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Cassandra Cole and Kathleen McCullough
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# Regulation and Surplus Lines Activity

*Courtney Baggett, Ph.D.*
*Cassandra R. Cole, Ph.D.*

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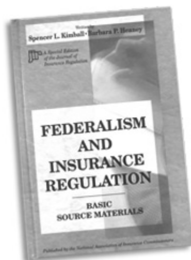


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# Regulation and Surplus Lines Activity

Courtney Baggett, Ph.D. *
Cassandra R. Cole, Ph.D. **

## Abstract

Surplus lines insurers play a crucial role in the marketplace. These companies commonly provided coverage for high capacity, distressed or unique risks, as well as new or emerging risks for which coverage is not available in the admitted market. Though surplus lines insurers play a valuable role in the marketplace and business written by these insurers have grown over time, there has been little academic literature that focuses on this segment of the industry. In this study, we examine whether surplus lines activity differs across regulatory environments, where activity is measured by surplus lines premiums, the number of active surplus lines companies and the concentration of the surplus lines market within each state. We find a positive correlation between premiums written and several regulatory measures, such as greater capital and surplus requirements, higher premium taxes and the existence of state surplus lines associations. The positive correlation with capital and surplus requirements and surplus lines associations is also observed when examining the proportion of surplus lines insurers in states. Finally, we find strong correlations between the concentration of the surplus lines market in states and all regulatory measures considered.

* Assistant Professor, Department of Risk Management and Data Analytics, Sorrell College of Business, Troy University; *cbaggett@troy.edu*.

** William T. Hold Professor in Risk Management and Insurance, Dr. William T. Hold/The National Alliance Program in Risk Management and Insurance, Department of Risk Management/Insurance, Real Estate, and Legal Studies, College of Business, Florida State University; *ccole@business.fsu.edu*.

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# Introduction

There are several different types of insurers operating in the marketplace today. These insurers can serve different purposes, and each has unique advantages relative to other structures. While most insurance is placed in the standard or admitted market, there are risks the admitted market is unable, or unwilling, to insure. Excess and surplus lines companies commonly insure these risks. Prior literature recognizes the importance of surplus lines insurers within the overall insurance economy, suggesting that the surplus lines market functions as a safety value to the standard market, specifically because surplus lines insurers are capable of solving market availability issues (Brockett, Witt, and Arid, 1990).[1] Thus, one could argue the most salient feature of the surplus lines market is ensuring the availability of insurance coverage to all consumers who wish to purchase.

Surplus lines insurers play a crucial role in the marketplace, primarily providing coverage for high capacity, distressed or unique exposures, as well as emerging risks. Often, coverages originally developed by surplus lines insurers will be offered by admitted carriers in the future. For example, while consumers can now purchase employment practices liability, directors' and officers' liability, medical malpractice, and cyber-risk policies in the admitted market, these coverages were initially written only by surplus lines insurers (ISLM, 2017). More recently, surplus lines insurers began providing coverage for ride-sharing services and drone activities (A.M. Best, 2017).

Relatively speaking, the surplus lines market is deregulated. That is, surplus lines insurers are free from certain aspects of insurance regulation imposed on their admitted counterparts, the most widely recognized of which is the freedom from rate and form regulation. This enables surplus lines carriers to charge a premium that is appropriate for a given degree of risk. Without this ability, surplus lines insurers would be unable to offer coverage for high risk exposures or unique and emerging risks and, therefore, would be unable to fulfill their role of ensuring availability within the insurance economy. Schwartz and Mendelson (1989) evidence this phenomenon through their examination of physicians that, due to excessive losses, were forced to purchase insurance from the surplus lines market. The authors acknowledge that premiums charged by the surplus lines companies are typically several times higher than what the physicians were charged when covered in the admitted market. The policies offered by surplus lines insurers also frequently contained very large deductibles.

Like admitted insurers, surplus lines carriers are required to maintain specified levels of capital and surplus, and their premiums are also subject to taxation.[2] In

1. The authors also note that some consumers may be forced into the surplus lines market if stringent rate regulation causes admitted insurers to temporarily cease writing new business.

2. The regulation of capital and surplus requirements, as well as taxes, within a given state can differ substantially between the surplus lines and admitted markets. This analysis focuses solely on the regulatory requirements affecting surplus lines insurers.

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addition to these regulations, surplus lines insurers face some impediments in terms of market access in that they must sell their insurance through a broker (GAO, 2014). These wholesale brokers, intermediaries licensed by the states, place business with surplus lines carriers. They are responsible for selecting eligible insurers, submitting premiums taxes due to states, reporting their transactions to regulators, and ensuring compliance with all requirements (GAO, 2014). Historically, states either maintained a list of eligible surplus insurers with whom brokers could do business, maintained a list of surplus lines insurers with whom brokers could not do business, or allowed brokers to exercise their own due diligence in identifying an appropriate surplus lines insurer.

The regulation of surplus lines insurers has been affected recently with the passage of the federal Nonadmitted and Reinsurance Reform Act (NRRA), found within the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Becoming effective in 2011, the NRRA stated that, generally, "the placement of nonadmitted insurance shall be subject to the statutory and regulatory requirements solely of the insured's home State" and that "no State other than the home State of an insured may require any premium tax payment for non-admitted insurance" (NRRA, Sec. 522 (a); Sec. 521 (a), 2010). The NRRA generally defined the home state as the state in which the insured's principle place of business was located, or in the case of individuals, the primary residence of the insured. The NRRA was designed to simplify the regulation of surplus lines insurers. The impact on specific areas of regulation relevant to the current study are discussed in later sections.

Though the surplus lines market serves a valuable function within the insurance marketplace, there is little academic research that focuses on this segment of the industry. Historically, business written by surplus lines insurers made up a small portion of total insurance premiums, which may explain the lack of interest up to this point in this group of insurers. However, the surplus lines market has shown active growth in recent years. In 1994, surplus lines insurers wrote barely 6% of all commercial lines premiums. However, by the end of 2014, this number had more than doubled, climbing to approximately 14% (A.M. Best, 2015).

The purpose of this study is to examine the existing regulation of surplus lines insurers and provide insight into how regulation has changed over time. In addition, we explore differences in surplus lines activity across different regulatory environments. First, we establish thresholds identifying individual states, over time, as either stringently or non-stringently regulated in each of the four regulatory areas examined. Next, we use a series of t-tests to compare means to determine whether there are significant differences in surplus lines activity across regulatory climates. We capture surplus lines activity using three measures: 1) the percentage of premiums written in each state that can be attributed to the surplus lines market; 2) the proportion of firms operating in the state that are classified as surplus lines insurers; and 3) the concentration of a given state's surplus lines market.

