL BUREAU OF INSURANCE?

The federal government's recent forays into the in surance industry are not likely to stop with the recent enactments of the Gramm-Leach Bliley Act and Terrorism Recovery Insurance Act. In fact, at least three concepts for new federal insurance oriented regulation are being debated.

Senator Fritz Hollings has introduced a bill by which a large new expensive federal bureaucracy would be created to completely take over insurance regulation of insurers doing business in more than one state. This proposal appears to be supported by Fritz and no one else on the planet that ELANY can identify. Fritz, what's second prize?!

Another proposal supported by several life insurance associations, the banks in insurance associations, several large brokers and insurers as well as the CIAB and AIA, is to authorize the creation of insurers chartered under federal law. This is known as the "Alternate Federal Charter" proposal. This proposal is intended to mirror the regulation of banks which can be chartered and regulated under federal law or under a particular state's law. Purely from an E&S perspective, Alternate Federal Charters offer nothing but downside. If the proponents had their druthers, Alternate Federal Charters would be completely free on rate and form creating a new, direct competitor to the E&S market. This however, is a very unlikely possibility. The probable outcome of enacting such a statute is that it would produce some level of rate and form regulation, some entanglements between state and federal regulation and a big new 51st regulatory bureaucracy, the costs of which would be borne by the industry.

In light of the foregoing, the E&S industry should appreciate the third approach which is being fashioned by Representative Oxley of Ohio and Representative Baker of Louisiana along with significant input from the industry. This proposal advocates the creation of "Federal Standards" with which the states would be forced to comply. The Federal Standards approach may streamline and improve regulation in the E&S industry, or at least be neutral in its effect.

While no bill has been introduced in Congress yet, a number of issues may be addressed in such draft legislation. The goals of the bill are said to be to broaden and make more uniform agent and broker licensing, to improve insurance company licensing, to speed products to market (improve rate and form approval systems) and to implement market conduct examination reform. Congressman Oxley has publicly stated he believes a choice of law provision establishing which state law governs each particular insurance placement should be addressed. He has also stated elimination of rate and form approval should be enacted for sophisticated insureds, however defined. Representatives of NAPSLO and PCI have emphasized surplus line standards in meetings with congressional staffers. Improving E&S broker licensing, retaining a single state filing requirement for E&S transactions, waiver of the diligent search for sophisticated insureds (a/k/a automatic export) have also been emphasized.

Recent developments show proponents of "Alternate Federal Charters" characterizing "Federal Standards" as a good starting place which gives the latter additional momentum.

RIMS and the CIAB have stressed the need to address and provide a uniform and simple tax payment process for multistate E&S placements, while the AIA has emphasized freedom of rate and form as a federal standard. Representative Oxley has said that he envisions an Illinois open ratings approach with continuing form regulation below the sophisticated insured level.

At this juncture, it is unlikely that a law will be enacted this year. Nevertheless, a federal law which forces the states to be less parochial and more uniform in the manner in which the insurance industry is regulated could have positive effects in the E&S industry.

P$As

PLACEMENT SERVICE AGREEMENTS

Eliot Spitzer's investigation of insurance broker com pensation, particularly PSA's (Placement Service Agreements), has raised more than a few eyebrows around the industry. The first question many ask is, is this investigation about all agreements containing contingents, profit commissions and overrides? Is there anything illegal or improper about such compensation?

In this writer's opinion, there is nothing illegal or improper under New York insurance law regarding such compensation

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arrangements although the New York Insurance Department might disagree based on the content of *Circular Letter 22* of 1998. The sum and substance of *Circular Letter 22* (1998) suggests that brokers are required to disclose to insureds "all compensation" received by the broker, as compensation arrangements might put the broker at odds with its duties to the insured and therefore may constitute untrustworthy conduct. Many representatives of insurance industry trade associations and brokers met with department officials back in 1998 to seek clarification about the circular letter. Subsequent to those meetings, several large brokers agreed to make disclosure to insureds regarding contingent income when insureds requested it. In the main, most industry representatives were as unclear about *Circular Letter 22* after the meetings as they were beforehand. With all due respect to the insurance department, it does not appear that the insurance law supports *Circular Letter 22*. Specifically, §2119(c) appears to be operative. That subsection essentially requires a broker who places insurance coverage to obtain a statement signed by the insured when charging the insured for any services above the policy premium, but excepts from this requirement commissions deductible from premiums. The law does not specify who deducts the commission from premiums or when. Brokers almost universally believe that they have in good faith complied with the letter of this law and do not believe contingent commissions violate this law.

