# Insurance Regulation and the Unlicensed Market in the United States

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In the United States, insurance is regulated by political subdivisions of the total insurance marketplace. The regulatory system is in large measure based on licensure, that is, on the governmental act of admitting insurers, one at a time, to those subdivisions of the market.

Under those circumstances, it is no surprise that the question what to do about unlicensed or non-admitted insurers is as old as insurance regulation itself. It is very much alive today in many forums.

The non-admitted market has a long history in the United States and is significant in the primary market, the subject of this paper, as well as in reinsurance.

Unlicensed carriers write some $3 billion of annual direct premiums here. American companies, often licensed only in their state of domicile, are important participants, as are Lloyd's and carriers domiciled in other countries.

So this may be an opportune time to look at the American experience with non-admitted insurers, at the origin and development of the state rules on the subject and at the prospects for both the non-admitted market and the rules governing it.

## Origins of Licensure

In the early part of the past century, before there was any regulation of insurance here, several large cities (including Boston and New York) were devastated by fire. With the local concentrations of insured property values and the rudimentary reinsurance typical of that era, the fires took many insurance companies with them.

Just after the Civil War, states began to enact laws requiring licensure, after proof of satisfactory financial condition, as a condition to letting an insurance company do business within their borders. Under those laws, the customary way of doing business in a state was to have a license from the state and either an office or a managing general agent there.

The underlying idea was that requiring an insurer to obtain a license from the state, subject to yearly renewal, gave the state the opportunity to review the insurer's financial condition and general fitness on a continuing basis. It also gave the state all the regulatory leverage implicit in the power to refuse to issue a license, to refuse to renew it or to cancel it during its term.

Throughout the history of American insurance regulation, licensure has been easy, particularly compared to the rules governing entry to other regulated businesses in this country. The legal steps are simple; no test of public necessity has to be met; existing competitors have no standing to object; and initial capital requirements are modest. Yet from the beginning insurance has also been written in every state by insurers not licensed to do business there.

## The Role of Unlicensed Insurers

At the very time the licensure requirement developed, the United States was building its physical capital more rapidly than the financial capital available to insure it. Owners were often unable to buy enough insurance fully to cover their properties.

So owners had to turn elsewhere for the remainder of their insurance needs, for the "excess" or "surplus" coverage.

In those situations, licensed insurers had all of an owner's business they could handle and yet the owner wanted more. Hence licensed insurers were unlikely to object if the owner got his additional coverage from an insurer not licensed in the state.

The owner presumably had made the arrangement with his eyes open and could hardly complain if the non-admitted insurer refused or was financially unable to pay his losses. The state was not in a position to help him, either with financial surveillance or with judicial process, but he had not made his arrangements in reliance on help from the state.

The key seems to have been that no one, such as a competitor, broker or insured, was disposed to complain or was in any equitable position to do so.

That did not remain the case for long. Shortly after the imposition of licensing requirements and the first use of unlicensed insurers to fill out capacity needs, another kind of non-admitted insurer turned up. It was the company which sold to people who were unable to get insurance at all in the voluntary, admitted market.

Upon the presentation of claims, some of those companies refused to pay, while staying safely out the state's jurisdiction, or else turned out to be insolvent. Their behavior was early recognized as an appropriate subject of regulatory concern.

## Regulation of the Non-admitted Market

By 1890, New York had a statute, which became a model for other states, setting two prerequisites for placing a risk situated in the state with an unlicensed carrier. First, the risk had to be placed by a local agent or broker who had a special surplus lines license. Second, the risk had to be incapable of placement in the admitted market, as evidenced by written rejections by licensed carriers.

In an era when the rationale for allowing the unlicensed provision of insurance was the shortage of admitted capacity, those two rules were intended to confirm that, in each case, admitted capacity was indeed not available.

Subsequently a third prerequisite developed in New York and other states: that the unlicensed carrier not have been specifically debarred by the insurance department or, alternatively, that it have been specifically approved. The rule was an attempt to keep out of the state's market, regardless of the capacity situation, insurers with bad records of behavior.