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Prior literature has long since recognized the potential impact of regulation on market structure. The number of insurers operating in a state, as well as the volume of business insurers are willing to write in particular states, have been identified as specific areas that could be affected by the stringency of regulation (e.g., Harrington, 1992; Browne and Hoyt, 1995; Suponcic and Tennyson, 1995; Tennyson, 1997; Bikker and Spierdijk, 2017). The number of firms within a market serves as one measure of market competition (see, for example, Vives, 2008 and Schmidt et al., 2017). However, a recognized limitation is that a market could be characterized by many active insurers, yet a small number of those insurers might possess significant shares of the market (Cole, He and Karl, 2015).[3] For this reason, we examine both the number of surplus lines insurers operating in states, as well as the concentration of each state's surplus lines market.

We find a positive correlation between premiums written and several regulatory measures, such as higher capital and surplus requirements, higher premium taxes, and the existence of state surplus lines associations. With respect to the proportion of surplus lines firms operating within a state, we find similar results with one exception: We do not observe any differences in the tax comparison. Finally, we find more concentrated surplus lines markets in states with greater capital and surplus requirements and in states that do not use eligibility lists to identify surplus lines insurers that have been preapproved to sell coverage in the state. States without surplus lines associations and lower tax rates are also more concentrated.

The paper is organized as follows. The following section describes the resources used to obtain information on the regulation of surplus lines insurers, as well as surplus lines activity by state. Then we examine changes in surplus lines activity over time. A discussion of existing regulation follows. Next, we provide some evidence as to the impact of regulation on surplus lines activity. Finally, we provide concluding remarks.

# Data Source

Information on surplus lines laws is obtained from *Excess and Surplus Lines Laws in the United States – Including Direct Procurement Tax Laws and Industry Insured Exemptions*. We use editions published annually from 2005 to 2015 and report three points in time in the regulation section.[4] Data on surplus lines activity is obtained from the National Association of Insurance Commissioners (NAIC) property/casualty (P/C) database during the same period. Surplus lines insurers are identified using A.M. Best guidelines, which require surplus lines business comprise at least 50% of the company's total business. To identify whether the

3. In cases such as these, though the number of firms is high, the market is quite concentrated, and the marketplace itself does not foster competition.

4. Detailed information on when changes to laws were made is available from the authors upon request.

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coverage written in a state is surplus lines, we examine the status held by each insurer in each state over time. If the insurer has positive premiums in a state and is classified as either "Surplus Lines," "Not Licensed" or "Eligible Surplus Lines," we consider premiums written in that state as surplus lines activity. We then retain only surplus lines insurers in our sample. Companies with nonpositive values for direct premiums written, total assets and surplus are excluded. We also limit our sample to stock and mutual companies before aggregating our data to the state level.

## Surplus Lines Activity

As mentioned previously, there has been a change in the proportion of premiums written by surplus lines insurers, with commercial premiums climbing from approximately 6% to more than 14% over the 20-year period spanning from 1994 to 2014 (A.M. Best, 2015). However, we do not find a corresponding increase in the number of individual surplus lines companies operating in the U.S. over our sample period.[5] Between the years of 2005 and 2015, the highest number of surplus lines insurers was 160 in 2011, and the lowest number was 147 in 2013. As an overall percentage of all insurers in the sample, surplus lines companies made up 7.29% in 2005 and 7.13% in 2015. As such, it follows that the increase in the proportion of premiums written by surplus lines insurers is explained not by an increase in the number of surplus lines companies, but rather a similar number of individual insurers writing a greater volume of business. A table tracking the number of surplus lines insurers over our sample period may be found in Table 1 on page 6.

Interestingly, the proportion of insurer groups that are affiliated with surplus lines insurers has changed over time. In 2005, approximately 17% of all insurer groups were affiliated with at least one surplus lines insurer. By 2015, the end of our sample period, this number had increased to 22%. This shift in the composition of insurer groups suggests that there are some advantages to being affiliated with one or more surplus lines companies, for at least a subset of insurer groups. Figure 1 on page 6 presents a graphical representation of this shift in the composition of insurer groups over the sample period.

5. It should be noted that surplus lines companies domiciled within the U.S. and licensed in at least one state are referred to as foreign insurers in states other than their domiciliary state, while those domiciled outside the U.S. are referred to as alien insurers (GAO, 2014). This analysis focuses on foreign surplus lines insurers only, as all insurers within our sample are domiciled within the U.S.

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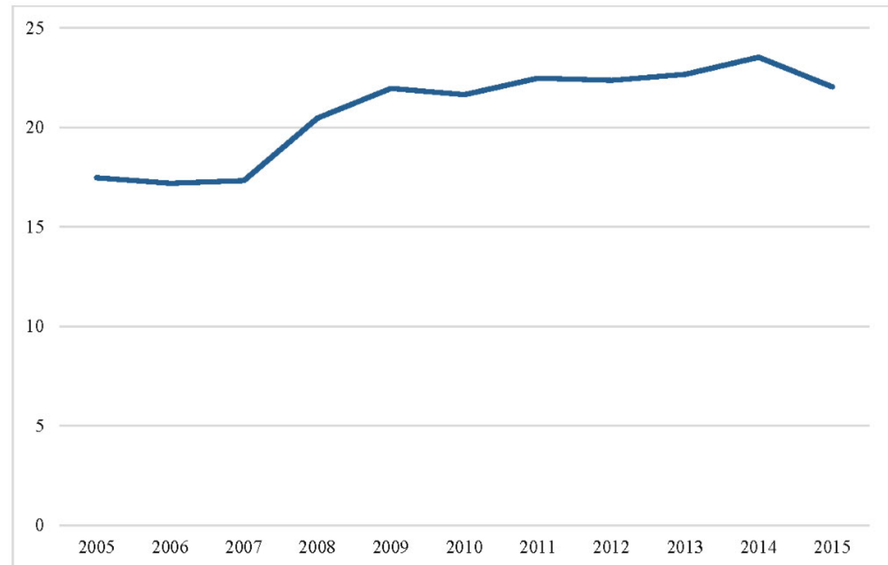
**Table 1:**
**Number of Firms**

| *Year* | *Surplus Lines* | *Admitted* | *Total* | *% Surplus Lines* |
|---|---|---|---|---|
| 2005 | 154 | 1,958 | 2,112 | 7.29 |
| 2006 | 148 | 1,970 | 2,118 | 6.99 |
| 2007 | 153 | 1,999 | 2,152 | 7.11 |
| 2008 | 159 | 2,013 | 2,172 | 7.32 |
| 2009 | 157 | 2,023 | 2,180 | 7.20 |
| 2010 | 155 | 2,006 | 2,161 | 7.17 |
| 2011 | 160 | 1,980 | 2,140 | 7.48 |
| 2012 | 148 | 1,957 | 2,105 | 7.03 |
| 2013 | 147 | 1,950 | 2,097 | 7.01 |
| 2014 | 150 | 1,935 | 2,085 | 7.19 |
| 2015 | 148 | 1,928 | 2,076 | 7.13 |

