Common Misconceptions of the Surplus Lines Industry in the Debate of H.R. 2901 and S. 1679

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1. MISCONCEPTION: THE SURPLUS LINES INDUSTRY IS UNREGULATED.

- **The surplus lines industry absolutely IS regulated.**
- Each U.S. based surplus lines insurance company is licensed in at least one of the 50 states or other U.S. jurisdictions and must maintain threshold capital and surplus levels. Put another way – *a surplus lines insurer is an admitted insurer in at least one state.* Non-U.S. based surplus lines insurers are regulated by a Committee of state regulators through the NAIC.
- **Seven states and the NAIC's International Insurer's Department (IID) regulate roughly 75% of the surplus lines market: New York, Delaware, Illinois, Ohio, Pennsylvania, New Hampshire and Texas.** For example:
  - All Lloyd's syndicates that write surplus lines insurance in the U.S. appear on the NAIC Quarterly Listing of Alien Insurers ("IID List"), which is subject to regulatory oversight by the NAIC's IID. The IID is governed by the NAIC's IID Plan of Operation Review Group and the Surplus Lines Task Force, which is comprised of 19 states.
  - NEW YORK regulates AIG, Zurich and XL America
  - DELAWARE regulates W.R. Berkley, Fairfax Financial, Assurant and Munich-American Holding Corp
  - ILLINOIS regulates Markel, CNA Insurance Companies, AXIS Insurance Group and Argo Insurance Group
  - OHIO regulates Nationwide Group, Great American P&C Insurance Group and James River Group
  - PENNSYLVANIA regulates ACE Insurance Group and QBE Americas Group
  - NEW HAMPSHIRE regulates Alleghany, Allied World Assurance Group and Western World Insurance Group
  - TEXAS regulates State National Group and Starr International
  - MISSOURI regulates Arch Insurance Group and Swiss Reinsurance

  For other states, see Appendix A.
- Top 50 insurance groups write 89% of the U.S. surplus lines market. This 89% is regulated by 19 states and the NAIC (*see Appendix B*).

Surplus Lines insurance is Subject to Substantial State Regulation

- To obtain and maintain their licenses, both standard/admitted and surplus lines/nonadmitted insurers are subject to **ALL OF THE SAME rigorous rules and regulations** and must comply with all

financial solvency requirements and market conduct standards and regulations of its jurisdiction of domicile.

- In a surplus lines transaction, both the nonadmitted insurer and the broker are regulated:
  - A surplus lines/nonadmitted **insurer** is regulated by the insurance department in their domestic state, submitting to all of the same rigorous rules and regulations as a standard/admitted insurer.
  - **This means that their financial solvency and soundness is reviewed by regulators just as it is in the standard market.**
  - The surplus lines **broker** is directly regulated by the insurance department of the home state of the insured. The state's insurance Commissioner can revoke the broker's license if necessary.
    - In a surplus lines transaction, the broker is responsible for placing the coverage with a financially stable, eligible surplus lines insurer, and assuring compliance with all of the requirements of surplus lines regulation.
    - Surplus lines brokers work directly with retail agents and brokers representing those insureds who are unable to obtain insurance through the standard market.
- Finally, any Insurance Commissioner may issue a Cease & Desist Order against a nonadmitted insurer from doing business in their state if significant regulatory concerns arise.

Surplus Lines has the Freedom of Rate and Form

- There is also a key difference and the regulation of admitted and nonadmitted insurers.
- Admitted insurers are subject to rate and form regulation at the state level. This regulation is done to facilitate easy comparison for consumers among similar products (e.g. auto insurance from Company A vs. car insurance from Company B).
- Surplus lines insurers, while still regulated at the state level, have freedom of rate and form.
- Freedom of rate and form means a surplus lines carrier can be more innovative, creative and responsive in developing a product that provides the level of coverage a consumer is seeking, while pricing the product in a financially responsible manner commensurate with the risk. Again, these products generally fall in the category of very unique and/or emerging risks.

