AN INTRODUCTION TO THE

Surplus Lines Market

THE FOLLOWING materials are intended to provide an overview and introduction to the surplus lines market. They have been created in collaboration with and support of the members of the state and national trade organizations and stamping offices representing the surplus lines insurance industry listed here. If you have any questions or would like to discuss these materials in more detail, please contact any of us directly.

What is Surplus Lines Insurance?

Surplus lines insurance is a $40.2 billion industry which represents 7.6% of the total property and casualty industry. Surplus lines predominantly covers commercial insurance risks, with the overall market share being approximately 13.9% of the total commercial lines market. The surplus lines market, also known as the nonadmitted market, functions as a supplement or complement to the standard (admitted) market.

In general, as a supplemental market, the surplus lines market does not compete with the standard market; rather, it provides coverage options (e.g., supplemental coverages, higher limits, unique terms and conditions, etc.) when the standard market cannot or will not underwrite the level of coverage needed.

The surplus lines market is not the primary market for most insurance coverages, but it is a critical market as supply and demand for insurance ebbs and flows. The surplus lines industry generally serves as the innovator for new and emerging risks and related insurance products. The ability and flexibility to customize coverage for new and emerging risks is one of the key strengths of the surplus lines market. Surplus lines insurers do this by focusing on underwriting for the specific risk to be insured. In order to ensure new or unique risks are underwritten appropriately, surplus lines insurers are highly specialized and conduct specific research to understand the underlying exposure. As loss histories develop on these product lines, the standard market will leverage the data and experience from the surplus lines market to develop more standardized products, rates and forms that offer similar solutions.

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Conversely, when the standard market experiences significant or catastrophic losses in certain product lines or regions (e.g., catastrophic storms in coastal states), their underwriting practices and risk appetites become more conservative resulting in a shift of these risks back to the surplus lines market. Regulators have a successful record handling the impact of catastrophic storms on the ability of standard insurers to continue to provide appropriate coverage to consumers and the surplus lines industry has been able to serve as an effective supplement in such cases, offering consumers options that no longer exist in their standard market.

How is the Surplus Lines Market Regulated?

The surplus lines market is regulated by state insurance regulators. Some state statutes refer to the surplus lines market as the “unauthorized” or “unlicensed” market, which can mistakenly give the impression that the market is not regulated. This is untrue. The surplus lines market is regulated!

Every state has rules and regulations within its insurance code that are specifically written to govern surplus lines insurance. Many of the same rules that are applicable to licensed, admitted insurers also apply to surplus lines insurers. The regulation of the surplus lines transaction allows the surplus lines market the opportunity to provide coverages consumers may otherwise go without, as well as protections for those consumers.

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To obtain and maintain their licenses, both standard and surplus lines insurers are subject to all of the same rigorous rules and regulations, and must comply with all financial solvency requirements, market conduct standards and regulations of their state or jurisdiction of domicile. Each U.S.-based surplus lines insurance company is domiciled 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 regulated as a domestic insurer in at least one state.

Surplus lines insurers domiciled outside of the United States are regulated, too. They may be included on the NAIC Quarterly Listing of Alien Insurers upon meeting capital and surplus requirements, agreeing to maintain U.S. trust accounts and meeting certain character, trustworthiness and integrity requirements. This process is overseen by state insurance regulators through the NAIC’s International Insurers Department (IID).

There are a few key differences in the regulation of surplus lines insurers. Surplus lines insurers generally do not write surplus lines in their state of domicile; rather, surplus lines coverage is generally written in other states where the insurer operates on a surplus lines basis. Therefore, in a surplus lines transaction, both the surplus lines insurer and the broker are regulated. In accordance with the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA), the insured’s home state requires a surplus lines broker to be licensed in order to sell, solicit, or negotiate surplus lines insurance with respect to such insured. Perhaps most importantly, in the typical surplus lines transaction, the surplus lines broker (often a wholesale broker with a high level of expertise in the underlying risk) works directly with the consumer's agent/producer that is seeking the nonstandard insurance solution on behalf of their client. In this regard, and also distinct from the standard market, the licensed surplus lines broker is responsible for (1) placing the coverage with a financially strong, eligible surplus lines insurer; (2) reporting the surplus lines transaction to insurance regulators; (3) remitting the premium tax due on the transaction to state tax authorities; and (4) assuring compliance with all the requirements of the surplus lines regulations for that state.

Surplus lines insurers in turn must be "eligible" in the home state of the consumer in order to underwrite coverage. To be deemed "eligible" under state law, and reinforced by the NRRA, the surplus lines insurer must meet capitalization thresholds. In most cases, these thresholds require a surplus lines insurer to keep more money in reserve than its standard insurer counterpart.

Regulating the Flow of Coverage between the Standard and Surplus Lines Markets

Placement of risks in the surplus lines market is governed by state statutes and regulations. Most states require an agent to seek coverage from the standard market and verify they were declined by that market before they may seek coverage from the surplus lines market through a licensed surplus lines broker. This process is often referred to as "diligent effort."

Additionally, some states use "export lists" to regulate the flow of business between the standard and surplus lines markets. An export list outlines the types of insurance products and coverages the state allows to go to the surplus lines market without a diligent search of the standard market. They represent an effective tool for each individual state to monitor and regulate their own insurance markets. The fact that the export lists vary by state, is evidence that not all products and coverages are available in all states on a standard basis and that insurance regulators have recognized the need for consumers to have this option.