**Figure 1:**
**Percentage of Insurer Groups With Surplus Lines Affiliates**

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The extent of surplus lines activity in individual states is likely affected by the demand for insurance. Demand can be affected by the size of a state/insurance marketplace and other factors. For example, Baggett and Cole (2017) examine insurer groups and find that groups with surplus lines insurers have higher levels of catastrophe exposure than groups without surplus lines insurers.[6] When examining the subset of groups with surplus lines affiliates, the authors also found that the inclusion of surplus lines insurers in the group increased catastrophe exposure by more than 17%. Given the exposure to natural disasters, such as hurricanes, tornados, flooding and wildfires, it follows that some geographic regions will have greater needs for participation from the surplus lines market. As such, we examine the premiums written in each state by surplus lines insurers over the period 2005 through 2015. Over this 10-year period, the five states with the highest dollar value of direct premiums written (in thousands) were: California ($13,508,407); Florida ($9,183,049); Texas ($8,812,087); New York ($7,018,385); and Illinois ($2,906,711). The five states with the lowest dollar value of premiums written were: South Dakota ($102,688); Wyoming ($107,140); North Dakota ($136,805); Maine ($162,682); and Vermont ($165,322).

# Regulation of the Surplus Lines Industry

While surplus lines insurers are not subject to rate and form regulation, they are subject to some of the same types of regulations as admitted insurers, including maintaining certain capital and surplus requirements, as well as paying state premium taxes.[7] In addition to these requirements, surplus lines carriers also face some restrictions on market access. To accommodate surplus lines producers, surplus lines associations provide information on local issues and serve to inform members of important regulatory changes (WSIA, 2017). This section of the paper explores each of these four areas and reviews how these regulations have changed over time.

## *Capital and Surplus Requirements*

Similar to admitted insurers, states require surplus lines insurers to meet minimum capital and surplus requirements. Table 2 on pages 8 and 9 presents a summary of capital and surplus requirements imposed by individual states on surplus lines insurers for the years 2005, 2010 and 2015. The capital and surplus requirements for surplus lines insurers are relatively consistent toward the end of

6. The authors measure catastrophe exposure as the ratio of premiums in Southeastern coastal states to total premiums written.

7. It should be noted that in almost all states, the tax rate for surplus lines insurers exceeds that of admitted insurers.

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the sample, at $15 million, though there are some significant difference between states in earlier years.

**Table 2:**
**Capital and Surplus Requirements**

| *State* | *2005* | *2010* | *2015* |
|---|---|---|---|
| Alabama | $5,000,000 | $5,000,000 | $15,000,000* |
| Alaska | $15,000,000* | $15,000,000* | $15,000,000 |
| Arizona | $5,000,000 | $5,000,000 | $15,000,000 |
| Arkansas | $3,000,000 | $3,000,000 | $15,000,000* |
| California | $15,000,000 | $15,000,000 | $45,000,000 |
| Colorado | $15,000,000 | $15,000,000 | $15,000,000 |
| Connecticut | $15,000,000 | $15,000,000 | $15,000,000 |
| Delaware | NA | NA | $15,000,000* |
| District of Columbia | $300,000 $300,000 | $300,000 $300,000 | $15,000,000* |
| Florida | $15,000,000 | $15,000,000 | $15,000,000 |
| Georgia | $3,000,000 | $3,000,000 | $15,000,000* |
| Hawaii | Domicile | Domicile | $15,000,000* |
| Idaho | NA | NA | $15,000,000* |
| Illinois | $15,000,000 | $15,000,000 | $15,000,000 |
| Indiana | NA | NA | NA |
| Iowa | $5,000,000 | $5,000,000** | $15,000,000** |
| Kansas | $1,500,000 | $1,500,000 | $4,500,000 |
| Kentucky | NA | NA | $15,000,000* |
| Louisiana | $15,000,000 | $15,000,000 | $15,000,000 |
| Maine | $500,000 $500,000 | $500,000 $500,000 | $15,000,000* |
| Maryland | $6,500,000 | $6,500,000 | $15,000,000* |
| Massachusetts | $20,000,000 | $20,000,000 | $15,000,000* |
| Michigan | $7,500,000 | $7,500,000 | $15,000,000* |
| Minnesota | $3,000,000 | $3,000,000 | $15,000,000* |
| Mississippi | $600,000 $900,000 | $600,000 $900,000 | $15,000,000* |
| Missouri | $1,200,000 $1,200,000 | $1,200,000 $1,200,000 | $15,000,000 |
| Montana | $15,000,000 | $15,000,000 | $15,000,000* |
| Nebraska | $1,000,000 $1,000,000 | $1,000,000 $1,000,000 | $15,000,000* |
| Nevada | $15,000,000 | $15,000,000 | $15,000,000* |
| New Hampshire | $20,000,000 | $20,000,000 | NA |
| New Jersey | $15,000,000 | $15,000,000 | NA |
| New Mexico | NA | NA | $15,000,000* |
| New York | $15,000,000 | $15,000,000 | $45,000,000 |
| North Carolina | $15,000,000 | $15,000,000 | $15,000,000* |
| North Dakota | $1,000,000 | $1,000,000 | $15,000,000 |
| Ohio | NA | NA | $15,000,000* |
| Oklahoma | $15,000,000 | $15,000,000 | $15,000,000* |

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**Table 2:**
**Continued**

| | | | |
|---|---|---|---|
| Oregon | $5,000,000 | $5,000,000 | $15,000,000 |
| Pennsylvania | $7,050,000 | $7,050,000 | $15,000,000* |
| Rhode Island | $15,000,000 | $15,000,000 | $15,000,000* |
| South Carolina | NA | NA | $15,000,000 |
| South Dakota | NA | NA | $15,000,000* |
| Tennessee | $1,000,000 $1,000,000 | $1,000,000 $1,000,000 | $15,000,000 |
| Texas | $15,000,000 | $15,000,000 | $15,000,000 |
| Utah | $15,000,000 | $15,000,000 | $15,000,000* |
| Vermont | $10,000,000 | $10,000,000 | $15,000,000 |
| Virginia | $15,000,000 | $15,000,000 | $15,000,000 |
| Washington | $15,000,000 | $15,000,000 | $15,000,000* |
| West Virginia | NA | $15,000,000 | $15,000,000 |
| Wisconsin | NA | NA | $15,000,000* |
| Wyoming | $3,500,000 | $3,500,000 | $15,000,000* |