2. MISCONCEPTION: SURPLUS LINES POLICIES LACK CONSUMER PROTECTIONS.

The surplus lines policyholder/consumer is afforded extensive consumer protection with their state insurance commissioner and the proven state-based system of insurance regulation.

- If the consumer's complaint is specific to the insurer, that Commissioner has the authority to investigate the complaint and coordinate its work and/or any regulatory action with the insurer's domiciliary state. The coordination of regulatory efforts among multiple states is a key strength of the state-based system of insurance regulation, which serves the consumer and the industry well.

- Regarding H.R. 2901, in the event a consumer leaves the NFIP for the private market (be it admitted or nonadmitted) and is displeased with a rate increase during their annual renewal, **the consumer has the option of returning to the NFIP.**
  - In the specific example of the private market renewal, that consumer **could and should** go back to their agent to seek additional quotes from other insurers, both admitted and nonadmitted, where appropriate, as well as the NFIP.
  - This is exactly how it would work under any other private market insurance renewal and there is no reason to expect differently for private flood.

3. MISCONCEPTION: IF WE LET SURPLUS LINES INSURERS WRITE PRIVATE FLOOD INSURANCE THEY WILL CHERRY-PICK THE BEST RISKS AND LEAVE THE NFIP MORE VULNERABLE.

- Terms like "cherry picking" offer a negative bias but the off-loading of exposure to the private sector is the exact intention legislators had when drafting BW12.
- **Insurance companies, admitted and surplus lines companies alike, will evaluate potential policies on a case-by-case basis using sound financial models, actuarial data, capacity, risk appetite and experience to determine their ability to provide coverage options to a consumer**.
- It is the responsibility of private insurance companies to ensure that they have the capital backing to cover the policies they are offering. This type of fiscal responsibility is what we expect to see out of businesses and ensures that the companies are prepared when paying out claims.
- The involvement of private insurance companies will reduce the overall exposure of the NFIP, enabling the program to instead focus on those properties that cannot be adequately priced – either because of repeated losses or affordability concerns related to current residents.
- As the GAO noted in its 2013 report, "subsidized properties count for the majority of the repetitive loss properties in the program." Specifically, "properties that have experienced repetitive flood losses represent 1% of all NFIP policies but 30% of all claims paid."
- In these cases, the private market will likely remain unwilling to insure those risks as insurance premiums are a reflection of risk and companies have a responsibility to ensure they can cover the claims made.

4. MISCONCEPTION: ENABLING SURPLUS LINES INSURERS TO PARTICIPATE IN THE PRIVATE FLOOD MARKET WILL LEAD TO INCREASES IN PREMIUMS.

- H.R. 2901 is a consumer choice bill. It would clarify the definition of "private flood insurance" to ensure lenders understand the types of policies they can accept. The bill PRESERVES the ability for consumers to seek policies in the surplus lines market IF THEY CHOOSE and/or NEED IT.
- H.R. 2901 does nothing to reduce or limit the ability for the NFIP to offer policy solutions at subsidized rates to consumers and they will always have the ability to choose the NFIP policy.
- The legislation merely gives consumers additional options to choose.
- Nothing in the legislation REQUIRES consumers to choose a surplus lines option and so they will continue to have the subsidized NFIP policy as an option.
- Enabling the participation of the surplus lines industry will encourage broader private insurer participation which will ultimately breed competition and LOWER premiums.

5. MISCONCEPTION: SURPLUS LINES INSURERS ARE PUSHING THIS LEGISLATION AS A WAY TO OPEN UP A NEW MARKET AND UNDERCUT THE NFIP.

