

**Study Guide
for the**



**Arizona Surplus Lines
Examination**

July 2010

The Surplus Line Association of Arizona
15849 N. 71st Street, Suite 100
Scottsdale, AZ 85254

In late 2009, the Arizona Surplus Line Association (SLA) and the Independent Insurance Agents and Brokers of Arizona (IIABAZ) combined their resources to develop an online education and preparation program for the Arizona Surplus Line licensing exam. There were several factors that drove this decision:

1. The content of the examination had changed since the last version of this Study Guide was updated.
2. The attendance at regular "live" classes had dropped to a point where it was difficult to schedule courses that made financial sense.
3. Surplus Line Association members were asking for an online alternative to attending a class.
4. Finally, the SLA and the IIABAZ wanted to do more than just offer a class that instructed people how to pass the test but to share some valuable information with the insurance community on the surplus lines marketplace.

This Study Guide is designed to be used in conjunction with the video program and PowerPoint presentation on the SLA website (www.sla-az.org). The majority of the material in the Guide was obtained from Section 20 of the Arizona Revised Statutes (ARS) that pertain to insurance and we invite you to visit the Department of Insurance website. The training class has been divided into four sections to allow students the opportunity to review the entire presentation or just those parts that are relevant to a particular issue or question they have. We hope that you will find it useful and we invite any comments or feedback that you have in regards to the content.

A special note of thanks goes to the IIABAZ team of Lanny Hair, Joni Fairbrother, Russell Reiten, Ray Garcia, and Teri Edwards for their assistance in developing this program. In addition, the Surplus Line Association would like to thank Chris Behymer, our designated Surplus Lines carrier representative, for his role as the "talking head" in the video.

J. Scott Wede, CPCU, ASLI
Executive Director
The Surplus Line Association of Arizona

Section I

Introduction, Program Objectives,
The Insurance Marketplace and
Excess and Surplus Lines

Objectives of this Class

1. Discuss the nature of the Property and Casualty insurance industry
2. Provide an understanding of the Excess and Surplus lines (E&S) insurance industry
3. Explain how E&S works with standard lines companies
4. Discuss workflow and how agents access E&S carriers
5. Administrative procedures associated with surplus lines placements, including regulation, markets, records and taxes
6. Provide an overview of the Arizona Surplus Lines licensing exam in regards to content, structure and continuing education requirements

Overview of the Insurance Industry

The Property and Casualty industry in the United States is comprised of a number of companies who provide insurance for a wide variety of business and personal exposures to loss. At last count, the number of carriers is in the neighborhood of 4,000 and they range from small local companies to the multi-national conglomerates. Total annual P&C premium paid by policyholders, depending on the market, is in excess of \$400 billion.

The industry plays a vital role in our economy and in addition to providing millions of jobs, the industry allows people to insure their assets (homes, cars, and businesses) and provides some peace of mind should something happen, like a windstorm, fire, or theft.

On a more local basis, the industry in the state of Arizona is vital to our economy as well. Over 37,000 insurance related jobs support the insurance business and 940 insurance companies are operating in the Grand Canyon state. These carriers collect in excess of \$8 billion a year in premiums and pay more than \$180 million in taxes. The Arizona Department of Insurance (DOI) is the regulatory body assigned the task of monitoring performance and assuring that rules and guidelines are followed by all insurance entities. Unlike some other jurisdictions, the relationship between the industry (companies and agencies) and the department is extremely professional and both parties work together to provide a stable, competitive marketplace for Arizona insurance consumers.

Arizona is somewhat unique in that many Excess and Surplus lines companies have elected to set up shop in our state. Throughout the country, and for that matter throughout the world, Arizona is seen as an E&S "hotspot" and, as such, we attract many local, regional, and national meetings which support our valuable convention business.

Before launching into the content of the presentation, it is important to keep a couple of definitions in mind. Standard, or sometimes called admitted insurers, are licensed and issued a certificate of authority by the state to write business in Arizona. Non-admitted or unauthorized insurers, also referred to as surplus lines insurers, are not licensed by the state, BUT are allowed to operate under specific circumstances. This distinction will become clear as you proceed through this Study Guide. You will also find out that all unauthorized insurers are NOT able to sell their policies in the state! This too will be explained in a later section.

Standard insurance companies are licensed entities that, for lack of a better term, write "standard stuff." In most cases, the products they offer provide insurance on types of exposures to loss that fit a fairly defined set of criteria. These carriers use policy forms and endorsements that have been approved by the Department of Insurance. Standard or admitted companies also participate in the state's Guaranty Fund which comes into play when an admitted company can't for whatever reason satisfy its contractual obligations. You will learn more about how this facility functions later on in this program. Collectively this segment of the business writes over 90% of the insurance in the state.