When capital and surplus requirements are reported separately for single-line and multiple-lines, the multiple-lines figures are used. Note that (*) denotes states that require the greater of a specified dollar amount of capital and surplus or domiciliary requirement, (**) denotes states that require the greater of a specific dollar amount of capital and surplus or risk-based capital (RBC) requirement, "domicile" denotes states that require the insurer to have capital and surplus equivalent to the requirements of that state for that type of insurer, while "NA" reflects states that do not specifically provide information related to capital and surplus eligibility requirements. While few states do not provide capital and surplus requirements in 2015, the NRRA requires the greater of $15 million or the minimum capital requirements of the insured's home state, and as such, $15 million is assumed for the purposes of the analysis.

Over the sample period examined, there are relatively few changes across time for a given state. However, there are wide fluctuations across states for a given year. For example, in 2005, the District of Columbia required $300,000 of surplus lines insurers in capital and surplus levels, and Maine and North Dakota each required $1 million. Alternatively, in the same year, Massachusetts and New Hampshire required $20 million in capital and surplus for surplus lines insurers. As demonstrated in Table 2, many states increased their capital and surplus requirements to $15 million between 2010 and 2015. This shift is explained by the enactment of the NRRA.

The NRRA became effective July 21, 2011, and served to simplify the regulation and taxation of surplus lines insurers. A key component of the NRRA was the introduction of a "home-state" system, whereby only the home state is permitted to regulate or tax surplus lines transactions (GAO, 2014). The NRRA establishes uniform eligibility requirements across individual states, thereby making it less cumbersome for a surplus lines insurer to write multistate risks. Before the passage of the NRRA, and as demonstrated in Table 2, it was possible for a surplus lines insurer to be eligible to conduct business in one state but not another. Under the NRRA, insurers are required to maintain the greater

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of $15 million or the minimum capital and surplus requirements imposed by the insured's home state (GAO, 2014).[8]

As noted above, though the capital and surplus requirements are now fairly consistent across states, this was not the case in earlier years. In examining the surplus and capital of insurers during the sample period, we find that nearly all insurers substantially exceed the minimum requirements. Specifically, we find that slightly more than 99% had capital and surplus that exceeded the minimum requirements set by the state and more than 96% exceeded the minimum requirements by at least 50%. This suggests that capital and surplus requirements are not binding. As such, we do not expect to observe differences in the volume of premiums written by surplus lines insurers in states, the number of surplus insurers operating in states or the level of market concentration in states with more stringent requirements in comparison to those with less stringent requirements.

### *Accessing the Surplus Lines Market*

The regulation of surplus lines companies also involves the supervision of agents and brokers. As discussed previously, wholesale brokers must be licensed by the states where they conduct business and serve an important role in placing coverage with surplus lines insurers. The surplus lines market does not compete directly with the admitted market, as evidenced by due diligence requirements. These requirements may differ by state, but typically require wholesale brokers to verify no less than three insurers in the admitted marketplace declined to provide coverage for a risk before sending the account to a surplus lines carrier (GAO, 2014). States with export lists identify lines of business that are generally unavailable in the admitted market, and because of this known availability issue, allow the wholesale broker to send the risk to a surplus lines carrier without first completing a diligent search in the admitted market (Dearie, 2015).

Brokers are also responsible for ensuring customers are placed with financially stable surplus lines insurers. Historically, these intermediaries generally used one of three methods, dictated by the individual states, to determine whether they could place a risk with a particular surplus lines company (Dearie, 2005). More recently, it appears states either use eligibility lists or rely on brokers to independently evaluate the appropriateness of surplus lines insurers. States that maintain eligibility lists provide brokers with a list of eligible surplus lines insurers that have been preapproved by the state. Brokers can place business with any surplus lines insurer that appears on the list. Alternatively, states employing broker responsibility rules require the broker practice due diligence when selecting a surplus lines insurer.[9]

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8. However, in some cases, a lesser amount may be permitted if the insurance commissioner deems an insurer acceptable, but capital and surplus should not be lower than $4.5 million (Dearie, 2015).

9. Though references to blacklists can still be found in some discussions of surplus lines insurers, it appears they are no longer commonly used. In addition, states that use eligibility lists

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In 2005, more than 75% (39 states) of states maintained a list of eligible surplus lines insurers. This has declined slightly over time. As shown in Table 3 on pages 12 and 13, 37 states maintained such lists in 2015. The states that moved away from maintaining eligibility lists over the sample period examined were Georgia, Nevada and Vermont. This information is summarized in Table 3.

Eligibility lists can serve to expedite the decision-making process regarding the placement of business by identifying the surplus lines companies with which a broker can place business in a particular state. This can lead to more efficient operations by brokers. As a result, these states represent a lower regulatory burden than states in which the broker must evaluate the eligibility of surplus lines insurers. Therefore, we hypothesize that if any observable differences exist among states relative to eligibility lists, the percentage of surplus lines premiums written and the percentage of active surplus lines insurers operating in those states with eligibility lists will be higher and the level of concentration of the market will be lower relative to those states that do not maintain these lists.

### *Surplus Lines Associations*

Not to be confused with stamping offices, surplus lines associations provide information on local issues. Some of the associations are full-time offices, while others use volunteer representatives (WSIA, 2017). One key difference between surplus lines associations and stamping offices is that participation is voluntary in an association (Dearie, 2015). WSIA (2017) notes that surplus lines insurers themselves started stamping offices to self-regulate and estimates that stamping offices currently process 80% of all surplus lines transactions. Additionally, these offices assist in preventing ineligible insurers from conducting business within a given state and may assist in evaluating the financial stability of eligible insurers. Table 4 on pages 14 and 15 tracks states with and without surplus lines associations over the years 2005, 2010 and 2015.

Over the sample period examined, there has not been a substantial shift in the number of states with surplus lines associations. In both 2005 and 2010, 33 states had associations, while in 2015, this number dropped slightly to 30.[10] Five states shifted from having surplus lines associations to dissolving them—Iowa, Michigan, North Dakota, South Carolina and Wisconsin—while two states acquired associations that did not have them at the beginning of the sample period—Minnesota and Ohio.