What about the argument that a broker's loyalty may be compromised by this compensation? It stands to reason that brokers work in the for profit world and broker compensation is no secret to insureds. Moreover, if an insurer offered brokers a commission rate below the broker's costs, the broker would not place business with that carrier even if the carrier was the greatest thing on earth for insureds. Moreover, insureds would not expect a broker to do so. Therefore, commissions and compensation, however characterized, do have an influence on which insurers a broker may do business with. Again, this should surprise no one.

In the real world of insurance, broker compensation varies by insurer, by class of business, and sometimes, by volume and profitability. It also varies by broker based upon the total business a broker can produce and how many carrier relationships the broker can support. Almost all carriers insist on a certain production level or they will close the broker. Insurers want a volume from each producer sufficient to gain efficiencies in maintaining the relationship and meeting the particular insurer's requirements.

What does this mean to insureds? First, it appears that insureds do not begrudge broker compensation anymore than you would begrudge Sears or Walmart for selling you a refrigerator and making a profit. In fact, if Walmart charges you less but makes a larger profit than Sears, do you care? The fact is insurance is a product where, even in a hard market, there is competitive pricing across the majority of lines. If a broker does not deliver a competitive quote, over time insureds realign with other brokers. The most practical realities of the marketplace are that brokers need insureds and markets to stay in business. To keep insureds, brokers must deliver competitively priced products and to keep markets, brokers must meet minimum volume requirements regardless of which insurer pays the most overall compensation.

But what about PSA agreements; are they in the same league as typical contingency arrangements? Some distinctions come to mind. Typical contingent arrangements are often offered at the initiation of the insurer to cement a stream of production. PSA's may be driven more by the broker, usually where the broker has tremendous clout. Some insureds have suggested that fees paid by the insured were supposed to supplant all commission income to the broker.

A number of press reports have raised questions about PSA's that imply the terms of a PSA agreement may go beyond typical contingency arrangements. Some of those questions include whether or not insurers were pressured to allow the brokers to place reinsurance, so called tie-in sales. Were PSA's the result of coercive negotiations due to a broker's clout in controlling substantial volumes of that insurer's business? Do these agreements violate anti-rebate laws or perhaps consumer protection laws such as §349 of the Business Corporation Law? These questions and perhaps others may be answered when the investigation is completed. In the meantime, here are some thoughts to consider.

- Brokers with PSA agreements may receive a greater overall compensation then other brokers placing business with the same carriers.
- They may also control a much larger volume of placements with such insurers than other brokers with whom the insurer does business.

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- Did the brokers with PSA agreements steer business away from the other carriers or did the risk size require capacity with numerous markets?
- Did the broker market the accounts to a reasonable number of carriers and release an appropriate number of quotes in each case?

In the end perhaps, it comes back to the Walmart example. Walmart is notorious for grinding down a manufacturer's charge for goods in exchange for volume commitment. If a broker can obtain the same effect with insurers, and the result is competitive pricing for the insured and greater compensation to the broker, has the insured suffered any damage? If not, this is not the makings of a Wall Street scandal; there is no late trading or market timing here.

Executive Director Daniel F. Maher

BINDERS VERSUS PLACEMENT OF COVERAGE CONFIRMATIONS

When an excess line broker wants to process a transaction quickly and knows the declarations page or cover note is unlikely to be issued immediately, a binder or a confirmation of placement of coverage can be processed for stamping.

BEWARE HOWEVER, and be careful about binders:

- If the binder is issued and signed by the insurer or an out-of-state general agent for the insurer, or if you have a binding authority on file with ELANY, issue the binder, no problem.
- If you do not have a binding authority, you should not issue the binder because a binder is supposed to be signed by an authorized representative of the insurer. The insurance department is adamant that excess line brokers represent the insured and do not have authority to "bind" an excess line insurer absent a filed binding authority agreement.
- Issue a confirmation of placement of coverage instead. This would contain terms essentially the same as a binder but you would be stating XYZ insurer has confirmed to us that it has bound coverage as follows. By not characterizing the document as a binder and not characterizing yourself as an authorized representative of the insurer, you will have helped yourself avoid regulatory problems.

