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Surplus lines: On the mend—but will it last?

18 January 2013 | JOY SCHWARTZMAN, FCAS, MAA

The segment of the property and casualty (P&C) insurance market known as "surplus lines" has been performing better than the rest of the P&C industry when measured by accident year loss ratios. Yet pessimism in the segment remains, and the outlook for the near future is mixed.

A.M. Best's Special Report on surplus lines, published October 1, 2012, notes: "…2011 largely reflected the impact of continued competitive pressures, the behavior of standard insurers willing to forgo this business, and weather related catastrophic events." Their view for the future is cautiously optimistic.

Some business leaders in the segment remain pessimistic about future prospects for this sector, despite upward movement in pricing and renewals over the past 12 or more months.

Attendees of the annual convention in October 2012 sponsored by the National Association of Professional Surplus Lines Offices, Ltd., said the rate increases witnessed across sectors of the surplus lines business likely will not be sustainable in the long term.[1] And Judith A. Patterson, head of E&S property for the specialty insurer group Beazley, stated, "When this market started improving…prognosticators thought this was going to be a slow, steady and sustainable upswing. But there is so much capital in the market that I now hope that we don't swing into the negative."[2]

A hard look at the segment's reported results from the past 10 years provides insights on where the surplus lines segment is today, and where it might be going in the near future.

The surplus lines insurance market: What is it?

Surplus lines insurance provides structure and oversight to that part of the P&C market that cannot be served within the usual structures and oversight offered by state regulators.

Most insurers in the United States are strictly regulated at the state level when it comes to solvency, rates and forms, and other factors.[3,4] But surplus lines companies write coverage that is otherwise unavailable to commercial buyers in the standard market because of unusual characteristics or the special needs of customers facing unusually high levels of risk.

Not long after states began to establish the rules for U.S. insurance in the late 19th century, it became clear that "admitted" insurance companies—those companies admitted to do business within a state—would not be able to handle every risk of every commercial customer; some commercial risks would require policies that exceeded allowable rates or violated established forms.

Cuthbert Heath of Lloyd's wrote the first American risk in Lloyd's "Non Marine" market in 1890.[5] Recognizing that non-admitted insurers such as Lloyd's were a necessity, state insurance regulators in the United States made space for them, allowing special rules to permit the writing of insurance with nonadmitted carriers under certain circumstances. "Freedom of rate and form" was therefore provided to a handful of "nonadmitted" companies and the agents and brokers who serviced them.

Surplus lines companies today insure three basic categories of risk:

1. Specialty risks that have unusual underwriting needs
2. Unique risks, for which standard carriers do not offer a filed policy form or rate
3. Capacity risks, where a higher coverage limit than any being offered by the standard market is desired or necessary[6]

Surplus lines insurance remains a boutique sector today, despite its vital importance to those customers who must have access to it. For the past 10 years, net earned premiums from the top 50 surplus lines companies have comprised less than 2% of total premiums for the entire P&C sector, as shown in Figure 1.

Figure 2 demonstrates, with respect to business written, that the annual statement lines “Other Liability Occurrence” and “Special Property” account for nearly 45% of the net earned premium distribution for surplus lines.

Often unlicensed but not unregulated

Surplus lines carriers are not required to be licensed by the states in which they do business. This does not mean they are unregulated—far from it. Surplus lines insurers are in some ways more regulated by the states in which they operate than admitted companies, but in a different way.

All states have statutes overseeing the placement of surplus lines insurance, with individual requirements varying from state to state. For example, some states require proof of some minimum financial strength, as well as evidence that the coverage is not readily available in their admitted markets. Most states also require that any surplus lines transaction be handled by a qualified surplus lines agent, responsible for guaranteeing that the company is qualified, the coverage otherwise unavailable in the admitted market, and the required state taxes (often higher than for the admitted market in that state) are paid in full and on time.

Typically, surplus lines companies are not protected by a state’s guarantee fund, so customers are not shielded in the event of insolvency. States keep a close eye on their surplus lines providers, however, maintaining a list of qualified insurers and only allowing policies to be written by companies on the approved list.

There are also three nationwide trade associations for the industry that protect

Figure 1: Net Earned Premium Comparison
50 largest surplus-lines companies combined vs. total P&C industry

Year	Surplus Lines Net Earned Premium	P&C Industry Total NEP	Surplus Lines as % of P&C Industry
2002	4,335,816	334,447,982	1.30%
2003	6,126,004	377,681,343	1.62%
2004	7,056,927	408,090,507	1.73%
2005	7,135,294	413,714,268	1.72%
2006	8,605,157	436,085,803	1.97%
2007	8,768,946	440,692,887	1.99%
2008	8,348,159	439,770,773	1.90%
2009	7,426,766	423,919,690	1.75%
2010	7,369,101	422,094,358	1.75%
2011	7,582,776	433,586,289	1.75%
10-Year Total	72,754,946	4,130,083,900	1.76%