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do not necessarily use these lists in the strictest sense. While insurers on the list have been preapproved by the Department of Insurance (DOI) in the state, participation can be voluntary, and brokers can place business with other surplus lines insurers not on the list if the insurers meet the requirements of the states. For an example of this discussion, see California's DOI website at *https://www.insurance.ca.gov/01-consumers/120-company/07-lasli/index.cfm*.

10. It should be noted that state associations are not directly correlated to market size. For example, Washington, DC, and Hawaii rank in the top five in terms of premiums written by surplus lines insurers relative to total premiums in 2015. However, neither has a surplus lines insurance association.

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**Table 3:**
**State Maintains List of Eligible Surplus Lines Insurers**

| *State* | *2005* | *2010* | *2015* |
|---|---|---|---|
| Alabama | N | N | N |
| Alaska | Y | Y | Y |
| Arizona | Y | Y | Y |
| Arkansas | Y | Y | Y |
| California | Y | Y | Y |
| Colorado | Y | Y | Y |
| Connecticut | Y | N | Y |
| Delaware | Y | Y | Y |
| District of Columbia | N | N | N |
| Florida | Y | Y | Y |
| Georgia | Y | Y | N |
| Hawaii | N | N | N |
| Idaho | Y | Y | Y |
| Illinois | N | N | N |
| Indiana | Y | Y | Y |
| Iowa | Y | Y | Y |
| Kansas | Y | Y | Y |
| Kentucky | N | N | N |
| Louisiana | Y | Y | Y |
| Maine | Y | Y | Y |
| Maryland | Y | Y | Y |
| Massachusetts | Y | Y | Y |
| Michigan | Y | Y | Y |
| Minnesota | Y | Y | Y |
| Mississippi | Y | Y | Y |
| Missouri | Y | Y | Y |
| Montana | Y | Y | Y |
| Nebraska | N | N | N |
| Nevada | Y | Y | N |
| New Hampshire | Y | Y | Y |
| New Jersey | Y | Y | Y |
| New Mexico | Y | Y | Y |
| New York | Y | Y | Y |
| North Carolina | Y | Y | Y |
| North Dakota | Y | Y | Y |
| Ohio | N | Y | Y |
| Oklahoma | Y | Y | Y |

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**Table 3: Continued**

| | | | |
|---|---|---|---|
| Oregon | N | N | N |
| Pennsylvania | Y | Y | Y |
| Rhode Island | Y | Y | Y |
| South Carolina | Y | Y | Y |
| South Dakota | N | N | N |
| Tennessee | Y | Y | Y |
| Texas | Y | Y | Y |
| Utah | Y | Y | Y |
| Vermont | Y | Y | N |
| Virginia | Y | Y | Y |
| Washington | N | N | N |
| West Virginia | Y | Y | Y |
| Wisconsin | N | N | N |
| Wyoming | N | N | N |
| *Totals* | *39* | *39* | *37* |

While not every state that has a surplus lines association has a stamping office, every state that has a stamping office currently has a surplus lines association, and it appears that these offices do work closely together.[11] As noted in a recent industry publication discussing California's surplus lines association (SLA), "The SLA operates as a self-governed private organization that serves as the statutory surplus line advisory organization to the CDI and facilitates the state's capacity to monitor and direct surplus line brokers' placements of insurance with eligible non-admitted insurers." (Insurance Journal, 2017). As such, we contend these associations offer a valuable service to surplus lines insurers. If any differences exist, we would expect states with SLAs to have more surplus lines activity, as measured by both percentage of surplus lines premiums and percentage of active surplus lines insurers, than states without. We would also expect these states to have lower levels of market concentration.

11. Based on the information currently provided on the WSIA (2017) website, 15 states currently have stamping offices. These are: Arizona, California, Florida, Idaho, Illinois, Mississippi, Minnesota, Nevada, New York, North Carolina, Oregon, Pennsylvania, Texas, Utah and Washington.

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**Table 4:**
**Surplus Lines Association**

| *State* | *2005* | *2010* | *2015* |
|---|---|---|---|
| Alabama | Y | Y | Y |
| Alaska | N | N | N |
| Arizona | Y | Y | Y |
| Arkansas | Y | Y | Y |
| California | Y | Y | Y |
| Colorado | Y | Y | Y |
| Connecticut | N | N | N |
| Delaware | N | N | N |
| District of Columbia | N | N | N |
| Florida | Y | Y | Y |
| Georgia | N | N | N |
| Hawaii | N | N | N |
| Idaho | Y | Y | Y |
| Illinois | Y | Y | Y |
| Indiana | N | N | N |
| Iowa | Y | Y | N |
| Kansas | N | N | N |
| Kentucky | Y | Y | Y |
| Louisiana | Y | Y | Y |
| Maine | N | N | N |
| Maryland | Y | Y | Y |
| Massachusetts | Y | Y | Y |
| Michigan | Y | Y | N |
| Minnesota | N | Y | Y |
| Mississippi | Y | Y | Y |
| Missouri | Y | Y | Y |
| Montana | Y | Y | Y |
| Nebraska | N | N | N |
| Nevada | Y | Y | Y |
| New Hampshire | Y | Y | Y |
| New Jersey | Y | Y | Y |
| New Mexico | Y | Y | Y |
| New York | Y | Y | Y |
| North Carolina | Y | Y | Y |
| North Dakota | Y | N | N |
| Ohio | N | Y | Y |
| Oklahoma | N | N | N |

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**Table 4:
Continued**

| | | | |
|---|---|---|---|
| Oregon | Y | Y | Y |
| Pennsylvania | Y | Y | Y |
| Rhode Island | N | N | N |
| South Carolina | Y | Y | N |
| South Dakota | N | N | N |
| Tennessee | N | N | N |
| Texas | Y | Y | Y |
| Utah | Y | Y | Y |
| Vermont | N | N | N |
| Virginia | Y | Y | Y |
| Washington | Y | Y | Y |
| West Virginia | Y | Y | Y |
| Wisconsin | Y | N | N |
| Wyoming | N | N | N |
| *Totals* | *33* | *33* | *30* |

## *Taxes*

Like insurance sold by admitted insurers, surplus lines premium taxes must be paid to the state for surplus lines transactions, and this responsibility falls on the wholesale broker.[12] Table 5 on pages 16 and 17 shows the tax rates applicable to surplus lines premiums across states for select years. The rates reported are for most P/C insurance products. Some states do have varying premium taxes for specific lines of business (e.g., wet marine and transportation), and others have additional charges, such as stamping or filing fees, service fees, and fire marshal taxes, that must be paid in addition to the premium tax.[13]

12. Though taxes are passed on to the consumer, they affect the cost of coverage. Additionally, there are a number of existing studies that find state taxes affect insurer decision-making and the size of the insurance industry in states (e.g., Petroni and Shackelford, 1995; Grace, Sjoquist and Wheeler, 2014). As such, taxes are relevant to consider as a measure of regulatory stringency.