E&S FUNDAMENTALS

In May 2004, ELANY released two bulletins (2004-13 and 2004-14) reminding the entire insurance com munity about the most fundamental rules in the E&S market. If you and the people with whom you do business can keep the following in mind, you should have few, or hopefully no, problems with regulators:

1) All nonadmitted placements on New York risks must be made by a licensed excess line broker.
2) Only insurers which are eligible at the inception date of the risk can provide coverage.
3) Most, but not all, types of P&C coverage can be

ELANY board members, senior management and association counsel at ELANY's new offices, March 31, 2004.

Front row seated (left-right): ***Thomas J. Derella, Margaret M. Beirne, Daniel F. Maher, David Isenberg.***

Second row standing (left-right): ***Guy Migliaccio, Robert Shapiro, Richard Schlesinger, Jay Martin, Donald Privett, Kurt Bingeman, John A. Buckley, Nancy Born, Kevin McGill, Lee Orabona.***

placed nonadmitted; (you need to know which coverages are not eligible for the E&S market).

4) New York placements made by brokers without an excess line license or with ineligible carriers are not made compliant with New York law merely by paying direct procurement taxes on the placement.

5) Coverage documents containing all necessary terms submitted for ELANY's review together with consistent and complete affidavits move through ELANY's review process swiftly.

EXCESS LINE BROKER LICENSE RENEWALS

Reminder: All excess line broker licenses expire on Oct. 31, 2004. Even if you just obtained your license for the first time recently, it expires on October 31.

To renew your license as a resident

1) Make sure you have renewed your underlying "brokers license" first.
2) Brokers need 15 C.E. credit hours every two years to renew their licenses.
3) If you work for a corporation or LLC, to be properly licensed, the corporation or LLC must hold the license with individuals qualified as sub-licensees.
4) No bond is required to obtain your excess line license. That requirement, at ELANY's behest, was repealed several years ago.
5) ELANY will offer C.E. courses at its headquarters in August for those who have not yet obtained 15 C.E. credits.
6) The insurance department plans to post renewal applications on its website for online renewal, sometime in August. For those who are not that internet savvy, paper applications can be obtained or downloaded and submitted as in the past. (http://www.ins.state.ny.us/)

Full nonresidential excess line licenses are now available to surplus line brokers residing in reciprocal states.

To renew your license as a nonresident

1) Your nonresident broker and excess line broker's licenses are combined in the insurance department's electronic application for renewal.
2) You must complete your home state C.E. requirements which must be certified to New York.
3) You should license your corporation or LLC if that is the legal entity for whom you work and which receives the commissions. (The exception to this, at least currently, is home states which license individuals only).

More to come on licensing issues this summer.

TAXES AND THE MULTISTATE E&S RISK

Many E&S brokers individually as well as insurance industry trade associations have called for a solution to the chronic difficulties dealing with the taxation of multi-state risks. Most recently, the Risk and Insurance Management Society Inc. and the Council of Insurance Agents & Brokers have advocated the need for a uniform system to address these problems. NAPSLO has adopted a white paper advocating the creation of a tax clearing house through state-by-state enactment of an interstate tax compact. This may not be as hard as it sounds since the result for each state will be a better and more accurate collection system resulting in each state receiving its fair share of taxes. For brokers, it will preserve a one state filing approach for every risk and avoid separate tax checks to separate states on each risk.

For a copy of the white paper, please contact ELANY Executive Secretary Margaret Sheehan at *msheehan@elany.org*.

BULLETIN BOARD AND CALENDAR OF EVENTS

The ELANY Web site contains a list of recent bulletins and upcoming industry events in its Hot News section. See ELANY's 2003 Annual Report by accessing the Lexicon and clicking on Annual Reports. The website is chock full of goodies – use it as a resource to better understand E&S compliance, filing requirements and for technical answers to E&S questions.

PREMIUM FINANCE LEGISLATION

This year legislation in the premium finance area is a hot topic in Albany. Three bills are pending which will affect you if passed:

- *A10254A/S6474* is a bill introduced at ELANY's request. The intent of the bill is to exempt excess line transactions from Insurance Law §3428(d). This subsection in effect states that the short rate penalty on premium financed policies is limited to the greater of 10% or $60. The insurance department has opined that this provision applies to excess line policies and therefore has superseded minimum earned premium provisions in some cases.
- *A2559A/S123A* is a premium finance bill introduced at the request of PIWA. This bill essentially requires notice to the wholesaler and insurer from the retailer through the premium finance company to insure that the wholesaler and insurer know the premium was financed. This bill may also include a requirement to advise the premium

finance company where the policy provides a minimum earned premium provision.