1. Premium amounts are in U.S. dollars, thousands.
2. P&C Industry column includes the surplus-lines premium.

Figure 2: Net Earned Premium Distribution
50 largest surplus-lines companies combined

Year	Other Liability	Special Property	All Other	Total
2002	22.1%	20.9%	57.1%	100.0%
2003	21.8%	23.0%	55.1%	100.0%
2004	27.5%	21.1%	51.4%	100.0%
2005	26.1%	16.0%	57.9%	100.0%
2006	26.5%	19.6%	54.0%	100.0%
2007	25.8%	20.5%	53.7%	100.0%
2008	24.8%	24.1%	51.1%	100.0%
2009	21.6%	21.8%	56.5%	100.0%
2010	21.7%	22.1%	56.2%	100.0%
2011	20.2%	25.5%	54.3%	100.0%
10-Year Total	24.0%	21.5%	54.5%	100.0%

1. Other Liability: Insurance coverage protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act causing property damage or personal injury to others. This is occurrence only.
2. Special Property: Property coverage that requires special knowledge and services: ocean marine property, inland marine, crime, burglary, glass, earthquake, etc.

customers by encouraging prudent and responsible standards: the National Association of Professional Surplus Lines Offices (NAPSLO), the American Association of Managing General Agents (AAMGA), and the Target Markets Program Administration Association (TMPAA).

Impact of the Nonadmitted and Reinsurance Reform Act of 2010

Included within the nearly 850 pages of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is a section titled the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA), which deals specifically with the surplus lines insurance sector, and could help to make it more competitive.

Prior to the implementation of the NRRA, which went into effect on July 21, 2011, each state had its own requirements and regulatory schemes for surplus lines insurance, many of which were duplicative—and some even contradictory. The burden of complying with all of these confusing and different requirements fell primarily on the surplus lines brokers, who have been asking for regulatory relief and a more uniform system for several years. The NRRA addresses those requests.

Under the new federal legislation, surplus lines applications have been streamlined for commercial customers meeting the federal statute's definition of "exempt."[7]

The NRRA eliminates the requirement for a due-diligence search to prove that admitted insurers in the state cannot meet the prospective customer's needs—relying instead on the affirmation of the broker involved—and requires that all states apply uniform eligibility requirements for both domestic and foreign surplus lines suppliers.

The new law also streamlines and simplifies the reporting, payment, and allocation of surplus lines taxes, establishing the home state of the insured as the only state eligible to impose premium taxes on surplus lines, and encouraging the states to establish an interstate agreement for the allocation and remittance procedures of those taxes.

These changes have been generally welcomed by the industry, and prompted David Bresnahan, president of Lexington, one of the largest surplus lines companies in the United States, to say: "[W]ith [Dodd-Frank] helping ease access…I am hoping the utilization will be less cyclical than in past markets."[8]

Current state of the surplus lines market

In hard markets, the surplus lines segment is serviced by companies with long experience in covering higher-than-normal or unusual risk.

When the general P&C market turns soft, it is common for some admitted carriers to begin writing surplus lines coverage to boost their shares. When markets firm up again, and it becomes easier to attract customers with less daunting risk factors—or when losses from venturing into surplus lines begin to manifest—these companies usually retreat to the relative safety of the admitted market.

According to Lexington's President Bresnahan, the recent recession prompted some admitted P&C companies to push into surplus lines between 2008 and 2010. That trend, Bresnahan says, began to reverse in 2011.

"[The admitted companies] were quite aggressive in 2010," Bresnahan noted, "but many of them have slowed down their appetite and zest for some of the tougher business.… We have seen a nice bounce in our casualty renewal retention rates [beginning] in 2011."[9]

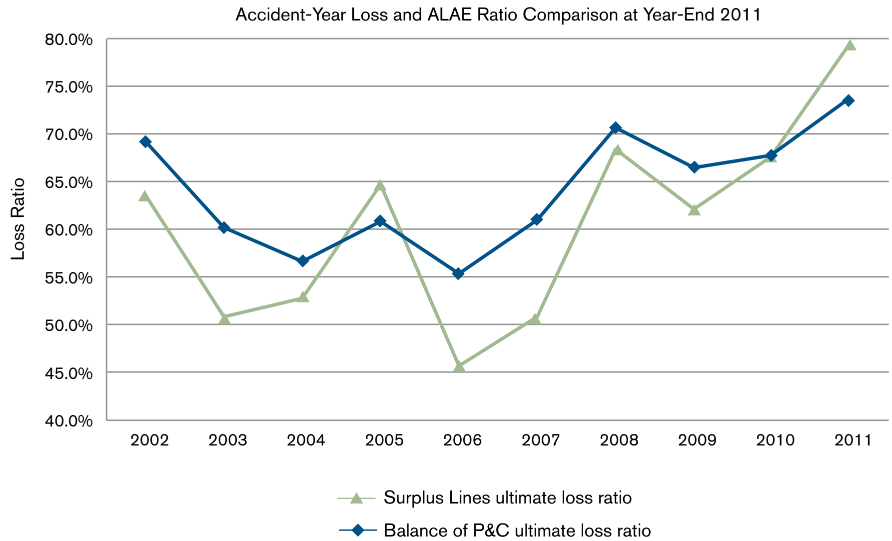
A.M. Best's Special Report on U.S. surplus lines, published October 1, 2012, noted a market turn in such that "many surplus lines insurers have reported lessening competitive pressure from standard market companies. Key performance measures…in 2011 continued to outpace that of the total property/casualty industry."