13. Where possible, any applicable fees and taxes are added to the base rate to arrive at the final tax rate shown in Table 5. We should also note that surplus lines premium taxes are higher than the taxes paid by admitted insurers in almost every state. These higher taxes are likely due, in part, to the additional costs mentioned above.

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**Table 5:**
**Premium Taxes**

| *State* | *2005* | *2010* | *2015* |
|---|---|---|---|
| Alabama | 6.0% | 6.0% | 6.0% |
| Alaska | 3.7%* | 3.7%* | 3.7%* |
| Arizona | 3.25%* | 3.2%* | 3.2%* |
| Arkansas | 4.0% | 4.0% | 4.0% |
| California | 3.225%* | 3.25%* | 3.2%* |
| Colorado | 3.10% | 3% | 3% |
| Connecticut | 4% | 4% | 4% |
| Delaware | 2%** | 2%** | 3% |
| District of Columbia | 2% | 2% | 2% |
| Florida | 5.55%* | 5.1%* | 5.175%* |
| Georgia | 4% | 4% | 4% |
| Hawaii | 4.68% | 4.68% | 4.68% |
| Idaho | 3.25% | 1.75% | 1.75% |
| Illinois | 3.8%** | 3.6%** | 3.7%** |
| Indiana | 2.5% | 2.5% | 2.5% |
| Iowa | 1.5% | 1% | 1% |
| Kansas | 6% | 6% | 6% |
| Kentucky | 3% | 3% | 4.8%* |
| Louisiana | 5% | 5% | 4.85% |
| Maine | 3% | 3% | 3% |
| Maryland | 3%* | 3%* | 3%* |
| Massachusetts | 4% | 4% | 4% |
| Michigan | 2.5%* | 2.5%* | 2.5%* |
| Minnesota | 3% | 3.025%* | 3.06%* |
| Mississippi | 4.25% | 4.25% | 4.25% |
| Missouri | 5% | 5% | 5% |
| Montana | 3.75%** | 3.75%** | 2.75%** |
| Nebraska | 3%** | 3%** | 3% |
| Nevada | 3.5% | 3.9% | 3.9% |
| New Hampshire | 2% | 2% | 3% |
| New Jersey | 3% | 5% | 5% |
| New Mexico | 3% | 3.003% | 3.003% |
| New York | 3.9%* | 3.8%* | 3.8%* |
| North Carolina | 5% | 5% | 5% |
| North Dakota | 1.75%** | 1.75%** | 1.75% |
| Ohio | 5% | 5% | 5% |
| Oklahoma | 6% | 6% | 6% |

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**Table 5: Continued**

| | | | |
|---|---|---|---|
| Oregon | 3%* | 2%** | 2.3%* |
| Pennsylvania | 3% | 3% | 3% |
| Rhode Island | 3% | 3% | 4% |
| South Carolina | 4% | 4% | 6% |
| South Dakota | 2.5%** | 2.5%** | 2.5%** |
| Tennessee | 2.5%** | 2.5%** | 5% |
| Texas | 4.95%* | 4.91%* | 4.91%* |
| Utah | 4.5%* | 4.4%* | 4.4%* |
| Vermont | 3% | 3% | 3% |
| Virginia | 2.25% | 2.25% | 2.25% |
| Washington | 2% | 2.25%* | 2.1%* |
| West Virginia | 5%* | 4.5%* | 4.55% |
| Wisconsin | 3%** | 3%** | 3% |
| Wyoming | 3% | 3% | 3% |

Note that (*) denotes states in which filing/stamping fee, special tax or service/fire marshal fee was added to the base premium tax, and (**) denotes states in which different tax rates apply to specific lines of business (e.g., wet marine and transportation, fire, and ocean marine).

In 2005, the District of Columbia (2%), Delaware (2%), Iowa (1.5%), New Hampshire (2%), North Dakota (1.75%) and Washington (2%) imposed state premium taxes of 2% or lower on surplus lines transactions. Alternatively, states charging more than 5.5% were: Alabama (6%), Florida (5.5%), Kansas (6%) and Oklahoma (6%). At the end of the sample period, in 2015, the high and low-tax thresholds were similar to the rates found in 2005, but the group of states in each category changed slightly. States charging 2% or less on surplus lines transactions in 2015 were the District of Columbia (2%), Idaho (1.75%), Iowa (1%) and North Dakota (1.75%), while states charging more than 5.5% were Alabama (6%), Kansas (6%), Oklahoma (6%) and South Carolina (6%). In examining the tax rates on a collective basis over the sample period, it appears that there has been little change, with average tax rates across states increasing from 3.55% in 2005 to 3.68% in 2015.

The home-state system created by the NRRA may also apply to taxation and has largely alleviated the complexities involved in paying premium taxes to various states, which frequently impose different tax rates on surplus lines transactions (GAO, 2014).[14] For accounts that involved exposures in multiple

14. The GAO (2014) notes that the home state is defined by the NRRA as, "the state in which the insured maintains its principal place of business, or in the case of an individual, the individual's principal residence. If all the insured risk is outside this state, NRRA defines the home state as the state to which the greatest percentage of taxable premium taxed for that insurance contract is allocated."

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states, apportioning premium taxes between the states involved was a burdensome and complex process for surplus lines brokers, as each state could potentially charge a different tax rate for their portion of the risk.[15] Despite the majority of states currently calculating surplus lines premium taxes on a home state basis, the tax rates charged by individual states are not consist.[16] As such, we expect less activity in states with higher tax rates. We would also expect states with higher taxes rates to be more concentrated.