While those three requirements have been supplemented over the years, they remain the main rules for the non-admitted market.

The American regulatory system relies heavily on licensure and physical presence, for reasons of orderliness, disclosure and regulatory leverage. But it also acknowledges the desirability of making insurance available, even where the admitted market cannot or will not provide it.

The present system is a compromise. The states could have left their marketplaces wide open, as they were in the early nineteenth century. Or they could have closed them entirely to unlicensed insurers, as many have done with primary automobile insurance and workers' compensation. They did neither.

## Reasons for the Regulatory Compromise

The states went to the compromise position because they were pulled in opposite directions by two powerful forces — the need for regulation based on licensure in order to protect the public and the need for outside capital to insure the developing country. If those forces were not enough to make the compromise inevitable, they were reinforced by the central role and by the needs and limitations of the fire insurance cartel.

At the time the surplus lines rules were developing, a far more serious debate was going on about the most desirable system of setting insurance prices. In that debate the alternatives were antitrust and the regulated cartel.

Different states went different ways for different lines of insurance, but the regulated cartel was the wider choice. The largest line at the time was fire, and the memory of the effect of conflagrations on insurer solvency had just been refreshed by the San Francisco earthquake and fire. Price competition was generally regarded as a drain on surplus and hence on the ability to respond to disasters and survive.

Having a single set of prices in a market requires a single effective pricing point, standardized products, market participation restricted to those who obey the rules, and effective enforcement. In insurance, that meant a rating bureau to make rates and forms, subject to state approval, controlled admission to the market, and policing of the market by both the rating bureau and the state. It meant, in short, a lot of standardization.

## Role of Surplus Lines under the Cartel

After the widespread affirmations of the cartel starting about 1910, the American economy continued to outrun the accumulation of finance capital to insure it.

There still seemed no reason not to let people, who wanted more or different insurance than the admitted market offered, go to unlicensed insurers. Indeed the uniformity and rigidity of the admitted marketplace probably increased the need for a resource outside the system if the demand for insurance were to be fully met.

About that time one first encounters a new rationale for the non-admitted market besides capacity — flexibility of rates and forms. Thereafter, whenever the cartel system was strengthened, the call for free access to the more flexible surplus lines market was not far behind.

In 1944, in the *Southeastern Underwriters* case, the Supreme Court held insurance, for the first time, to be subject to the federal antitrust laws. The following year, Congress passed a law, the McCarran-Ferguson Act, granting the insurance business an antitrust exemption conditioned on its being regulated by the states.

The condition was widely interpreted as requiring “affirmative” state regulation, especially of rates and policy forms. To preserve their jurisdiction, most states enacted laws requiring prior state approval of changes in rates and forms. The effect, ironic in the aftermath of a price conspiracy case, was to put the power of the state more squarely than ever behind the cartel.

Predictably, one consequence of the *Southeastern Underwriters* episode was increased use of the surplus lines market for the capacity and flexibility unavailable in the cartelized admitted market.

## The Decline of the Cartel

Starting in the 1940s the insurance marketplace began to feel the presence of companies which processed and distributed personal automobile insurance at a lower cost than the average company. A lower cost does not have to be passed along as a lower price. But the lower cost companies were relative newcomers to the market and outsiders to the cartel world and mentality, and the coverage involved was rather routine. Passing the saving along in price was only rational competitive behavior.

After years of fighting in the courts in the 1950s, the insurance departments of some large states succeeded in allowing those savings to be passed along. The attack of the direct writers on, first, the personal automobile market and, later, the entire personal lines market really began.

That development made rating bureaus less effective for price maintenance, an erosion of their cartel role continued today through enactment of open competition rating laws. The

change is not yet fully accomplished, and the American insurance business has been fortunate in the gradualness of so great a change, but each year there is some movement somewhere.

Rating bureaus remain important in their statistical and actuarial role in analyzing losses and developing rates, but, except in a very few states, they no longer have a role in enforcing adherence to rates. That change has made it easier for the admitted markets to respond to the need for capacity and flexibility in coverage and price. The original reasons that gave rise to the surplus lines market are declining in importance.

