

Common Misconceptions of the Surplus Lines Industry



In the Consideration of Private Flood Insurance Options
H.R. 1422/S. 563

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.
- **Nine states and the NAIC’s International Insurer’s Department (IID) regulate roughly 80% 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, XL Catlin America, Navigators, SCOR U.S. Group and White Mountains Insurance Group
 - **ILLINOIS** regulates Markel, CNA, AXIS, Argo, RLI Group and IFG Companies
 - **DELAWARE** regulates W.R. Berkley, Fairfax Financial, Endurance, Everest Re, Munich-American Holding Corp, Assurant P&C Group and AmTrust Group
 - **OHIO** regulates Nationwide, Great American, James River, State Auto Insurance Companies and The Cincinnati Insurance Companies
 - **PENNSYLVANIA** regulates Philadelphia/Tokio Marine, QBE Americas and Global Indemnity
 - **INDIANA** regulates Chubb
 - **NEW HAMPSHIRE** regulates Alleghany, Allied World and Western World Insurance Group
 - **TEXAS** regulates State National Group, Starr International and HIIG Group
 - **NEBRASKA** regulates Berkshire Hathaway

For other states, see Appendix A.
- Top 50 insurance groups write 90% of the U.S. surplus lines market. This 90% is regulated by 20 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 in 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.

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. 1422/S. 563, 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.

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.
- Through the underwriting process, 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.

MISCONCEPTION: Enabling surplus lines insurers to participate in the Private Flood market will lead to increases in premiums

- H.R. 1422/S. 563 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. 1422/S. 563 does nothing to reduce or limit the ability for the NFIP to offer policy solutions at subsidized rates to consumers and they will always be able 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.

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.**
- 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.
- Further, flood insurance is not new to the surplus lines market. Consumers whose risks have not fit within the terms and limits of the NFIP and whose risks have been declined by the standard market have leveraged the surplus lines market for many years.
- Based on data from nine of the 14 states with surplus lines stamping offices (California, Florida, Illinois, Mississippi, New York, Pennsylvania, Texas, Utah and Washington), the surplus lines market generated flood insurance premium of \$205.5 million in 2016, \$40.6 million of which was for primary residential flood insurance coverage and \$24.9 million of which was for excess residential flood coverage.
- While these figures represent a very small proportion of the \$41.3 billion surplus lines market and the \$3.3 billion of premium written by the NFIP, they represent solutions for consumers who:

- (1) need higher limits than the \$250,000 residential, \$100,000 personal contents and \$500,000 commercial limits offered by the NFIP;
 - (2) need enhanced coverage from that offered by the NFIP such as replacement costs of the damaged property rather than actual cash value of the property, additional sublimits, additional structures, or the ability to schedule multiple properties on one policy; and/or
 - (3) need additional coverage such as additional living expense, basements, or business interruption for commercial entities.
- H.R. 1422/S. 563 will amend the definition of private flood insurance to provide lenders with the certainty they need to accept surplus lines flood insurance policies and will ensure consumers have access to the options they need from the surplus lines market.

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.

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 twelfth (12th) year in a row whereas the property/casualty industry experienced 217 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 2016, **97% of surplus lines companies have excellent, superior or exceptional ratings**, compared to 76% of the total P/C industry with similar ratings.

**Best's Rating Distribution
As of August 15, 2016**

Best's Financial Strength Ratings		Domestic Professional Surplus Lines Insurers		Total Property/Casualty Industry	
Category	Rating Level	# of Companies	Percentage	# of Companies	Percentage
Exceptional	aaa	1	1.12%	3	0.39%
Superior	aa+	8	8.99%	14	1.82%
Superior	aa	4	4.49%	17	2.20%
Superior	aa-	16	17.98%	44	5.71%
Excellent	a+	12	13.48%	86	11.15%
Excellent	a	28	31.46%	174	22.57%
Excellent	a-	17	19.10%	245	31.78%
Good	bbb+	2	2.25%	37	4.80%
Good	bbb+	1	1.12%	43	5.58%
Good	bbb-	0	0.00%	47	6.10%
Total Secure Ratings		89	100.00%	710	92.09%
Fair	bb+, bb, bb-	0	0.00%	32	4.15%
Marginal	b+, b, b-	0	0.00%	5	0.65%
Weak/Very Weak	ccc+, ccc, ccc-, cc	0	0.00%	2	0.26%
Poor	c	0	0.00%	1	0.13%
Under Regulatory Supervision	e	0	0.00%	21	2.72%
In Liquidation	f	0	0.00%	0	0.00%
Total Vulnerable Ratings		0	0.00%	61	7.91%
Total Issued Credit Ratings		89	100.00%	771	100.00%

When was the last impairment in the industry 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 over 217 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 changes 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 \$46 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 2015 Market Share