## Analysis of the Impact of Regulation on Surplus Lines Activity

In the comparative analysis, we consider three measures of surplus lines activity: 1) the volume of premiums written by surplus lines insurers in the state; 2) the number of surplus lines insurers operating in the state; and 3) the extent of concentration within the surplus lines market in the state. To control for variations in market size, both the premium volume and the number of insurer variables are scaled. Total direct premiums written by surplus lines insurers is divided by total direct premiums written in the state. Likewise, total surplus lines insurers operating in the state, defined by positive direct premiums written in the state in that year, is scaled by total insurers operating in the state. Finally, market concentration is measured using a Herfindahl Index (HHI).[17]

After reviewing the laws regarding surplus lines insurers over the three years of interest, each state is identified as more stringent or less stringent. All comparisons are made between these two groups over the sample period, and t-tests are conducted to determine if differences observed are statistically significant. Table 6 provides summary information for both stringent and less stringent states. In Table 7, we present the results of a series of t-tests capturing each of the four regulatory areas examined. In Panel A, results are presented for differences in premiums, while in Panel B, results are presented for differences in the number of active surplus lines insurers. Panel C presents results for differences in degrees of market concentration. Details regarding the identification of states as

15. Tax-sharing agreements between states are permitted, though not required, by the NRRA. The Non-Admitted Insurance Multi-State Association (NIMA) and the Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT) are two such agreements that followed the NRRA's passage. However, SLIMPACT was abandoned and NIMA was dissolved effective Oct. 1, 2016, with the run-off period ending Oct. 1, 2017 (WSIA, 2017).

16. Moynihan (2018) reports that only four remaining states fail to calculate surplus lines taxes on a home state authority: Florida, Hawaii, New Hampshire and Vermont.

17. The HHI is a common measure of concentration. To determine the HHI, we first calculated the market share of each surplus lines insurer and then added the square of each. This is done for each state in each year. The higher the HHI, the more concentrated (or less competitive) the market.

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more stringent or less stringent across each of the regulatory areas, respectively, are provided below.

**Table 6**

Panel A. Surplus Lines Premiums

| | Mean | | | |
|---|---|---|---|---|
| | *Stringent* | *N* | *Non-stringent* | *N* |
| Capital and Surplus | 1,027,044.0 | 43 | 328,012.2 | 86 |
| Eligibility List | 287,566.6 | 38 | 610,255.7 | 115 |
| Association | 205,032.3 | 57 | 723,126.0 | 96 |
| Taxes | 817,579.5 | 38 | 435,121.0 | 115 |

Panel B. Surplus Lines Firms

| | Mean | | | |
|---|---|---|---|---|
| | *Stringent* | *N* | *Non-stringent* | *N* |
| Capital and Surplus | 152.7674 | 43 | 149.1512 | 86 |
| Eligibility List | 150.2105 | 38 | 150.687 | 115 |
| Association | 150.193 | 57 | 150.7917 | 96 |
| Taxes | 150.6316 | 38 | 150.5478 | 115 |

## *Capital and Surplus Requirements*

In surveying whether capital and surplus requirements result in differing degrees of surplus lines activity, we consider stringently regulated states to be those where the capital and surplus requirements are in the 75$^{th}$ percentile for the years 2005 and 2010. In both years, this was $15 million or greater. Due to the passage of the NRRA and the consistency across states in the year 2015, we consider stringently regulated states to be those where the capital and surplus requirements exceed $15 million.

As shown in Table 6, on average, more premiums are written in states with higher capital and surplus requirements. Premiums written in states with stringent capital and surplus requirements average more than $1 billion relative to premiums written in states without stringent capital and surplus requirements, which average less than $330 million. Additionally, states with stringent capital and surplus requirements average approximately 153 active surplus lines firms, while non-stringent states average 149 active firms.

Contrary to expectations, we find correlations between capital and surplus regulations and all three measures of surplus lines activity. Panel A of Table 7 reports the results of the comparison of the percentage of premiums written by

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surplus lines insurers. We find a higher percentage of surplus lines premiums written in states with more stringent capital and surplus requirements, approximately 6% compared to 4.4%. We also find that, on average, there is a greater proportion of surplus lines insurers operating in states with more stringent capital and surplus requirements. However, the difference is negligible, 7.25% compared to 7.19%. Finally, in Panel C, we find greater concentration (i.e., less competition) in states with stringent capital and surplus requirements.

**Table 7**

Panel A. Percentage of Surplus Lines Premiums

| | Means | | | | Significance |
|---|---|---|---|---|---|
| | *Stringent* | *N* | *Non-stringent* | *N* | |
| Capital and Surplus | 0.0602 | 43 | 0.0438 | 86 | *** |
| Eligibility List | 0.0489 | 38 | 0.0478 | 115 | |
| Association | 0.0447 | 57 | 0.0500 | 96 | * |
| Taxes | 0.0575 | 38 | 0.0449 | 115 | *** |

Panel B. Percentage of Surplus Lines Firms

| | Means | | | | Significance |
|---|---|---|---|---|---|
| | *Stringent* | *N* | *Non-stringent* | *N* | |
| Capital and Surplus | 0.0725 | 43 | 0.0719 | 86 | *** |
| Eligibility List | 0.0720 | 38 | 0.0722 | 115 | |
| Association | 0.0720 | 57 | 0.0722 | 96 | ** |
| Taxes | 0.0723 | 38 | 0.0721 | 115 | |

Panel C. Concentration in Surplus Lines Market

| | Means | | | | Significance |
|---|---|---|---|---|---|
| | *Stringent* | *N* | *Non-stringent* | *N* | |
| Capital and Surplus | 0.0863 | 43 | 0.0787 | 86 | * |
| Eligibility List | 0.0919 | 38 | 0.0809 | 115 | ** |
| Association | 0.0931 | 57 | 0.0781 | 96 | *** |
| Taxes | 0.0738 | 38 | 0.0869 | 115 | ** |

Note that capital and surplus information is not available for all states in all three years of observation. Specifically, West Virginia does not report for 2005. Information is missing for both 2005 and 2015 for the following states: Delaware, Hawaii, Idaho, Indiana, Kentucky, New Mexico, Ohio, South Carolina, South Dakota and Wisconsin. Information is missing for 2015 for New Hampshire, New Jersey and Texas. These 24 missing observations account for the difference between the total observations for the three other regulatory areas of interest (N = 153) and the total for the capital and surplus variable (N = 129).

In exploring why more premiums are written in states with stringent capital and surplus requirements, we consider the demand for surplus lines insurance in the states. States with greater catastrophe exposure may also be the states with more stringent regulation, thereby affecting the results obtained. As such, we drop

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from the sample the 10 states identified as having the greatest catastrophe exposure and re-run the comparison.[18] The results are qualitatively similar to those presented here. The differences observed may be due to the demand for surplus lines insurance. However, this appears to be unrelated to catastrophe exposure.

### *Access to the Surplus Lines Market*

Also of interest is whether there are differences in surplus lines activity based on variations in market accessibility. As noted earlier, states that place the decision-making responsibility on the broker can be viewed as having a greater regulatory burden in comparison to states that provide a list of eligible insurers. As such, states using eligibility lists are considered less stringent. As shown in Table 6, greater premium volume is written by surplus lines insurers in states using eligibility lists, though the numbers of surplus lines insurers operating in states with and without eligibility lists are relatively equal. The results of the t-tests of the scaled variables presented in Table 7 indicate there are no differences in the degree of surplus lines activity based on stringent and non-stringent market accessibility, with the exception of market concentration. As shown in Panel C, as expected, states with eligibility lists, or greater market accessibility, are less concentrated (i.e., more competitive) than those that do not maintain these lists.

