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Excess and Surplus Lines The Exciting Insurance Market!

*The Role of the Surplus Lines
Market in
Property/Casualty Insurance*

By John T. Bogart

"Proceed carefully in that direction from which all others are fleeing." (old E&S maxim)

The surplus lines segment of insurance is important, even vital, to the health of the industry because it provides a market for hard-to-place risks that standard (i.e., licensed, admitted) carriers are unable or unwilling to cover. Sound simple? Basically, it is! I'm going to try to explain this as well as I can, given the limits of my space and your attention span.

The purpose of the surplus lines market is to supplement the standard market, not to compete with it. Not being subject to filed rates or policy forms or to prior approval of underwriting criteria by state regulatory authorities, the surplus lines market fills a genuine need for coverage by insuring risks which would otherwise go unprotected. A good example is the liability insurance crisis of 1986. For various reasons, the standard carriers sharply and abruptly constricted their writings of liability insurance, especially products liability. Seemingly countless numbers of risks were begging for a home and accepting restricted coverages and lower limits of liability at vastly increased premiums

or were forced, unprepared, into self-insurance. The situation became so severe that even general news magazines such as *Time* featured cover stories bearing such titles as "America, Your Insurance Is Canceled!"

The surplus lines market responded in its historic role of "safety valve" to the larger insurance industry and relieved the pressure on the standard markets until the situation stabilized. Admittedly, surplus lines carriers and brokers made themselves a tidy profit performing their heroic role and now lazily dream of those halcyon days, vainly hoping for their unlikely return. But the system worked! The surplus lines market did proceed in that direction from which all others were fleeing.

Some years earlier, the reduced amount

of available fire insurance following the riots of the 1960s led to permanent solutions, such as the FAIR Plan, because of the joint intervention of industry and government, but the surplus lines market gave those entities the necessary breathing room in which to find those solutions. The same can be said of the severe contraction of medical malpractice insurance in the 1970s. The list is lengthy and filled with anecdotes, but you get the idea of the importance of this unsung market, populated with rugged individualists just brimming with creative solutions that the more staid standard markets sometimes view with suspicion.

The surplus lines market is relatively free

(**Exciting**, continued inside)

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(*Exciting*, continued from cover)

from state regulation in the areas of rate and policy form. That does not mean that it is unregulated. Each surplus lines carrier must be admitted (licensed) in one of the 50 states and must meet all of its solvency requirements. Thus that state, called the *state of domicile*, becomes the regulator of that carrier. The other 49 states are not powerless to prevent a surplus lines carrier from writing in their states even though it has met the requirements of its state of domicile. Quite the contrary, states' rights is still a very viable concept in the insurance world. After receiving the blessing of its home (domicile) state to go forth and write amongst the multitudes, the surplus lines carrier solicitously asks permission of other states to be *whitelisted* (allowed to write business) in that state. Procedures have been implemented in recent years to streamline this lengthy system, but any state has the right to decline approval to write within its borders or to order a carrier to "cease and desist" binding risks.

This is not just theory — it's done all the time. In addition to operating under the not-always-benevolent gaze of the various insurance commissioners, surplus lines carriers are subject to thorough financial scrutiny by organizations such as A.M. Best, among others. So while we can say that these carriers have nontraditional ways of underwriting and marketing, they must, and usually do, operate from a solid financial base and in harmony with sound business practices.

Where does this relatively small number of carriers get its business? The sheer number of insurance agents and brokers precludes them from dealing with all or most of them, even those who hold the required surplus lines brokerage license. These few carriers would be overwhelmed by the number of risk submissions and would be unable to control their sources of business.

They have solved this logistical problem by appointing only specialty surplus lines brokers called wholesalers. These producers deal only with retail insurance agents and brokers who actually control the risk or are bidding on it. Wholesalers rarely, if ever, deal directly with the insured. Their client is the insured's agent or broker. Wholesale E&S

brokers range in size from a small single office to large regional, national and international firms.

Sometimes these brokers may hold a binding authority granted them by one of their surplus lines carriers for a specific class of business. The jargon for this is "having the pen." Thus, in addition to being surplus lines brokers, they are also managing general agents. To further complicate things for you, a surplus lines carrier may give the broker authority, within rigid guidelines, to arrange facultative reinsurance on its behalf. Now the broker is acting as a reinsurance intermediary.

In addition to frequently changing hats, the broker is also responsible for arranging the state filings for risks placed in the nonadmitted market and for the submission of these filings to the stamping offices of various states. Most jurisdictions require a special surplus lines license in addition to the standard agents and brokers license as well as a separate surety bond. Almost all brokers and carriers exclusively engaged in surplus lines belong to a professional organization of their peers called NAPSLO (National Association of Professional Surplus Lines Organizations).

In the interests of simplicity, I'm writing about the largest segment of surplus lines carriers, those that A.M. Best calls the domestic professional surplus lines companies. These companies are licensed in at least one state (remember the state of domicile) and write at least 50 percent of their total book of business on a nonadmitted basis. This segment wrote \$6.5 billion of direct premiums, or 70.3 percent of the total market share, in 1995.

Then comes Lloyd's of London, whose premium volume for this business was at a reduced \$1.3 billion, accounting for 14.1 percent of the surplus lines market, down from 23 percent at its peak a decade earlier.

The third segment consists of regulated alien companies, those which are domiciled outside the United States but which write business in accordance with the standards of the National Association of Insurance Commissioners. They racked up premiums of \$1 billion, or 11 percent of the market.

The remaining market share came from U.S. carriers, which wrote only a small per-

centage of their volume in surplus lines and from the unregulated alien market, a group having virtually no financial reporting requirements and which are subject to no U.S. regulatory authority.

In closing let me share with you an anecdote which will give you insight into the excess and surplus risk selection process.

Twenty-five years ago, after serving nine years as a standard market underwriter, I showed signs of chafing under the necessarily slow and measured pace of an industry giant. My supervisor, not meaning it as a compliment, observed that I probably should be in the nonadmitted market with the other mavericks. Within a month I was sitting in a premier surplus lines company, puzzled by the absence of manuals, directives and referral sheets on my desk. Observing two of our seasoned underwriters chatting at the water cooler (yes, we had water coolers in those days), I timidly approached and asked them just how they decided which was a good risk and which should be declined. After informing me outright that damned few risks should be declined, that almost anything can be written at some kind of price and on some terms, the property underwriter gave me his example: "Look, rookie, suppose you're offered a local restaurant for a package policy including business interruption. After you've determined that it has at least conformed to the minimum fire code, drive by on a Monday or Tuesday night. Count the cars in the parking lot. If it's more than half full, it ain't gonna burn. Write it!" I turned to the casualty underwriter, who told me that that very morning he was offered a fireworks display exhibitor. "My only questions were these," he said. "Has he been doing fireworks displays for five years? If his answer is yes, does he have 10 fingers and 10 toes? If yes again, he knows what he's doing. I wrote it!" And thus to this day the surplus lines underwriter and his equally inscrutable broker carefully proceed in that direction from which all others are fleeing. **KHA**

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