Overview of Surplus Lines Operations

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WHAT IS THE SURPLUS LINES MARKET AND WHY IS IT NEEDED?

When faced with a hard-to-place risk that has been declined by insurers in the standard market, where can a producer turn to obtain the required coverage for his or her customer?

It can be difficult to obtain insurance for some risks because of their characteristics. When the standard market is unable or unwilling to provide coverage, producers can turn to the surplus lines market (also known as the excess and surplus, or E&S, market) to find the insurance protection their customers need. Surplus lines risks are traditionally classified as distressed, unique, or high capacity.

A Supplementary Market

The majority of property-casualty risks in the United States are underwritten by **admitted insurers** in the **admitted market, or standard market**. In an effort to maintain insurer solvency and to protect consumers, state insurance departments require admitted insurers to file and obtain approval for their rates, forms, and underwriting rules. Because they cannot deviate from their approved filings, admitted insurers in the standard market do not have the flexibility to underwrite high-risk loss exposures profitably. For example, a standard market insurer might decline to insure a high-rise condominium in a hurricane-prone area.

In addition, it is usually not cost-effective for standard market insurers to develop the underwriting expertise needed to insure highly specialized loss exposures, such as space satellites. These constraints create a need for a supplementary market that can accommodate special risks. The **surplus lines market**, a comparatively small segment of the insurance industry, performs this vital function in the U.S. See the exhibit "How Big Is the Surplus Lines Market?."

Insurance purchased through the surplus lines market is provided by **nonadmitted insurers**, which are not licensed to operate in the insured's home state. Under each state's **surplus lines law**, licensed surplus lines brokers are permitted to place insurance with approved, nonadmitted insurers for risks that cannot be placed in the admitted market. Nonadmitted insurers typically are not required to obtain approval for their rates, forms, and underwriting rules.

Admitted market, or standard market

The distribution system consisting of admitted insurers and their producers.

Admitted insurer

An insurer to which a state insurance department has granted a license to do business within that state.

Surplus lines market

The distribution system of surplus lines insurers and intermediaries that provides insurance on risks for which insurance is not available from admitted insurers.

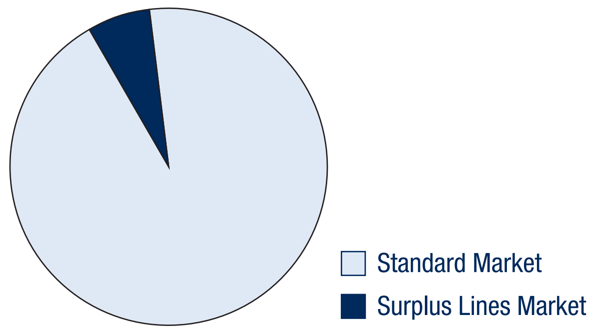
Nonadmitted insurer

An insurer not authorized by the state insurance department to do business within that state.

Surplus lines law

A state law that permits any producer with a surplus lines license issued by that state to procure insurance from an eligible surplus lines insurer if the applicant cannot obtain the desired type of insurance in the admitted market.

How Big Is the Surplus Lines Market?



Between 2001 and 2010, direct premiums written (DPW) for the surplus lines market averaged 6.6% of DPW for the total property-casualty industry. In 2010, surplus lines premiums totaled $31.7 billion, while the total property-casualty industry developed $481 billion in premiums.

A.M. Best Co., 2011 Special Report: U.S. Surplus Lines—Market Review (Oldwick, N.J.: A.M. Best Co., 2011), p. 2. [DA08661]

As a result, they can modify coverage and pricing in ways that allow them to underwrite special risks profitably. This benefits consumers by providing them with coverage that would otherwise not be available. Many businesses and not-for-profit organizations would be unable to operate without these surplus lines coverages.

The surplus lines market writes a wide variety of risks and coverages. Risk examples include airports, amusement parks, drug and alcohol treatment centers, hazardous waste facilities, medical centers, mobile home parks, railroads, security services, and sports facilities. Coverage provided may include, among others, professional liability, environmental impairment liability, excess and umbrella liability, kidnap and ransom, and event cancellation. To a lesser extent, individuals and families may have loss exposures that can be insured only in the surplus lines market, such as a valuable art collection or homes in areas prone to hurricanes or earthquakes.