Surplus Lines Market Financial Safety

The surplus lines market has a stellar financial reputation. A.M. Best, a credit rating agency with a focus on the insurance industry, has monitored and reported on the surplus lines insurance market for over twenty years, publishing an annual special report providing data and an overview of the market for those involved in the insurance industry as well as insurance regulators and legislators.

In the 2015 report A.M. Best once again indicated that 100% of the surplus lines insurers have a secure rating, and that they have a higher secure rating than their admitted counterparts — an important factor for businesses whose unique and innovative risks brought them to this market for insurance.

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	

Why do Consumers need Surplus Lines Insurance?

Surplus lines insurance is often referred to as the 'market of last resort' by the business community and the 'safety valve' of the insurance industry. These labels recognize the important role of surplus lines insurers to fill the need for coverage in the marketplace by providing capacity to catastrophe-prone risks and coverage for risks that are declined by the standard underwriting and rating processes of standard/admitted insurance carriers. By stepping in to provide coverage, surplus lines insurers allow consumers to avoid purchasing coverage that doesn't meet their needs, self-insuring against their risks, or going without the financial protection insurance provides to these consumers.

The surplus lines consumer is afforded extensive consumer protection with their state insurance commissioner and the proven, state-based system of insurance regulation. If the consumer has a complaint, they may go directly to their insurance department. If the 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.
Additionally, the Commissioner directly regulates the surplus lines broker and will work through them as well to resolve complaints.

The Impact of the Surplus Lines Market on Communities

For insurance risks such as vacant properties, nursing homes, builder's risk and older high-value homes, the surplus lines market functions as the insurance industry's safety-valve and foundation for economic innovation and has a critical impact on commerce in communities across the nation. There are many examples of the significant impact the surplus lines market, including:

- **New business start-ups:** According to Forbes Magazine, over 540,000 Americans start businesses every month. These hopeful entrepreneurs fuel our economy and keep our towns and cities vibrant. One of the first things these new business owners need is an insurance policy to protect their investment, but without a track record, standard insurers may decline offering coverage. The surplus lines insurance market is where these budding enterprises turn for help in making their dreams realities.

- **Innovative products and new technology**: Standard insurers look to standardized, regulated forms and rates to address the needs of their business customers. This model takes time and an established loss record of both

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the risks and all the possible consequences involved in insuring products and services. But what if there is a business that wants to introduce cutting edge technology or has developed something so new and innovative that it will change everything? Surplus lines insurance is the place that can structure insurance protection for what is unique, new and different, freeing our best minds to find that next breakthrough that will move us all forward.

- **A risk that is too big to consider:** Businesses face risks every day. There are risks they understand, like building niche markets. There are risks they choose to transfer, like the risk of losing their offices to fire. Then there are other kinds of risks that by their very nature would be devastating, like losing all their customer records to computer hackers (data breach). Standard insurers may decline to write these 'catastrophic' types of exposures. It is in the surplus lines insurance market that one typically finds the knowledge and capacity necessary to insure these very real concerns for the business community.

- **Catastrophic storm impacts:** All states with a history of dealing with catastrophic storms have been impacted by the normal, downward shift in the standard market's appetite for providing coverage in the wake of catastrophic losses. The surplus lines industry has been able to serve as an effective supplement in such cases, offering consumers options that may no longer exist in the standard market. Such events result in an ebb and flow of business and risk appetite between the standard and surplus lines markets – a market cycle that has proven to be quite effective for decades and illustrates the supply and demand for insurance products.

- **Cutting-edge research:** The United States is one of the greatest innovators for research in areas such as medicine and science. Many of the areas of research are unique, pioneering projects that save and transform our nation and our world; however, in order to make these groundbreaking changes, the researchers need insurance coverage. This is a prime example of where the surplus lines market is able to provide specific, tailored coverage for these unique risks so that the researchers may conduct their studies and bring their ideas to reality.

- **Evolving risks:** As businesses develop and grow, so do the types of risks they experience. Over the years the surplus lines market has developed coverages to address and protect these businesses and allow them to further develop and become national and world-wide leaders. Some examples of coverage first developed by the surplus lines market include: employment practices liability, directors' and officers' liability, medical malpractice, and cyber risks.

Preserving Consumer Options

The Surplus lines market offers critical coverage options and opportunities for consumers that may otherwise have no solution. It is a strong and well-respected market making significant impacts on the development and continuation of commerce and industry in communities around the nation.

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Preserving Consumer Options for Hard-to-Place Insurance

1 INSURANCE NEED

Consumer needs insurance.

2 NONSTANDARD RISK

The consumer's risk is considered nonstandard. The individual, business or professional presents an insurance risk that is new (startup business); distressed (vacant property); unique (hazmat); high-capacity (art collection); catastrophe exposure (hurricane); or, emerging risk (TNC).

3 STANDARD INSURANCE MARKET

Coverage may be available to the consumer in the standard market, however it may not be adequate. In many instances, the standard market may decline the risk altogether.

4 COVERAGE UNAVAILABLE

If the standard market cannot or will not provide coverage for the consumer, their retail insurance agent may seek coverage through the surplus lines market with the help of a licensed surplus lines broker.

5 WHOLESALE VALUE ADDED

Skilled agents and brokers retain the ability to access the surplus lines market to find solutions for the insured client's complex risk.

6 SOLUTION

The surplus lines industry is preserved as a market where freedom from rate and form regulation enable specialty insurers to offer options and solutions to consumers that exceed the limits, coverage terms, conditions and services the standard market is able to offer.