The surplus lines industry is designed to provide an orderly process for insuring those risks that the standard carriers elect not to insure. Accounts that make their way into surplus lines tend to have one or more of the following characteristics:

- Unique. A person who wants to set up remote cameras to look for Bigfoot in a national forest needs a liability insurance policy in the event someone is injured by one of the cameras.
- Non-standard. An apartment risk with multiple property and liability losses might not qualify for coverage from a standard insurer.
- High limits. The owner of a billion dollar off-shore oil rig needs coverage in the event of an explosion.
- Tailored coverage forms. A manufacturer of airplane parts needs a type of coverage that is not available in the standard market.

These are a few examples of how the surplus lines market adds value to the insurance process. E&S companies are not required to file their rates or forms with the DOI thus they have the flexibility to develop coverages and rating methods without the need to obtain prior approval. As these companies are not licensed, they do not participate in the state Guaranty Fund.

If a particular risk qualifies for coverage in the admitted market, existing statutes require that it be placed with a licensed carrier. When the risk does not qualify, the agent may seek to place it in the non-admitted (or surplus lines) market. To do so, the agent must contact a licensed intermediary for assistance. The agents who specialize in surplus lines placements go by many names; surplus lines broker, managing general agent, general agent, wholesaler, or managing general underwriter. The key is that you must deal with someone who has either a resident or nonresident surplus lines brokers license in the state of Arizona.

A word of caution is in order. When you receive a quotation for a surplus lines placement, it is very important that you carefully review the quote. Many times surplus lines carriers use manuscript forms which may include special limitations and exclusions that are not used by standard companies. Be sure to notify your customer of these exclusions and limitations at the time of the placement, NOT after an uncovered loss!

Section II

Licensing, Regulation, Authority, and General Requirements

Licensing

When an insurance producer sells a non-admitted insurance policy, it is *mandatory that* a surplus lines broker license be in place somewhere along the distribution line of the sale. Generally speaking, the corporation (agency) will hold the license. Individuals may also be licensed. In the case of entity (Corporate, Partnership) licenses, it is necessary that at least one (1) individual license be in force. That individual licensee is known as the "Designated Responsible Licensed Producer" aka "DRLP. The surplus lines broker can be a retail producer selling directly to the insured or can be a wholesale producer, who arranges coverage on behalf of a retail producer and does not deal with the general public directly.

Keep in mind that any producer in an agent's office who assists in the placement of surplus lines insurance must be properly licensed. Some agencies might have 10 producers and one "designated" person to sign off on surplus lines transactions. This is not permitted as anyone who places business in the surplus lines market must have a surplus lines license.

To obtain a surplus lines license, the individual must have a resident property and casualty insurance license and successfully complete the surplus lines broker's examination. A non-resident surplus lines broker, one who is properly licensed in another state, does not have to take the Arizona surplus lines or producers exams in order to qualify for a non-resident license. If the wholesale producer holds a surplus lines license, then it is not necessary for the retail producer to also obtain a surplus lines broker license. The corporation or individual in the transaction that holds the license will ultimately make the necessary state filings and pay the surplus lines tax.

Current law permits the Director to license a corporation or a partnership as a surplus lines broker. The law establishes four (4) requirements that must be satisfied for a surplus lines broker license to be issued.

1. At least one natural person in each of the surplus lines broker's offices must be licensed as a property/casualty producer in this state. That person must take and pass the surplus lines license examination. (We recommend two people take the examination for each corporation)

2. If the surplus lines broker intends to do business under a trade name, that name must have been lawfully registered to the corporation or partnership.

3. The articles of incorporation, partnership agreement or other similar document authorize the entity to act as a surplus lines broker.

4. The surplus lines broker must promptly notify the Director of all changes to its members, directors, and officers.

License Duration and Maintenance

The Surplus Lines Broker License works in a similar manner of a regular license. The license is valid for a period of four (4) years. At which time it must be renewed or it will be invalid. An application for renewal will be done at the same time as the property casualty producer license. There is, of course, the renewal fee that must also be paid. The applicant must disclose any prior or pending criminal activity and pending civil action on the renewal application.

The renewal application, fees, and proof of evidence of completion of continuing education requirements (if applicable) must be submitted on or before the close of business on the expiration date, which for an individual is the last day of the licensee's birth month. If the license is for a business entity, the renewal documents must be received by the director on the last day of the month four years after the effective date of the license issue date.

If the application is not received by the Arizona Department of Insurance by that time, the application is considered "late" and will be subject to late fees. If the application is renewed within six (6) months of the expiration, a late fee plus the renewal fee can be paid to reinstate the license. After six months, the process of applying for a surplus license, including taking the exam, must be repeated.

As previously stated, all changes experienced by the licensee must be reported to the Arizona Department of Insurance, including a change of address, members, directors, officers, or designated producer. This change must be reported within 30 days of the occurrence. Keep in mind that regarding addresses, street addresses must be used. Post Office box numbers are not permitted.