Almost any coverage that cannot be written in the standard market is eligible for placement in the surplus lines market. However, state laws generally require workers compensation and automobile liability coverage to be placed with admitted insurers.

Categories of Surplus Lines Risks

A traditional method of classifying risks insured in the surplus lines market uses three broad categories to describe the characteristics that make risks unacceptable in the standard market:

- Distressed risks
- Unique risks
- High-capacity risks

Underwriters in the standard market generally prefer to avoid a **distressed risk**. A property risk with a large recent loss attributable to poor maintenance or an apartment complex with a high frequency of general liability losses could be unacceptable to standard market insurers. Similarly, an insured that engages in hazardous operations, such as crop dusting or serving alcoholic beverages to the public, might be unable to obtain insurance in the standard market.

Distressed risk
A risk characterized by unfavorable attributes that have made it unacceptable to admitted insurers.

Unlike a distressed risk, a **unique risk** does not necessarily have unfavorable attributes. Examples include special events, like festivals or parades, or a medical device manufacturer that needs products liability coverage while a new product is in clinical trials. Admitted insurers are generally unwilling to insure unique risks for a number of reasons. Typically, their staff does not have the specialized skills to underwrite and price the coverage, and they may not have a policy form that appropriately covers the exposure. Moreover, they do not expect to insure an adequate number of similar risks. The premium they can charge may not justify the administrative expense of underwriting and rating the risk.

Unique risk
A risk that is so specialized or unusual that admitted insurers are unwilling to insure it.

A **high-capacity risk** represents a significant loss exposure that standard insurers prefer to avoid. A museum may own an art collection insured for more than $1 billion. A chemical plant could become legally liable for several hundred million dollars in damages if a toxic chemical were to escape in large quantities.

High-capacity risk
A risk that requires high limits of insurance that may exceed the underwriting criteria of admitted insurers.

Closely related to unique risks is the fourth category of new risks. Because surplus lines insurers are not subject to rate and form filing regulations, the surplus lines market has the flexibility to respond to new or emerging risks more quickly than the standard market. For example, employment practices liability insurance, environmental insurance, and cyber risk coverages all originated in the surplus lines market before eventually being offered in the standard market. These coverages continue to be written in the surplus lines market for insureds that are unacceptable to admitted insurers.

Reality Check

Surplus Lines Solution for a Daycare Center

Tony is a commercial lines producer at Regional Insurance Brokerage. He has been approached by the owners of a new venture, ABC Daycare. The owners want to obtain the property, liability, and workers compensation coverage they need to begin operations. Tony knows he will be able to place the property and workers compensation coverage relatively easily, but he is concerned that daycare centers present liability loss exposures most standard insurers prefer to avoid. He explains the situation to his clients and says that the only real option is the surplus lines market. Tony approaches a surplus lines broker who is able to place ABC's daycare liability coverage with a nonadmitted insurer that offers a special policy designed specifically for daycare operators. Although the premium is higher than the owners had anticipated, they are pleased with the coverage and accept the price because they would not have been able to open their doors without the required liability coverage.

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WHAT ENABLES THE SURPLUS LINES MARKET TO FUNCTION EFFECTIVELY?

The purpose of the surplus lines market is to provide insurance protection for distressed, unique, high-capacity, and new risks that cannot obtain coverage in the standard market. The surplus lines market functions effectively in the United States because it is supported by surplus lines laws in all states and because of attributes of the market itself.

Several factors allow the U.S. surplus lines market to accomplish its purpose:

- Surplus lines laws
- Freedom from form and rate filing requirements
- The surplus lines distribution system
- Surplus lines insurers
- Surplus lines insurance products

Surplus Lines Laws

The first property insurance company in Colonial America was the Philadelphia Contributionship, which began operations in 1752. Although individual states enacted insurance laws before 1800, it was not until the mid- to late 1800s that the growing industry began to be actively regulated. States licensed insurers and, to protect the insurance-buying public, regulators worked to prevent unlicensed insurers from underwriting risks in their jurisdictions.