- This is simply incorrect. **The bill PRESERVES the ability for consumers to seek policies in the surplus lines market IF THEY CHOOSE and/or NEED IT**. *See Appendix C.*
- The preservation of the surplus lines option ensures that consumers will have an alternative choice to the NFIP and to ensure consumers have options when they do not qualify for the NFIP or when they need alternatives to the NFIP.
- **Without the existing surplus lines alternative, consumers who need it will be left with no option.**
- But remember – the surplus lines market is not a direct competitor to the admitted market but rather a supplement or alternative when the admitted market is unable or unwilling to provide coverage.
    - In most instances, brokers must TRY to get flood insurance from the admitted market first. This is called the "diligent search" requirement. Insurance coverage generally has to be declined three times by admitted carriers before the surplus lines market becomes an option.
    - In some states this requirement has been waived for certain products, including flood insurance, because the state insurance commissioner has determined that an admitted option does not exist or nonadmitted options are necessary and good for the consumer.
- In the event a more significant private flood insurance market takes off, the admitted market will become a more active participant and the normal market cycle and related ebb and flow of business between the two markets will result.

- Because of the current prohibition of Write Your Own standard carriers from offering competing products with the NFIP, the standard market will continue to be very slow to develop. As a result, prohibition of the surplus lines will effectively eliminate the development of any private market for flood insurance.

6. MISCONCEPTION: A Transition Period for the Surplus Lines Market will allow Flood Insurance in the admitted market to develop.

- **No. Any prohibition against the surplus lines market is a prohibition to any private market insurance solutions for consumers and will leave the NFIP as the ONLY option.** This result will:
  - Be **bad for consumers**, because consumer choice and alternatives to the NFIP, including cases where the NFIP is not an option for the consumer, will be eliminated;
  - **Kill the development of a private flood insurance marketplace** by thwarting the private market's innovation and development of flood insurance products; and
  - Be **bad for the NFIP** which, without the private market, will be unable to transfer any of its exposure from the federal government's balance sheet to the private market and therefore remains exposed to the next significant flood event.
- **The surplus lines market facilitates the development of the admitted market for unique and emerging risks**. Preventing the participation of the surplus lines market now will completely thwart the development of the admitted market.
- A perfect example of the evolution of surplus lines products to the admitted market is medical malpractice insurance. When physicians first started looking for this product, the admitted market was unable to provide the coverage because there was not enough risk data and experience to understand how to price the product. Surplus lines carriers provided the coverage. As loss data became more available – off of the experience of these surplus lines policies – the admitted market began to move into the space and now offers the majority of medical malpractice insurance.

7. MISCONCEPTION: Taxpayers and Consumers Could Be Left Holding the Bag Because the Surplus Lines Industry Does Not Participate in the State Guaranty System. What Happens if There is a Financial Impairment or Insolvency?

- **Surplus lines insurers have a proven track record of financial solvency. They typically do not participate in the state guaranty system.**

Track Record of Solvency

- The recent A.M. Best report highlighted that the surplus lines industry reported **zero financially impaired companies** for the eleventh (11th) year in a row whereas the property/casualty industry experienced 207 disclosed financial impairments over the same period.

- The primary reason for an absence of impairments is due to the surplus lines industry's improved underwriting performance, driven by demonstrated underwriting discipline and adequate pricing overall. Additionally, states generally require surplus lines insurers to maintain a higher level of capital and surplus (compared to an admitted carrier) due to the lack of guaranty fund participation.

- As of August 2015, **99% of surplus lines companies have excellent or superior ratings**, compared to 78% of the total P/C industry with similar ratings.

Best's Rating Distribution
As of August 2015

Best's Financial Strength Rating		Domestic Professional Surplus Lines		Total P/C Industry	
Level	Category	# of Companies	Percentage	# of Companies	Percentage
A++	Superior	8	8.79%	24	2.75%
A+	Superior	21	23.08%	81	9.28%
A	Excellent	43	47.25%	290	33.22%
A-	Excellent	18	19.78%	285	32.65%
B++	Good	1	1.10%	94	10.77%
B+	Good	-	0.00%	59	6.76%
Subtotal		91	100.00%	833	95.42%
B	Fair	-	0.00%	25	2.86%
B-	Fair	-	0.00%	7	0.80%
C++	Marginal	-	0.00%	1	0.11%
C+	Marginal	-	0.00%	3	0.34%
C	Weak	-	0.00%	3	0.34%
C-	Weak	-	0.00%	1	0.11%
D	Poor	-	0.00%	-	0.00%
E	Under Regulatory Supervision	-	0.00%	-	0.00%
F	In Liquidation	-	0.00%	-	0.00%
Subtotal		-	0.00%	40	4.58%
Totals		91	100.00%	873	100.00%
Not Rated		4		970	
		95		1,843	

7A. When was the Last Insolvency in the Surplus Lines Market and Why Did it Happen?