The Arizona Department of Insurance also requires a report to them of any administrative action taken against the producer in another jurisdiction or by another governmental agency in this state. The report must be made within 30 days after the final disposition of the matter. Also a report made, within thirty days after the initial pretrial hearing date of criminal prosecution of the producer taken in any jurisdiction.

DISCIPLINARY ACTIONS ON LICENSE:

The Arizona Department of Insurance (ADO!) has authority to take disciplinary action, including suspension, revocation, refusal to renew or imposition of a civil penalty or a combination of actions where the licensee has committed any one of a number of offenses. The reasons for disciplinary actions include:

1. Providing incorrect, misleading, incomplete or materially untrue information
2. Violating any provision of the Arizona law regarding insurance
3. Obtaining or attempting to obtain a license through misrepresentation or fraud.
4. Misappropriation of funds
5. Intentional misrepresentation of insurance or application for insurance
6. Conviction of a felony
7. Committing insurance unfair trade practice or fraud
8. Demonstration of incompetence, untrustworthiness or financial irresponsibility
9. Insurance producer license denied, suspended or revoked in any other state
10. Forgery
11. Aiding or assisting any person in the unauthorized transaction of insurance
12. Violations of premium finance laws or illegal commission.

If the Director of the ADOI believes that any person has violated or is about to violate Arizona statute regarding insurance, the director may order a cease and desist. Civil penalties include \$1,000 for each act or violation with an aggregate of \$10,000. If the director finds the violations were intentional, a civil violation of \$5,000 per violation with an aggregate of \$50,000 may be levied.

Authority of Surplus Lines Brokers

Unlike an insurance agent that represents an admitted insurance company, a surplus lines broker, in general, has a different relationship. By definition an "agent" is someone who represents the company - can speak for the company - has authority with the company such as binding authority, possibly some small claim authority or more common authority to quote premium on risks. Surplus Lines Brokers, because of the very nature of the business that they are writing, unusual, unique, or capacity related risks, generally have no binding authority unless the insurance company specifically gives them the authority. Claim settlement authority is normally not extended unless the company has set up special provisions for this process.

A licensed surplus lines broker may accept or place surplus lines business from any insurance producer licensed in this state for the kind of insurance involved and may compensate the insurance producer. The broker shall have the right to receive from the insurer the customary commission.

The surplus lines broker may also include additional service fees for placing the risk as long as the fees are conspicuously shown on the proposal for insurance and applicable taxes and fees are paid.

Licensing of Mexican insurance surplus lines brokers

People entering Mexico with vehicles are required to purchase Mexican Auto Insurance. Most people buy the coverage before crossing the border. Any licensed insurance producer that maintains an office in this state may be licensed as a Mexican insurance surplus lines broker to transact insurance business if the director determines that the insurance producer is competent and trustworthy and the insurance producer complies with all of the requirements of Arizona insurance laws. The director shall provide application forms for any person that wants this limited insurance license. In addition, Arizona taxes and not paid on accounts written in Mexico. To sell Mexican auto insurance, you must have either the limited Mexican Auto Insurance license or a surplus lines broker license or as a licensed producer, place business through a licensed surplus lines broker.

Unfair Practices and Frauds

(Arizona Title Reference - ARS 20-443, ARS20-443.01, ARS20-447, ARS20-444, ARS20-448, ARS 20-451, ARS20-452, ARS20-461)

As with all states, Arizona has laws to require that producers/brokers conduct themselves in a fair manner with consumers and with insurance companies. It is therefore illegal to make, issue, or circulate materials or statements which misrepresent the terms of any policy. Statutes state specifically that a producer / broker can not:

1. Misrepresent the terms of any policy issued or to be issued or the benefits or advantages promised or the dividends or share of the surplus to be received.
2. Make any false or misleading statement as to the dividends or share of surplus previously paid on similar policies.
3. Make any misleading representation or any misrepresentation as to the financial condition of any insurer or as to the legal reserve system upon which any life insurer operates. Other statutes continue talking about this aspect of unfair practices that anything published about financial information on an insurer that is false is also illegal.
4. Use any name or title of any policy or class of policies misrepresenting the true nature of the policy.
5. Make any misrepresentation to any policyholder for the purpose of inducing or tending to induce the policyholder to lapse, forfeit, surrender, retain, or convert any insurance policy.

Anyone violating this law can be found guilty of a class 5 felony.

The unfair practice laws also include unfair discrimination which includes victims of domestic violence. Insurance coverage can not be denied, refused to renew, restricted, cancelled, or charged a different rate to a victim of domestic violence. Claims can not be denied as intentional acts to a victim of domestic violence. The victim must cooperate in the investigation and can not have contributed to the creation of the property loss. Further, insurers must adopt procedures to be followed by employees, producers / brokers to ensure the privacy of and to help protect the safety of a victim of domestic violence when taking an application, investigating a claim, pursuing subrogation or taking any other action relating to a policy or claim involving a victim of domestic violence.