Still, pessimism remains in the surplus lines segment.

Patterson said that the market for catastrophe-exposed property in 2012 had not hardened as many had expected, and that increases

seen were insufficient to help insurers recover from the long soft market that preceded rising rates.[10]

Figure 3: Surplus Lines vs. P&C Industry: Loss Ratio Comparison



1. Surplus Lines: The 50 largest surplus lines companies and all their lines combined.

2. Balance of P&C: All P&C industry excluding the 50 surplus-lines companies.

Surplus lines reported results

Figure 3 shows that 2011 was among the worst years for results for surplus lines carriers. Figure 3 compares accident-year loss ratios for the top 50 surplus lines writers with the remainder of the P&C industry. Accident-year loss ratios[11] for the surplus lines carriers have run between two and 10 loss ratio points more favorable than they have for the balance of P&C industry writers in the last 10 years,[12] with only two exceptions: accident-years 2005 and 2011.

Accident-year 2005 had the largest insured catastrophe losses for the P&C industry on record as a result of Hurricanes Katrina, Rita, and Wilma. Catastrophe losses for 2011 include Hurricane Irene as well as multiple tornadoes and other storms occurring that year. With 20-25% of premium generated by property coverages for the surplus lines carriers, an adverse catastrophe year is certain to have an adverse influence on results for surplus lines. In fact, it is the special property line that is most volatile, as borne out in Figure 4.

Figure 4: Surplus Lines: Loss Ratio Comparison

1. Surplus Lines: The 50 largest surplus lines companies and all their lines combined.
2. Other Liability: Insurance coverage protecting the insured against legal liability resulting from negligence, carelessness, or a failure to act causing property damage or personal injury to others. This is occurrence only.
3. Special Property: Property coverage that requires special knowledge and services: ocean marine property, inland marine, crime, burglary, glass, earthquake, etc.

A look at favorable/adverse reserve development for surplus lines writers versus the balance of the P&C industry is also revealing.

Figure 5 shows calendar-year reserve development as a percentage of loss reserves at the previous year-end for surplus lines carriers, comparing it with those same results for the balance of the P&C industry during 2003-2011.

It is clear that whatever the direction of the reserve movement in P&C—up or down—surplus lines carriers' runoff experience has

been more extreme than the rest of the P&C market, with few exceptions.

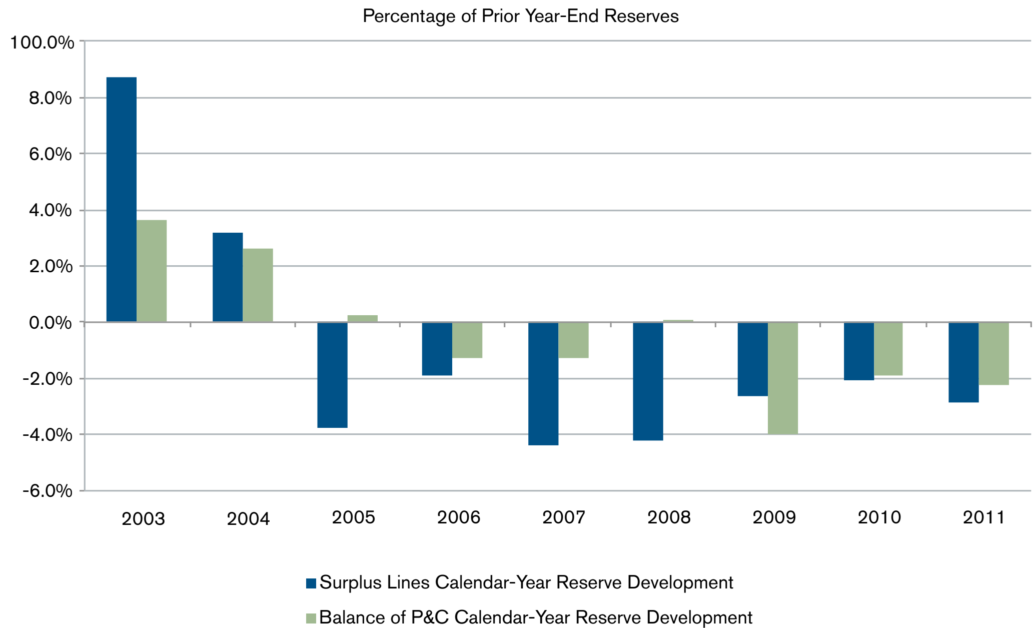
In the years showing adverse reserve development (2003 and 2004), the adverse development percentage for surplus lines carriers exceeded that of the remainder of the P&C industry. For accident-years 2006-2011, favorable runoff has also exceeded that of the admitted P&C industry—for all years except 2009.