## A Third Rationale for the Surplus Lines

From its earliest days, the surplus lines market has also served risks which were not acceptable in the admitted market for reasons other than financial capacity or flexibility of rate and form. Today this insurance world of beauty parlors, truckers, window washers, guard services, motorcycles and demolition contractors — the specialty market — is a very important part of the world of surplus lines.

Its characteristic is not that the standard companies do not have the financial capacity or legal latitude to write the risks. It is that the standard companies do not want to write them or are not able to reach them on an economical scale.

At first the specialty market was synonymous with the non-admitted market, for only on that legal basis could an insurer charge the rates and impose the conditions which made the risks insurable at all. But as the cartel has declined and rate and form freedom has increased, it has become possible, though not yet always as economical or convenient, to write them on an admitted as well as a non-admitted basis. More and more specialty organizations seem to be doing business both ways.

In the early days of scarce capital and rigid price control, a distinct market for extra capacity and flexibility had, almost by definition, to have a distinct legal status. That is not as true of a market which is identified by its willingness to insure. It becomes possible to push that market toward admitted status without destroying it.

The shift in rationales is one key to the market's changing fortunes. There are others, both cyclical and structural.

## Cyclical Concerns about Surplus Lines

Over the years, the business and regulatory fortunes of the unlicensed or surplus lines market in the United States have varied with changes in admitted capacity.

When markets are tight, admitted insurers have all the business they want and needs are still unmet. For the last hundred years, that has been a situation in which recourse to the non-admitted market has not posed problems for admitted carriers or for regulatory officials.

When, as today, markets are competitive and carriers want all the business they can get, admitted insurers see the non-admitted competition as unfair, because it is not subject to

equal legal and regulatory burdens. Regulators see it as unnecessary, because the non-admitted market is not supplying anything admitted carriers would not supply.

Those shifts in attitude have occurred repeatedly in the past.

Around the turn of the century, when markets were tight and pure capacity was the usual reason for going to the non-admitted market, the system seems to have worked without incident. That is also true of its role as a flexible supplement to the rigid fire insurance market.

In the 1920's, however, insurance markets were highly competitive and sometimes irresponsible, and state regulators and legislators called for a crackdown on "wildcat" insurance.

And so on. Most recently, the capacity crunch in the standard markets in the mid-1970's led to several years of remarkable growth and profit for the surplus lines, with scarcely a complaint from admitted carriers or regulators. Only at the end of the decade, with capacity abundant, did the non-admitted market stop growing and concerns begin to be heard from all sides.

In short, concern over the surplus lines market has been cyclical. The more willing the admitted market to provide capacity and flexibility, and to write theretofore unattractive specialty risks, the more concern about the unregulated provider. But neither the competitive nor the regulatory behavior is simply cyclical.

## Structural Changes in Surplus Lines

In a competitive market like the present one, the use of the non-admitted market for capacity and flexibility becomes almost impossible to distinguish from using it for price competition and for efficient access to the fiercely competitive world reinsurance markets. To the extent it is so used, the surplus lines market is doing something which could be done as well on an admitted basis.

Similarly, the specialty market, lacking the logical necessity of separate legal status, is being assimilated to the admitted or standard market both in what it writes and in how it is organized.

More and more standard companies, seeing the superior profitability of the specialty writers, are moving into the business directly and through new affiliations. The ten largest specialty market intermediaries and managers are now affiliated with major insurance companies or brokers.

The regulatory effect of the structural changes in the market is the same as the effect of the changes in its rationale from capacity and flexibility to specialty risks. It is the same as the effect of the current competitive cycle. It is the same, for that matter, as the eventual regulatory effect of the postwar loosening of regulatory control over commercial lines rates, forms and underwriting. The effect is to push the admitted and non-admitted markets closer together.

## Rapprochement of the Two Markets

The coming together of the standard and the surplus lines markets, for legal and regulatory purposes, is evident from the way public officials are treating three current issues.