REBATES: Rebating is not allowed in the state of Arizona. Specifically, the statute says: No insurer or licensee shall ... "offer, pay, allow or give, directly or indirectly, as an inducement to insurance, or after insurance has been effected, any rebate, discount, abatement, credit or reduction of the premium named in a policy of insurance, or any special favor or advantage in the dividends or other benefits to accrue thereon, or any valuable consideration or inducement whatever, not specified in the policy of insurance..." A rebate is any prize, goods, tangible property of an aggregate value of more than ten dollars (\$10).

UNFAIR CLAIM SETTLEMENT PRACTICES

Claim practices apply more to insurance companies than to producers or brokers, however, if a producer or broker contributes to the violation or keeps information from the insurance company the consequences can be strict.

A person shall not commit or perform with such a frequency to indicate as a general business practice any of the following:

1. Misrepresenting pertinent facts or insurance policy provisions.
2. Failing to acknowledge and act reasonably and promptly upon communications with respect to claims arising under an insurance policy. (10 days)
3. Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under an insurance policy. (30 days)
4. Refusing to pay claims without conducting a reasonable investigation based upon all available information.
5. Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed. (30 days)
6. Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.
7. Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by the insureds.
8. Attempting to settle a claim for less than the amount to which a reasonable person would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.
9. Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured.
10. Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which the payments are being made.
11. Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.
12. Delaying the investigation or payment of claims by requiring an insured, a claimant, or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof

of loss forms, both of which submissions contain substantially the same information.

13. Failing to promptly settle claims if liability has become reasonably clear under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.
14. Failing to promptly provide a reasonable explanation of the basis in the insurance policy relative to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.
15. Attempting to settle claims for the replacement of any non-mechanical sheet metal or plastic part which generally constitutes the exterior of a motor vehicle, including inner and outer panels, with an aftermarket crash part which is not made by or for the manufacturer of an insured's motor vehicle unless the part meets the specifications of section 44-1292 and unless the consumer is advised in a written notice attached to or printed on a repair estimate which:
16. Clearly identifies each part.
17. Contains the following information in ten point or larger type:
18. "This estimate has been prepared based on the use of replacement parts supplied by a source other than the manufacturer of your motor vehicle. Warranties applicable to these replacement parts are provided by the manufacturer or distributor of these parts rather than the manufacturer of your vehicle."
19. Failing to pay charges for reasonable and necessary services provided by a licensed physician if the services are within the lawful scope of practice of the physician and the insurance coverage includes diagnosis and treatment of the condition or complaint, regardless of the nomenclature used to describe the condition, complaint, or service.
20. Denying liability for a claim under a motor vehicle liability policy in effect at the time of an accident without having substantial facts based on reasonable investigation to justify the denial for damages or injuries that are a result of the accident and that were caused by the insured if the denial is based solely on a medical condition that could affect the insured's driving ability.

One area that comes up frequently involves the idea of making what is referred to as courtesy filings. Here's how it works. An agent in Texas writes a business located in El Paso and the business owner purchases a location in Arizona. The Texas agent does not have a non-resident producers or surplus lines license in Arizona and calls and asks you to make a courtesy filing to pay the taxes and fees. Don't do it! This practice is prohibited in Arizona and many other states. The potential for errors and omissions (E&O) problems are significant and you can be fined for making this filing. The best advice you can give is to encourage the Texas agent to procure the necessary licenses in order to properly write the Arizona location.

Diligent Search (Diligent Effort)

As mentioned earlier in this Study Guide, surplus lines coverage is designed to be written on risks that do not meet the requirements of standard or admitted carriers. To that extent, Arizona has a diligent search (effort) statute that requires brokers to make an effort to place the risk with a licensed carrier. To qualify for surplus lines, a minimum of three licensed companies must decline the business before a placing the account with an unauthorized insurer. Keep in mind that the requirement applies to both new and renewal accounts. For example, last year you performed a search for risk and could not find a licensed carrier to accept the risk so you wrote it with a surplus lines company. When it comes up for renewal this year, you must conduct a similar search to assure that a licensed carrier won't offer a policy.

The director of insurance may declare that certain classes and lines of business are generally not procurable from licensed carriers and are recognized as surplus lines. These classes and lines include: reinsurance, ocean marine, insurance on subjects located outside the state of Arizona, railroad related risks, and other lines determined by the director. This list is sometimes referred to as an "automatic export list" and risks that fall into these categories are not subject to the diligent search requirement.

The director may hold hearings to determine if new classes should be added or existing classes and lines should be deleted. For a current list, check out the Arizona Department of Insurance website at www.id.state.az.us/. Look for Docket Number 05A-108-INS under the Surplus Lines Forms tab.