Top 50 Insurance Group and 2015 Market Share				
Insurance Group	Rank	State of Domicile/Lead State	2015 SL Premium	% Market Share
Lloyd's	1	NAIC's IID/Quarterly Listing	\$ 8,645,000	23%
American International Group	2	New York	4,656,353	13%
Nationwide Group	3	Ohio	1,787,725	5%
W. R. Berkley Insurance Group	4	Delaware	1,547,181	4%
Zurich Financial Svcs NA Group	5	New York	1,229,918	3%
Markel Corporation Group	6	Illinois	1,175,820	3%
XL Catlin America Group	7	New York	1,154,629	3%
Chubb INA Group	8	Indiana	1,037,188	3%
Berkshire Hathaway Ins Group	9	Nebraska	1,000,700	3%
Ironshore Insurance Group	10	Arizona	871,249	2%
Alleghany Ins Holdings Group	11	New Hampshire	780,416	2%
Fairfax Financial (USA) Group	12	Delaware	744,372	2%
CNA Insurance Companies	13	Illinois	675,663	2%
AXIS Insurance Group	14	Illinois	603,112	2%
Philadelphia Ins/Tokio Mar Group	15	Pennsylvania	590,615	2%
Argo Group	16	Illinois	578,360	2%
Chubb Group	17	Indiana	571,890	2%
QBE Americas Group	18	Pennsylvania	544,813	1%
Great American P & C Ins Group	19	Ohio	543,619	1%
State National Group	20	Texas	534,027	1%
Allied World Assurance Group	21	New Hampshire	529,782	1%
Arch Insurance Group	22	Missouri	527,384	1%
Aspen US Insurance Group	23	North Dakota	500,436	1%
Starr International Group	24	Texas	448,580	1%
Travelers Group	25	Connecticut	385,775	1%
Swiss Reinsurance Group	26	Missouri	385,049	1%
Endurance Specialty Group	27	Delaware	371,617	1%
Navigators Insurance Group	28	New York	357,445	1%
Liberty Mutual Insurance Companies	29	Massachusetts	340,198	1%
James River Group	30	Ohio	308,714	1%
Everest Re U.S. Group	31	Delaware	264,797	1%
RLI Group	32	Illinois	254,431	1%
Western World Insurance Group	33	New Hampshire	246,755	1%
State Auto Insurance Companies	34	Ohio	244,382	1%
SCOR U S Group	35	New York	235,468	1%
Munich-American Hldng Corp Companies	36	Delaware	234,227	1%
White Mountains Insurance Group	37	New York	214,433	1%
HIIG Group	38	Texas	204,037	1%
Assurant P&C Group	39	Delaware	196,999	1%
The Cincinnati Insurance Companies	40	Ohio	183,392	0%
IFG Companies	41	Illinois	183,064	0%
Selective Insurance Group	42	New Jersey	179,383	0%
Kinsale Insurance Company	43	Arkansas	175,981	0%
Global Indemnity Group	44	Pennsylvania	172,587	0%
IAT Insurance Group	45	North Carolina	166,244	0%
Maxum Specialty Insurance Group	46	Connecticut	155,299	0%
Allianz of America Companies	47	Minnesota	135,707	0%
GeoVera U.S. Insurance Group	48	California	128,162	0%
Atain Insurance Companies	49	Michigan	122,940	0%
AmTrust Group	50	Delaware	118,319	0%
			\$ 37,244,237	100%
		2015 U.S. Surplus Lines Market	\$ 41,259,000	90%

Appendix B – 20 States and the NAIC Regulate the Top 50 Surplus Lines Insurance Groups, Representing 90% of U.S. Surplus Lines Market

State of Domicile/Lead State	Surplus Lines	% Share of Top 50	% Share of 2015 SL Market
NAIC's IID/Quarterly Listing	\$ 8,645,000	23.2%	21.0%
New York	7,848,246	21.1%	19.0%
Illinois	3,470,450	9.3%	8.4%
Delaware	3,477,512	9.3%	8.4%
Ohio	3,067,832	8.2%	7.4%
Pennsylvania	1,308,015	3.5%	3.2%
Indiana	1,609,078	4.3%	3.9%
New Hampshire	1,556,953	4.2%	3.8%
Texas	1,186,644	3.2%	2.9%
Nebraska	1,000,700	2.7%	2.4%
Missouri	912,433	2.4%	2.2%
Arizona	871,249	2.3%	2.1%
Connecticut	541,074	1.5%	1.3%
North Dakota	500,436	1.3%	1.2%
Massachusetts	340,198	0.9%	0.8%
New Jersey	179,383	0.5%	0.4%
Arkansas	175,981	0.5%	0.4%
North Carolina	166,244	0.4%	0.4%
Minnesota	135,707	0.4%	0.3%
California	128,162	0.3%	0.3%
Michigan	122,940	0.3%	0.3%
	\$ 37,244,237	100.0%	90.3%

2014 U.S. Surplus Lines Market \$ 41,259,000

Consumer Options for Flood Insurance

The current definition of private flood insurance causes uncertainty regarding the role that surplus lines insurance can continue to play in fulfilling a consumer's obligation to purchase flood insurance. H.R. 1422/S. 563 was introduced to ensure consumers continue to have surplus lines options when securing flood insurance from the private market.