First, in today's highly competitive commercial insurance markets, many people are complaining that the prerequisites for access to non-admitted markets, chiefly the requirement of prior refusal by licensed carriers, are met more in form than in substance. Some regulators have taken the position that unlicensed insurers are, therefore, unfairly free to compete for desirable business with licensed insurers which are subject to heavier regulatory obligations.

So they are trying to force through the admitted market transactions which used to go straight to the non-admitted market and to take jurisdiction of someone in every insurance chain.

The second current development is that several states have set up new facilities with some admitted, some non-admitted and some novel characteristics. New York, Illinois, Florida and Colorado have set up exchanges, free trade zones, captive havens, filing exemptions and other facilities and attractions to keep in the state and country business which would otherwise have moved into non-admitted markets here and abroad.

The new institutions symbolize the coming together of the two markets in that they occupy positions somewhere between them.

The third development is that American regulators are wrestling with the significance for public policy of the rapid growth of captive insurers and other methods of funding risk outside the established insurance mechanism. Frequently they involve unlicensed carriers.

Regulation of admitted markets in the United States is far more open, with far more scope for diversity and far more reliance on competition as an instrument of social control, than it was thirty or forty years ago. The specialty and surplus lines markets are functioning far more like the admitted market than they once did and are structurally more integrated with it.

So as the markets come together, it is easy to predict the legal basis on which they will generally do so.

More regulators more times will make more efforts to get at the non-admitted market, to make it less accessible, to hold some admitted entity responsible for the non-admitted insurance transaction and, most important, to get business into admitted markets.

Every regulator knows that an admitted market is easier to regulate than a non-admitted or a mixed one. Every regulator knows that as among states and countries, the content and quality of regulation are most uneven. He knows that he cannot always count on the insurance department of another state or another country to protect his policyholders against the depredations of an insurer domiciled there. Every regulator also knows that

getting licensed by his state is pretty easy, and it is in the nature of the regulatory perspective to believe that one's own regulations are rather reasonable.

Our system is a practical compromise, quite lacking in conceptual elegance. Practical considerations now create a tendency both to liberalize admitted market regulation for commercial lines and to bring specialty and surplus lines market activities more onto the same footing as the admitted market. Circumstances permitting, and now they do more than before, the natural regulatory direction is to close a market, any market, in order to regulate it better.

## Conclusion

State regulation of insurance in the United States calls for the larger insurance marketplace to be regulated by its political subdivisions. The system is best appreciated in the historical context of a developing economy and in the legal context of a federal structure of government.

State regulation is a compromise to start with, and it contains yet other compromises. One is the status of the unlicensed or surplus lines market. It balances the desirability of closing markets by universal licensure, in the interest of orderly and evenhanded regulation, against the desirability of making insurance available, in the interest of economic development.

Originally, in the capital-starved America of the 19th century, unlicensed insurers were allowed to participate in the market because admitted carriers did not have enough financial capacity.

Later, at the peak of effectiveness of the fire insurance cartel, unlicensed insurers provided a flexibility of rate and form not permitted in the admitted market.

During those periods, the main role of regulation was to assure that the non-admitted market stayed within its rationale, that is, that it provide only coverage unobtainable in the admitted market.

With the growth of capacity and the decline of the cartel, the rationale for the surplus lines market has changed again. Its two earlier roles are less important, and less distinctive, than in the past. More and more, it is a specialty market for programs of difficult risks.

In its current role, the surplus lines market is less dependent on the legal status of being unlicensed.

Regulatory concerns about the surplus lines market have always been strongest in times of overcapacity in the admitted market, and to that extent today's concerns are cyclical and have ample precedent. But the changes today are structural as well.

The admitted and non-admitted markets are being drawn together. Their insuring appetites overlap. Their organizations are integrating with one another. Their legal positions are being assimilated to one another.

As the two markets become more alike, regulators will tend to treat them more alike. They will loosen the rules for the licensed market and will tighten the rules the unlicensed market. The distinctive legal status of being unlicensed will matter, in law and business practice, less in the future than in the past.