Validity of Contracts

(Reference to Arizona Title ARS 20-41 OA, ARS-402)

Insurance policies or contracts are as valid as any contract issued by an admitted market insurance company. If the transaction of surplus lines is in violation of the law, it does not invalidate the insurance policy. If an insurer is in violation of the law and fails to pay any claim or loss within the provisions of the insurance contract, any person who acted directly or indirectly as an insurance producer for or otherwise represented or aided the insurer in the solicitation, negotiation, procurement or effectuation of the insurance contract is liable to the insured for the full amount of the claim or loss in the manner proved by the provisions of the insurance contract.

Arizona Guaranty Fund

Like many other states, Arizona maintains a Guaranty Fund to protect consumers in the event their insurance company becomes insolvent and/or is unable to satisfy its financial obligations. This fund, in all states except New Jersey, applies only to policies written by licensed, authorized insurers. As such, policies issued by unauthorized insurer are not covered by the provisions of the fund. However, it is considered an Unfair Trade Practice in Arizona to promote or sell a policy of insurance by referring to the Guaranty Fund.

Any policy and any evidence of coverage that is issued by an alien insurer and that is issued pursuant to this section for delivery to the insured in this state shall contain a conspicuously stamped or written notice in bold-faced type that states:

This policy is issued by an insurance company that is not regulated by the Arizona department of insurance. The insurance company may not provide claims service and may not be subject to service of process in Arizona. If the insurance company becomes insolvent, insureds or claimants will not be eligible for protection under Arizona law.

Section III

Insurance Markets

United States Non-Admitted Market

The non-admitted market provides an orderly process for the placement of insurance on risks that are non-standard, have unique risk characteristics, or the amount of coverage needed is significant. There are a number of sources where this coverage might be available:

- Foreign Insurers: those companies domiciled in another state in this country.
- Alien Insurers: those organizations domiciled outside of the United States.
- Lloyd's of London.
- Other insurance exchanges
- Captives.

Each of these markets is administered in a different fashion. The common thread among each of the categories is that in order to transact business in the state of Arizona they must be on the Director's List of Qualified Unauthorized Insurers, also known as "The White List." In other words, a surplus lines broker may not write an account with a carrier that is not on the list. This information is available on the Arizona Surplus Line Association website at www.sla-az.org.

The director may refuse to add or may remove an insurer currently on the White List if he or she believes:

- The insurer no longer meets the requirements of article 20-413. An example would be an insurer judged to be in hazardous financial condition, is unreliable in insurance transactions, and/or improperly managed.
- Does not have the endorsement of an Arizona surplus lines broker.
- Does not comply with all applicable provisions of this title (Title 20).

Arizona statutes set minimum financial requirements for all unauthorized insurers to issue their coverage in this state on a surplus lines basis. The law sets the financial requirements applicable to unauthorized foreign insurers, alien insurers, and insurance exchanges and their syndicates. The Arizona Department of Insurance (DOI) uses the requirements to determine who qualifies for the White List. The chart on the next page lists the amounts required depending on the legal form of the surplus lines provider:

Type of Surplus Line Insurer	Applicable Financial Requirements	
	Capital and Surplus	Public Custody
Foreign unauthorized insurer	\$5,000,000	\$ 2,500,000
Alien unauthorized insurer	\$ 15,000,000	\$ 2,500,000
Unauthorized Lloyds Association or other similar organizations		\$100,000,000
Unauthorized insurance exchange	\$ 50,000,000	\$ 2,500,000
(per syndicate)	\$ 5,000,000	

Public custody as used here refers to cash or securities deposited with the treasurer of Arizona or other state or states. This can be equated to a security deposit of sorts to assure that the entity has the financial resources to meet their obligations.

Arizona is a broker sponsor state and each US non-admitted carrier must be sponsored by a licensed Arizona surplus line broker. The carrier files with the broker all the required documentation necessary to be placed on the "White List." It the sponsoring broker's obligation and responsibility to see this qualification is handled in a timely basis. Once a carrier has been placed on the "White List," they must re-qualify each year to maintain their ability to transact business in Arizona.

Alien Non-Admitted Market

No discussion of surplus lines or specialty insurance or the non-admitted market would be complete without a look at Lloyd's of London. Probably the world's most easily recognized insurer and currently the world's leading market for specialist insurance services. It is the world's second largest insurer and the sixth largest reinsurance group. Currently approximately Syndicates are underwriting insurance at Lloyd's. Approximately 5% of the world reinsurance is placed at Lloyd's, which also accounts for half of the London market's international insurance premiums.

In order to understand the insurance giant; let us take a brief look at the history of Lloyd's of London. Lloyd's began in Edward Lloyd's coffeehouse on Tower Street in the city of London. The exact date of the establishment is unknown, however evidence exists that Lloyd's coffeehouse was well-known in London business circles by the late 1680's. Lloyd himself was not involved in insurance but provided the premises, reliable shipping news, and a variety of services to enable his clientele of ships' captains, merchants, and rich men to carry on their business of insuring ships and their cargoes. The wealthy individuals in the coffeehouse would take a share of the risk by signing their names one beneath the other on the policy together with the amount they agreed to cover. Thus, they became known as "underwriters."