Just as with the overall P&C industry, the favorable reserve runoff in surplus lines is generally shrinking and expected to disappear in the next year or so.

The future of surplus lines

It is generally agreed that growth in both the admitted and nonadmitted P&C market is dependent to a large degree on how global and U.S. economies perform over the near term.

Figure 5: Calendar-Year Reserve Runoff



1. Surplus Lines: The 50 largest surplus lines companies and all their lines combined.
2. Balance of P&C: All P&C industry excluding the 50 surplus-lines companies.
3. The calendar-year reserve development is the one-year development as recorded in the Annual Statement Schedule P as a percentage of prior year-end carried total loss and defense and cost containment (DCC) including IBNR reserves for all lines and all years.

"That will have a real effect on our ability to grow and…have rates translate into premium growth," says Lexington CEO Bresnahan.[13]

In its 2010 report on the segment, A.M. Best suggested that the continuing soft market would continue to put pressure on profit margins, but that the greater freedom of surplus lines to set pricing and terms "should enable them to react quickly," and take advantage of even modest improvements in rates.

Dick Bouan, an executive director of the surplus lines industry group NAPSLO, believes there will be opportunities for future growth in the segment based on digital and IT issues, such as coverages related to systems hacking, loss of information, and privacy issues. He also believes changes in the healthcare marketplace will generate business for surplus lines providers.

Lexington's Bresnahan also expects the market to benefit from the provisions of the Dodd-Frank Act.

"In the medium to long run it should be a real win-win situation for both our brokers and our clients," he told *Reactions*.

The surplus lines segment is "a very nimble type of marketplace and it adapts to the general market that is going on at the time," Bouan said at an A.M. Best panel discussion held in January 2012.

MarketScout's CEO Richard Kerr also believes recent results may foretell a coming uptick in business for the surplus lines sector.

"Recently, we have noticed admitted and nonadmitted insurers are pricing similarly," Kerr said in a statement to *Business Insurance*'s Bill Kenealy.

"[These] recent similar pricing strategies could continue to lead to more business for the nonadmitted insurers, as observed late in 2011 through 2012, as admitted insurers continue to restrict their risk appetite and simply decline to write tougher accounts."[14] But with ample market capital available, these favorable trends may be short-lived.

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[1] *Kenealy, Bill (October 22, 2012). Business Insurance 46. 41.*

[2] *Kenealy, ibid.*

[3] *Recent legislation has shifted some insurance industry oversight to the federal government. See Schwartzman, Joy & Ross, Gail (September 27, 2010). The Dodd-Frank Act and the insurance industry: Strategic considerations of U.S. financial reform. Milliman Insight.*

[4] *The Impact of the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA, discussed below).*

[5] *Surplus Lines Association of Oregon (SLAOR, 2011). SLAOR Mission Statement. Retrieved May 22, 2012, from* **http://www.slaor.org/About.aspx#tabs-2**.

[6] *Lughes, Jay (January 2008). Looking for solutions to challenging exposures. Risk Management 55 1: 20-22, 24-25.*

[7] *The Mayer Brown report, Understanding the New Financial Reform Legislation: The Dodd-Frank Wall Street Reform and Consumer Protection Act, provides the definition of "exempt" on p. 61. The report is available at:* **http://www.mayerbrown.com/files/Publication/1ec275f4-5618-4a63-9d38-3129010c06db/Presentation/PublicationAttachment/ef42ecce-49ff-44b2-b37a-72b81d87fb79/Final-FSRE-Outlinev2.pdf**.

[8] *Loney, Michael (October 2011). Interview: Lexington's CEO on surplus lines. Reactions.*

[9] *Loney, ibid.*

[10] *Kenealy, ibid.*

[11] *Accident-year loss ratios are inclusive of allocated loss adjustment expense (ALAE).*

[12] *Accident-year loss ratios as reported as of year-end 2011.*

[13] *Loney, ibid.*

[14] *Kenealy, Bill (May 4, 2012). Property/casualty insurance rates up 3% in April: MarketScout. Business Insurance.*

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