### *Surplus Lines Associations*

We also explore whether there are significant differences between levels of surplus lines activity between states with and without SLAs. As discussed previously, SLAs broadly serve their local areas, whether on a full-time or volunteer basis, to ensure compliance with surplus lines regulations. Since these associations are beneficial to the surplus lines market and offer a valuable service, we consider states with these associations to be more "surplus lines friendly" and, therefore, acknowledge they may encourage more surplus lines activity in the state.

Based on the summary information in Table 6, there does not appear to be differences in activity based on the number of surplus lines insurers operating in the states, but we do observe higher premiums written in states that have SLAs. The results of the t-tests suggest there are substantial differences across all three measures of surplus lines activity when considering the existence of SLAs. Presented in Panel A of Table 7, we find a greater proportion of premiums are written, on average, in states with SLAs relative to states without associations. In

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18. The 10 states identified by the CoreLogic Hazard Risk Score as having the greatest catastrophe exposure are: California, Connecticut, Delaware, Florida, Kansas, Louisiana, Massachusetts, Oklahoma, Rhode Island and South Carolina. We explored conducting a similar analysis using only these 10 high catastrophe risk states. However, due to the small sample size, there was not sufficient variation in the four stringency measures examined to produce meaningful results.

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states with SLAs, surplus lines premiums account for 5% of total premiums, relative to less than 4.5% in states without associations. In addition, as shown in Panel B of Table 7, we find that surplus lines insurers make up 7.22% of the overall number of insurers in states with associations relative to 7.20% of overall insurers in states without associations. Panel C also indicates that there is evidence of lower levels of market concentration (i.e., greater competition) in states with associations when compared to states without. These results are all consistent with expectations.

### *Taxes*

With respect to taxation, we identify stringently regulated states as those with tax rates in the 75th percentile for each of the three years of analysis. This threshold was 4.25% or greater in 2005, 4.4% or greater in 2010, and 4.8% or greater in 2015. The summary information presented in Table 6 is contrary to expectations for premium volume and reveal no discernable differences for the number of surplus lines insurers. The t-tests of the scaled variables yield similar results. We find, as demonstrated in Panel A of Table 7, a greater percentage of overall premiums are written, on average, in states with stringent taxation. After scaling by the total premiums written in a given state, surplus lines insurers account for 5.75% of premiums in stringently taxed states and less than 4.5% in non-stringently taxed states. This difference is statistically significant. In Panel B of Table 7, we report the proportion of surplus lines firms operating in stringently and non-stringently taxed states, but we find no statistical difference. Finally, contrary to expectations, we find that markets are more concentrated (i.e., less competitive) in non-stringent states relative to states with more stringent taxation.

One explanation for these findings is that more premiums are written in states that charge higher taxes simply due to particular exposures in these states being well-suited for placement in the surplus lines market. Surplus lines companies, assuming they want to remain competitive, must write policies in states where surplus lines exposures are most plentiful. As such, regulators in these states may encourage higher taxes to capitalize on premium revenues. Nine states have stringent tax requirements in all three years of analysis: Alabama, Florida, Kansas, Louisiana, Missouri, North Carolina, Ohio, Oklahoma and Texas. More than one of these states were mentioned previously as being in the top five states for overall surplus lines premiums. However, none of these were found to be in the lowest five states for overall surplus lines premiums.

## Conclusion

As a vital component of the overall insurance economy, surplus lines insurers provide coverage for risks deemed uninsurable in the admitted market. This segment of the industry, while deregulated to a great extent, must meet minimum

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capital and surplus requirements and pay state premium taxes, like their admitted counterparts. Some states make writing business on a surplus lines basis easier by maintaining SLAs or maintaining a list of eligible surplus lines carriers with which they conduct business. The objective of this study was to review regulation that applies to surplus lines insurers, while examining the differences between states with respect to four regulatory areas.

The surplus lines industry has experienced significant changes with respect to regulation in recent years. The NRRA sought to make regulation more efficient among surplus lines brokers and insurers by implementing a "home state" system. This provided consistency with respect to both taxation and capital and surplus eligibility requirements for multistate exposures. While the sharing of premium taxes between states is permitted under the NRRA, both agreements thus far attempting to do so—the Non-Admitted Insurance Multi-State Association (NIMA) and the Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT)—have either failed or have been dissolved.

We consider four regulatory areas over the years 2005, 2010 and 2015, and examine whether surplus lines activity differs across regulatory environments, where surplus lines activity is measured by the proportion of premiums written by surplus lines insurers, the proportion of surplus lines insurers conducting business in the state, and the level of market concentration in the state. We find a positive correlation between premiums written and several regulatory measures, such as greater capital and surplus requirements, higher taxes and the existence of SLAs. Additionally, we find that surplus lines carriers make up a greater proportion of total insurers in states requiring higher levels of capital and surplus requirements, as well as those that maintain SLAs. There is also evidence that markets are less concentrated in states with lower capital and surplus requirements, in states that maintain eligibility lists, in states with SLAs and in states charging higher taxes.

Earlier in this analysis, we acknowledge that capital and surplus requirements on surplus lines insurers are not binding, and therefore the seemingly counterintuitive finding of greater activity in states with higher capital and surplus requirements is not suspicious. However, our results also indicate that surplus lines insurers have greater activity and less concentrated markets in stringently taxed states, which is contrary to standard expectations. It is important, however, to recall that surplus lines insurers do not compete directly with the standard market. For that reason, these insurance companies have a more limited pool of potential exposures available to insure and must capitalize on available business, even if such business is in a stringently taxed state. Consistent with this supposition, states in our sample with consistently stringent tax environments have relatively high surplus lines activity. We contend that regulators in these states may use higher taxes to benefit from the high volume of surplus lines activity in the state.

Most existing literature focuses on admitted insurers. However, surplus lines insurers play a distinct and important role within the insurance industry. The results of the current study indicate correlations between several regulatory provisions and surplus lines activity. This suggests that changes to these provisions by policymakers could affect the surplus lines insurance market. To the

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extent that future legislation resulting in changes to the regulation of surplus lines insurers reduces the willingness of surplus lines insurers to operate in particular states, the supply of coverage to consumers could be affected.

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**Journal of Insurance Regulation**

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