By the end of the 18th century, the underwriters had elected a committee and moved to their own premises in the Royal Exchange. Only members of Lloyd's were allowed to accept insurance business. The Society of Lloyd's was incorporated by Lloyd's Act of 1871, which provided the business with a sound legal basis and laid the foundations for today's market. By the turn of the century the traditional club of marine underwriters had become an international market for insurance risks of almost every type. Lloyd's preeminence as a world center for insurance had been established.

We know that Lloyd's is currently made up of 80 Syndicates. Each syndicate is made up of investors who provide the capital, which permits the syndicate to compete on price, and service for business from 96% of the Fortune 100 companies and 93% of the Dow Jones companies. From its beginning until a few years ago, syndicate membership was limited to individuals, but with changing times and the limited wealth from even the richest of individuals, the syndicates were forced to allow corporate membership.

In summing up, it should be pointed out that while Lloyd's is one of the world's largest insurance providers; it is not an insurance company. Rather, it is an association of syndicate members accepting portions of risk.

While the ultimate responsibility for placement on the "White List" rests solely with the Director of Insurance, the various states have agreed the auditing procedure of Alien Insurers, could best be accomplished by the International Insurance Division (IID) of the National Association of Insurance Commissioners (NAIC). Each quarter, the NAIC provides a list of qualified unauthorized alien carriers, with the Director having the option to remove any of these insurers as he feels necessary. It must be noted that while a carrier may be on the NAIC's list, it still must be sponsored by a licensed Arizona surplus line broker in order to transact business in this state. The financial requirements for alien carriers are \$15,000,000 in capital and surplus and \$2,500,000 in public custody. The examination and auditing procedures relative to the Lloyds Exchange are the same as the rest of the alien market and are handled by the III) of the National Association of Insurance Commissioners. Lloyds of London is required to maintain \$100,000,000 in public custody.

Other Alternative Markets

Risk Retention Groups and Risk Purchasing Groups

In 1986, Congress enacted the Liability Risk Retention Act (LRRRA) to help businesses, professionals and municipalities obtain liability insurance which had become either unavailable or unaffordable due to the liability capacity crisis which hardened the insurance beyond anything anyone had seen in many, many years. In passing the Liability Risk Retention Act of 1986, Congress provided insurance buyers with an alternative marketplace. It provided a solution to the "liability crisis," enabling buyers to have better control over their liability insurance programs. To achieve this end, Congress created risk retention groups (RRGs) and risk purchasing groups (RPGs).

What is a risk retention group?

A risk retention group is a liability insurance company that is owned by its members. Under the Liability Risk Retention Act, RRGs must be domiciled in a state. Once licensed by its state of domicile, an RRG can become registered in any other state and is free to do business across state lines. Because the LRRRA is a federal law, it preempts state regulation making it easier for RRGs to operate nationally. As a RRG is in fact an insurance company, Risk Retention Groups retain risk.

What is a purchasing group?

A purchasing group, or risk purchasing group, is comprised of insurance buyers who band together to purchase their liability coverage from an insurance company. The insurance company may operate on an admitted basis, a surplus lines basis or as a risk retention group. As the name implies, the RPG serves as an insurance purchasing vehicle for its members.

What is the difference between risk retention groups and risk purchasing groups?

The primary difference between risk retention groups (RRG's) and Risk purchasing groups (PGs) is that RRGs retain risk and the RPGs do not. RPGs purchase insurance from an insurer which issues the policies and serves as the risk bearer. RRGs, as insurers, issue policies to their members and bear risk. Another key difference between the two is that RRG's typically require members to capitalize the company whereas RPG's require no capital. Other differences are the way in which the entities are regulated. Both fall under the LRRRA of 1986, however Purchasing Groups also adhere to State Regulation. Another difference is that Risk Retention Groups engage in the purchase of reinsurance.

What are the similarities between risk retention groups and purchasing groups?

Both RRGs and PGs are required by the Liability Risk Retention Act of 1986 to be made up of homogeneous groups, i.e. engaged in similar businesses or activities that expose them to similar liabilities. This is an important similarity as Purchasing Groups can reorganize into RRGs at a future time.

What kinds of coverage do risk retention groups and purchasing groups provide?

For both risk retention groups and purchasing groups, the type of insurance permitted is set forth in the Liability Risk Retention Act's definition of "liability" which includes all types of third party liability such as general liability, errors and omissions, directors and officers, medical malpractice and products liability. The LRRRA does not extend to workers compensation, property insurance or to personal lines such as homeowners and personal auto coverage.

Other Insurance Exchanges

As mentioned earlier, Lloyd's is the most well known insurance exchange but there are other exchanges providing coverage. These unauthorized entities offer admitted or nonadmitted insurance coverages in at least one other state and are required to have a minimum capital and surplus for the total exchange of at least \$50 million. In addition, each syndicate operating within the exchange must have a minimum of \$4 million in capital and surplus.