- The last reported financial impairment was in 2003.

- **Since that date, there have been ZERO reported financial impairments of surplus lines insurers**. During the same time-period, there were 207 reported financial impairments of admitted/standard carriers.

- The 2003 impairment is attributable to the surplus lines subsidiary of a group of insurers, under common ownership, that operated primarily in the admitted market. The group's program

operations were very poorly managed and the surplus lines subsidiary became part of the group's insolvency. The surplus lines business represented only a fraction of the group's total writings.

- The surplus lines insurer was placed in liquidation by its domiciliary state and an "estate" or trust fund was established to pay claims. The company was highly reinsured, which allowed for the continued payment of most claims, with a significant portion paid at 100%. In some cases, the insured successfully sued the surplus lines broker for the unpaid claim.

Did taxpayers pay any of the losses or costs associated with the insolvencies?

- No. The claim costs as well as the costs of administering the estate were paid out of the insurer's remaining funds / assets.

Were there any regulatory <u>changes</u> after the 2003 failure for surplus lines insurers?

- States such as California and New York have increased their minimum policyholder capital and surplus from $15 million to $45 million.

- The NAIC's IID Quarterly Listing of Alien Insurers also requires a minimum capital and surplus of $45 million. Other states, upon implementation of the Nonadmitted and Reinsurance Reform Act of 2010, require a minimum capital and surplus of at least $15 million.

How has the surplus lines market been able to better withstand adverse market conditions?

- One of the hallmarks of the surplus lines insurance market is the development of new insurance solutions to address new or emerging risks, or to provide continually evolving coverage for known risks.

- The core competencies of the successful surplus lines carriers remain the same, focused on effective strategic analysis, innovation, product diversification and underwriting discipline.

- These companies typically concentrate more on bottom-line underwriting performance and profitability than top-line organic growth, while providing coverage for the varied, nonstandard risks that they underwrite.

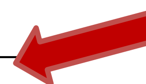
- This focus gives these insurers the best chance to withstand adverse market circumstances and succeed over the long term.