- *A10927* is the third bill and is sponsored on behalf of the Premium Finance Association. This bill would set the effective date of cancellation at the date on which the premium finance company sends notice of cancellation, not the date on which the insurance company or its agent receives the notice.

QUICK ACCESS TO ELANY

Whether you are phoning, faxing or emailing, note this: Each ELANY staff member has a direct dial telephone number, a separate direct fax number and a personal email address. Use these tools for direct access.

If you have not already received a copy, this information can be obtained by contacting Margaret Sheehan—at *msheehan@elany.org*—and requesting a copy of our laminated staff directory, or retrieving a copy from our website, see Bulletin #2004-03 in the Hot News section.

Discontinue use of old numbers. We continue to receive phone calls and faxes to our old contact numbers. This causes delays in our response time. Please note our correct main number is (646) 292-5500, but please use the direct dial telephone numbers whenever possible.

THE MARKET CYCLE

The insurance market cycle is about the dislocation of insureds and reductions in supply which can not meet current demand.

Several familiar names in the insurance industry in New York have left the marketplace (many not by choice) over the past five years. Major groups such as Frontier, Kemper, Legion, Reliance and Trenwick have withdrawn as a result of financial difficulties or due to their insolvencies. Others such as Royal and St. Paul have withdrawn from lines of business or territories, implementing a major change in underwriting philosophy. These withdrawals resulted in over $10 billion of group capacity vanishing from the property/casualty marketplace.

When the insurance industry, as a market, loses such significant capacity due to insolvencies, carriers strategically exiting certain lines of business or re-underwriting books of business and with reinsurers seeking rate increases and coverage changes, many insureds, and their agents and brokers are forced to seek new insurance partners for their insurance needs.

As the industry reaches this point in the cycle, pricing usually heads north. While many carriers as a result will offer renewal terms that are more stringent and costlier, other risks will have to find new homes for their coverages.

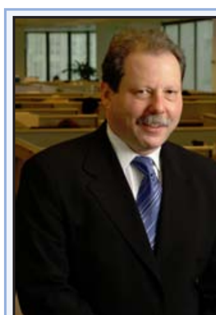
During the past five years, ELANY's records reflect the cycle. E&S premiums written quadrupled since 1999 in New York. In that same period of time, documents processed nearly doubled indicating several licensed carriers abandoned the underwriting of many risks previously written in the licensed universe. Many insureds were compelled to seek coverage in the alternative and excess line market.

Insureds sometimes refer to their premium for "renewal policies" as having increased by a multiple of the expiring policy premium; this is a misnomer. It is a misnomer because to the new insurer it is not a renewal. The price quoted is what the new insurer is willing to insure the new account for. The expiring price is not relevant to the new insurer. This point is noteworthy because one could perceive a renewal where the premium is a multiple of expiring as unfair perhaps, but it is not unfair for the new insurer offering terms. If it were unfair, the insured would probably have other options.

After three years the cycle has allowed the industry to reach the breakeven point with 2003 producing its lowest combined ratio in 25 years at approximately 100%. Several studies indicate that rates are starting to fall especially on the property side. At the minimum, increases across all lines are at a lower percentage. The top of the roller coaster has been reached and the cars are starting their downward descent.

A major reason for this inevitable downward movement in pricing is the additional capacity that has returned to the marketplace. ELANY has processed an increased flow of applications of companies seeking eligibility in New York. We have seen several major insurance groups adding companies to our eligibility list. These groups include: Ace, Alea, Allianz, Arch, Aspen, Axis, Berkshire Hathaway, Catlin, QBE, Quanta, Renaissance Reinsurance and White Mountain. The licensed market and reinsurance market have also seen capacity starting to return. As in past cycles the additional licensed capacity will start to take back some of their traditional business currently being written in the E&S marketplace. Higher rates will allow the licensed carriers to reconsider writing these traditional lines where there is potential for a reasonable rate of return. It is in fact axiomatic that these new insurers and older insurers which raised billions of dollars of new capital must deploy it and underwrite risks to obtain any return on equity.

Market cycles are a fact of life, but will the marketplace learn from the past and avoid the temptations of underpricing its products again? Will disciplined underwriting give way to market share underwriting? The answers to these questions will tell us how soft a market the industry is willing to tolerate.



Financial Director Richard Schlesinger