Industrial Insureds

There is a provision in the statutes that allows certain insureds to deal directly with an unauthorized insurer without using a licensed surplus lines broker. To qualify, the must have a "Risk Manager" as defined in the statute, and must satisfy at least two (2) of the following criteria:

1. Aggregate annual Property & Casualty premiums for all risks totaling at least \$100,000
2. Net revenues or sales over \$25,000,000
3. More than 80 full time equivalent employees (FTE's) or 100 FTE's in a holding company system.

These requirements must be confirmed by a Certified Public Accountant (CPA) and the insured is required to pay premium taxes on or before March 1 in the year following the effective date or renewal date of the policies. Keep in mind that industrial insureds are not the same as a self insured business and a broker cannot be involved in the industrial insured transaction.

Captives

A captive is an insurance entity formed by an individual company or group of companies engaged in similar operations designed to insure the exposures of the business or group of businesses. Minimum surplus and capital requirements vary from \$250,000 to \$500,000 depending on the nature of the business. A captive may write most lines of business except workers compensation, personal lines, medical services organizations including hospitals, and other classes as specified in the statutes. Captives must file an operational plan with the director of insurance and report any changes in the plan to the director within 30 days.

Service of Process

(Arizona Reference, ARS 20-419)

Each policy issued with a surplus lines carrier must contain a service of suit clause appointing the Arizona Director of Insurance the statutory agent for the acceptance of all legal processes issued in this state in any action or proceeding under or arising out of the policy. The Director must transmit this notice by certified mail - return receipt, a copy of the legal service to the surplus lines insurance carrier. An insurer will then have forty (40) days after the date of mailing within which to file an answer or otherwise defend the action.

Section IV

Records, Taxes, Fees, the Arizona
Surplus Line Association, Surplus Line
Examination, and Continuing
Education

Records, Taxes and Fees

Records

There are certain requirements associated with placing business in the surplus lines market that you need to be aware of. They are not particularly onerous but they are quite specific and to avoid any unnecessary problems it is important that they be followed.

First off, each broker must maintain the following information regarding placement of a surplus line policy for a minimum of three years with one notable exception which is listed below:

- Name and address of the insurer
- Name and address of the insured
- Amount of insurance
- Gross premium charged and return premium if any is paid
- Rate used to calculate the premium
- Effective date and terms of the contract
- Brief description of the risks insured against and property insured
- Results of the diligent search effort. (NOTE: Keep this information for SIX years!)

Within 60 days after the effective date of the surplus lines policy, the broker shall file with the director or the director's designee (the Surplus Line Association) the following information:

- The name of the insurer and the carriers NAIC identification number
- The policy number of the policy issued
- The name and address of the insured
- The premium, including taxable policy fees
- The identity of the specific surplus line coverage written

If the coverage is not recognized as a surplus lines (in other words, is not on the automatic export list), an affidavit executed by the broker attesting to compliance with the diligent search requirement. Keep in mind the results of the search, which is required at the time the policy was originally placed and all subsequent renewals, must be kept for six years after the expiration of the policy

The policy effective dates that are not open to public inspection

The applicable surplus lines stamping fee is also payable with this report. More on the stamping fee in a minute.

The director may impose a civil penalty of not more than \$25 per day for each day the report is late.

Taxes

All states impose a premium tax on business written and Arizona is no exception. For licensed insurance companies, the tax is imbedded in the premium and the company remits it directly to the state. For surplus lines, the situation is a bit different. The amount of premium tax is shown separately on the policy and is paid to the state by the surplus lines broker. Currently, the tax rate is 3% of the premium including all broker, policy, and inspection fees. Taxes are payable no later than March 1 for policies with effective dates between July 1 and December 31 of the preceding year. For policies effective from January 1 to June 30, taxes are due no later than September 1. Amounts due are paid directly to the state department of insurance.

Stamping Fees

A separate fee of .02% is applied to all surplus lines transactions, including broker, policy, and inspection fees, to assist in funding the Arizona Surplus Line Association. The remittance is different from the tax issue just discussed in the following ways:

1. The fee is paid directly to the Arizona Surplus Line Association.
2. The amount is due at the time of the transaction

An example will help explain how these processes work. Assume that a broker has written a surplus line policy effective September 1 and the total premium, including the broker and inspection fees, is \$5,000. The transaction must be reported to the SLA no later than November 1 (60 days). The taxes of \$150.00 (3% of \$5,000) are due and payable to the state no later than March 1 of the next year and the stamping fee of \$10 (.02% of \$5,000) is payable to the SLA immediately.