Appendix A: Top 50 Insurance Groups and 2014 Market Share

Insurance Group	2014 DWP	Rank	State of Domicile/Lead State	2014 SL Premium	% Market Share
Lloyd's	$ 8,157,000	1	NAIC's IID/Quarterly Listing	$ 8,157,000	23%
American International Group	5,531,759	2	New York	4,679,470	13%
Nationwide Group	1,985,973	3	Ohio	1,780,987	5%
W. R. Berkley Insurance Group	1,770,734	4	Delaware	1,485,813	4%
Zurich Financial Svcs NA Group	1,747,564	5	New York	1,204,752	3%
Markel Corporation Group	1,191,302	6	Illinois	1,191,418	3%
ACE INA Group	1,032,388	7	Pennsylvania	1,032,388	3%
Ironshore Insurance Group	1,101,430	8	Arizona	894,986	3%
Berkshire Hathaway Ins Group	1,338,445	9	Nebraska	835,316	2%
Fairfax Financial (USA) Group	798,975	10	Delaware	793,974	2%
Alleghany Ins Holdings Group	780,841	11	New Hampshire	780,703	2%
CNA Insurance Companies	743,617	12	Illinois	745,886	2%
XL America Group	726,070	13	New York	726,916	2%
AXIS Insurance Group	590,914	14	Illinois	591,135	2%
Chubb Group	692,732	15	Indiana	574,424	2%
Arch Insurance Group	548,473	16	Missouri	548,931	2%
Argo Group	553,381	17	Illinois	526,430	1%
QBE Americas Group	522,585	18	Pennsylvania	522,550	1%
Allied World Assurance Group	905,644	19	New Hampshire	517,560	1%
Great American P & C Ins Group	472,634	20	Ohio	472,262	1%
Catlin U.S. Pool	444,388	21	New York	443,724	1%
State National Group	434,505	22	Texas	434,505	1%
Aspen US Insurance Group	426,378	23	North Dakota	425,002	1%
Starr International Group	396,952	24	Texas	396,987	1%
Swiss Reinsurance Group	381,215	25	Missouri	378,134	1%
HCC Insurance Group	407,157	26	Pennsylvania	375,470	1%
Travelers Group	713,128	27	Connecticut	360,946	1%
Liberty Mutual Insurance Companies	349,680	28	Massachusetts	350,326	1%
Navigators Insurance Group	755,453	29	New York	316,221	1%
Assurant P&C Group	913,491	30	Delaware	296,296	1%
Munich-American Hldng Corp Compani	604,520	31	Delaware	296,040	1%
Western World Insurance Group	277,072	32	New Hampshire	277,071	1%
Endurance Specialty Group	268,187	33	Delaware	268,714	1%
RLI Group	264,505	34	Illinois	259,933	1%
James River Group	252,703	35	Ohio	252,707	1%
Everest Re U.S. Group	257,874	36	Delaware	225,986	1%
White Mountains Insurance Group	226,916	36	Pennsylvania	225,272	1%
State Auto Insurance Companies	224,805	38	Ohio	222,567	1%
IFG Companies	190,370	39	Illinois	190,370	1%
HIIG Group	189,077	40	Texas	182,997	1%
Global Indemnity Group	184,974	41	Pennsylvania	177,299	0%
SCOR U S Group	183,382	42	New York	174,815	0%
The Cincinnati Insurance Companies	162,412	43	Ohio	162,412	0%
Philadelphia Ins/Tokio Mar Group	161,539	44	Pennsylvania	161,444	0%
Kinsale Insurance Company	158,477	45	Arkansas	157,917	0%
Maxum Specialty Insurance Group	151,703	46	Delaware	151,425	0%
IAT Insurance Group	255,879	47	North Carolina	150,163	0%
Selective Insurance Group	157,586	48	New Jersey	147,070	0%
GeoVera U.S. Insurance Group	141,132	49	California	141,024	0%
Atain Insurance Companies	112,368	50	Michigan	110,009	0%
	$ 40,840,289			$ 35,775,747	100%
			2014 U.S. Surplus Lines Market	$ 40,234,000	89%

Appendix B – 19 States and the NAIC Regulate the Top 50 Surplus Lines Insurance Groups, Representing 89% of U.S. Surplus Lines Market

State of Domicile/Lead State	Surplus Lines	% Share of Top 50	% Share of 2014 SL Market
NAIC's IID/Quarterly Listing	$ 8,157,000	22.8%	20.3%
New York	7,545,898	21.1%	18.8%
Delaware	3,518,248	9.8%	8.7%
Illinois	3,505,172	9.8%	8.7%
Ohio	2,890,935	8.1%	7.2%
Pennsylvania	2,494,423	7.0%	6.2%
New Hampshire	1,575,334	4.4%	3.9%
Texas	1,014,489	2.8%	2.5%
Missouri	927,065	2.6%	2.3%
Arizona	894,986	2.5%	2.2%
Nebraska	835,316	2.3%	2.1%
Indiana	574,424	1.6%	1.4%
North Dakota	425,002	1.2%	1.1%
Connecticut	360,946	1.0%	0.9%
Massachusetts	350,326	1.0%	0.9%
Arkansas	157,917	0.4%	0.4%
North Carolina	150,163	0.4%	0.4%
New Jersey	147,070	0.4%	0.4%
California	141,024	0.4%	0.4%
Michigan	110,009	0.3%	0.3%
	$ 35,775,747	100.0%	88.9%



2014 U.S. Surplus Lines Market	$ 40,234,000

Appendix C: Preserving the Consumer Option