The Surplus Line Association

The Surplus Line Association of Arizona was founded in 1970. It was formed by a small group of concerned and yes, even patriotic retail brokers. Their concern was that most of the non-admitted business was being procured by Surplus Lines Brokers operating outside the state of Arizona and the taxes were either not being paid, or being paid to the domiciliary state of the broker. Working in conjunction with the Department of Insurance the Association became a reality and ultimately was awarded a contract by the Department to oversee the filing of surplus lines taxes. Other duties of the Association included:

- Assist in the monitoring, development, and growth of the surplus lines industry in Arizona
- Operates as a “designee” of and has contractual and organizational ties to the Arizona Department of Insurance
- Provides statistics and reports to the DOI regarding surplus lines placements
- Oversees the filing of surplus lines taxes and stamping fees which can be done electronically via their website (www.sla-az.org)
- Assists surplus lines brokers in reporting taxes
- Serves an important advocacy and educational role for the insurance industry throughout the state.

The stamping fee of .02% mentioned above funds and supports these efforts as well as the overall goal of the protection of Arizona surplus lines consumers.

The Surplus Lines Examination

As mentioned earlier, anyone involved in the placement of a risk in the surplus lines market must be properly licensed. Requirements include:

- The person must have a resident property and casualty producer’s license
- Take and successfully complete the surplus lines examination.
- File the necessary licensing forms including verification of compliance with state continuing education requirements (if necessary)
- Pay the appropriate fee of \$1,000 for a four-year license which will expire at the same time as the existing P&C license. Note: if the surplus lines license is added mid-term, the cost is \$500 if two years or less remains on the license. For example, Joe received his P&C producer’s license on October 1 of 2009 and wants to obtain his surplus lines license on July 1 of 2010, he would pay the full \$1,000 and the license would expire at the end of October in 2013. If, on the other hand, the surplus lines license is added on December 1 of 2011, his cost would be \$500.

The examination consists of multiple choice questions and examinees are allowed one hour to complete the test. The exam will cover insurance regulation, licensing, surplus lines markets, and other relevant topics discussed in this Study Guide. A publication from the DOI website is shown on next page regarding areas that will be addressed in the examination.

Licensing forms and instructions are available on the following websites:

www.sla-az.org

www.id.state.az.us

Arizona Examination for Surplus Lines Insurance Broker Series 13-41

For Surplus Lines Insurance Broker 60 questions – One-hour Time Limit

1.0 Insurance Regulation 35%

1.1 Licensing

- Assumed name (20-297)
- Who needs a license (20-407, Bulletin 2004-4)
- Who may be licensed (20-411)
- Licensing requirements (20-411)
- Maintenance and duration
- Disciplinary actions

2 Authority of surplus lines broker

- Binding
- Underwriting
- Claims
- Commissions (20-298, 412)
- Service fees (20-410(C))
- Mexican insurance surplus lines broker limited authority (20-411.01, 422)

1.3 General prohibitions

- Unfair practices and frauds Unfair claim settlement practices (20-461)

1.4 General requirements

- Recognized surplus lines (20-409)
- Diligent effort (20-401(1), 407)
- Validity of contracts (20-402, 410(A))
- Exemptions from surplus lines provisions (20-420)
- Notice to insured (20-410(B))

2.0 Markets 40%

2.1 United States nonadmitted market

- Nonadmitted insurers
- Insurance exchanges

2.2 Alien nonadmitted market

- London market
- Other alien markets
- United States trust funds

2.3 Alternative markets

- Foreign risk retention groups
- Industrial insureds

2.4 Qualified unauthorized insurers (20-413)

- Requirements
- List of unauthorized insurers
- Withdrawal of certificate
- Service of process (20-419)

3.0 Records and Tax 25%

3.1 Record of coverage (20-414)

3.2 Report of broker (20-408)

- Timeliness (20-408(A), (E))
- Contents (20-408(A))
- Surplus Lines Association (20-408(C))
- Stamping fee (20-167(I), 20-408(D))

3.3 Statement of transactions

- (20-415)

3.4 Surplus lines tax (20-416, 417)

- Amount
- Collection
- Remittance
- Tax report
- Civil penalty

Continuing Education

Arizona is unique in its approach to continuing education requirements. If a resident Arizona licensee holds only an Arizona P&C license, there is no continuing education (CE) requirement. If on the other hand the licensee holds or has held a non-resident license any time during the expiring license term, there is a requirement that the licensee complete 10 credit hours per year of approved continuing education courses offered by an approved provider for one line of insurance (such as a property/casualty license) or 40 hours for an expiring four year license.

The licensee is required to keep track of the required hours and obtain an official certificate of completion from the approved CE provider.

Reference Material

There are a number of specific statutes that apply to the business of insurance. The Arizona Examination for Surplus Lines Broker Series overview on the previous page makes reference to specific statutes that went into the development of this Study Guide. You will find a separate document on this website with copies of these statutes for your reference. All applicable statutes are available on the State of Arizona website at:

<http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp?Title=20>.