Introduction to Surplus Lines

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NOVEMBER 12, 2024

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Rising Complexity of Property Insurance is Driving the Surplus Lines Market

- As climate becomes more volatile, insurers becoming less confident about property risks.
- When insurers become less confident, they raise prices and tighten availability.
- Regulators trying to limit impact on policyholders by restricting rate increases and non-renewals.
- This restricts insurer ability to rapidly respond to market conditions, worsening the situation, causing:
  - Increase in markets of last resort (e.g. FAIR Plans / Citizens - see PIR this week).
  - Increase in voluntary market surplus lines.
- Surplus lines have been growing in size and importance in many states.
- Among most complex parts of P&C insurance business.
- We’ve created an overview of how surplus lines works and why it matters.

What is the Surplus Lines Market?

- Surplus lines is a market that is **not admitted**.
- Surplus lines carriers may be **domiciled**:
  - In another state as admitted.
  - In another state as surplus lines, where permitted (i.e., AZ, UT).
  - In another country (alien).
- Surplus lines carriers **do not participate in a state's guaranty fund.**
- Surplus lines carriers **are subject to *less* regulation than admitted carriers** because the insurance products are not filed with the state where the insurance is sold.
- As a result, surplus lines carriers **are more flexible in the kinds of risks they can write.**

What Does a Surplus Lines Transaction Look Like?

1. Customer having difficulty getting an **admitted policy**.
2. Customer referred to a surplus lines broker.
3. Surplus lines broker satisfies **diligent effort** of admitted market to export risk to surplus lines.
4. Surplus lines broker identifies a carrier that meets **surplus lines requirements** in the property state.
5. Surplus lines broker issues policy **with required disclosures / reporting**.

How Does the Surplus Lines Broker Satisfy Diligent Effort?

- Diligent effort requirements vary by state. Generally, is a search of the admitted market and getting 2-3 quote declinations by admitted carriers.

- Some states do not require it at all while some prescribe coverages/exposures that automatically qualify, enumerated in an **export list** (e.g. CA: excess flood, vacant buildings; AZ: earthquake, flood, medical marijuana dispensary/grow facility).

- Brokers ensure carrier meets diligent effort requirements.

How Does a Surplus Lines Broker Identify a Surplus Lines Insurer?

- Ensure carrier meets requirements of state from which the risk is being exported.
- One way is to see if insurer is on the state's approved surplus lines insurer list.
- Another way is to verify that the insurer meets the capital requirements and other requirements required by the state from which the risk is being exported (e.g., CA insurer is license for the line of business in its domicile state and has over $45 million in PHS).

Other Surplus Lines Broker Responsibilities

- Surplus lines brokers have requirements above and beyond typical agents:
  - Must be licensed as a surplus agent.
  - May require a bond up to $50,000.
  - Pay surplus lines premium tax to property state (instead of insurer).
  - Reports surplus lines policies, due diligent effort, and surplus lines stamping fee.
  - Provide notice to policyholder that policy not covered by guaranty fund.
- What is a stamping office?
  - Non-governmental non-profit agency authorized by law, one for each state.
  - “Stamp” surplus lines policies with fee and notice that no rate and form regulatory review.
  - May provide reporting on surplus lines market for their state.

How Does Surplus Compare to Admitted?

- **Less regulation** – product filings not necessary but subject to surplus regulatory requirements.
- More capital – surplus lines **capital requirements higher than admitted** (ie: CA $45 million).
- Surplus lines carriers are **generally prohibited from direct marketing** (allowed under strict rules).
- Instead, everything goes through the surplus lines **broker who plays a more prominent role**.

How Can Insurers Use Surplus Lines?

- Allows carriers to create new insurance products to underwrite emerging markets profitably. An insurance group needs to be careful to avoid overlapping underwriting eligibility between admitted and surplus lines programs.
- More control over rates, profit, and risk, and can rapidly respond to changing market needs.
- Surplus lines rates not regulated so can consider all costs of risk transfer and quickly react to evolving costs.
- Surplus lines underwriting and policy language can be tailored to customer's specific risk.
- Rather than declining a customer altogether, can write the risk via surplus lines.

What Does it Take to Get Started as Surplus Lines?

- Today, some states (i.e., AZ, UT) have an application process to domicile a new carrier as surplus lines. The surplus lines broker may prefer dealing with a carrier focused on surplus lines underwriting, acceptance, reporting, and capital requirements.
- Doesn’t need to be set up as a ‘surplus lines’ insurance company though. Could be an existing admitted insurance company in another state.
- Carrier injects capital that meets highest surplus lines capital requirements across target states it plans to import business and implements a strong ERM program to maintain financial strength.
- Develop relationships with surplus lines broker(s) licensed in target states.
- Offer flexible insurance products and responsive solutions to meet unique risks being exported to surplus lines.

States With Highest Surplus Lines Market Share CY 2022 Property

State	Surplus Market Share (% of State Admitted + Surplus)
Alabama	12.8%
California	10.7%
South Carolina	4.5%
Mississippi	4.5%
Florida	4.1%
Louisiana	3.8%
Other States	0.4%
Countrywide	**2.2%**

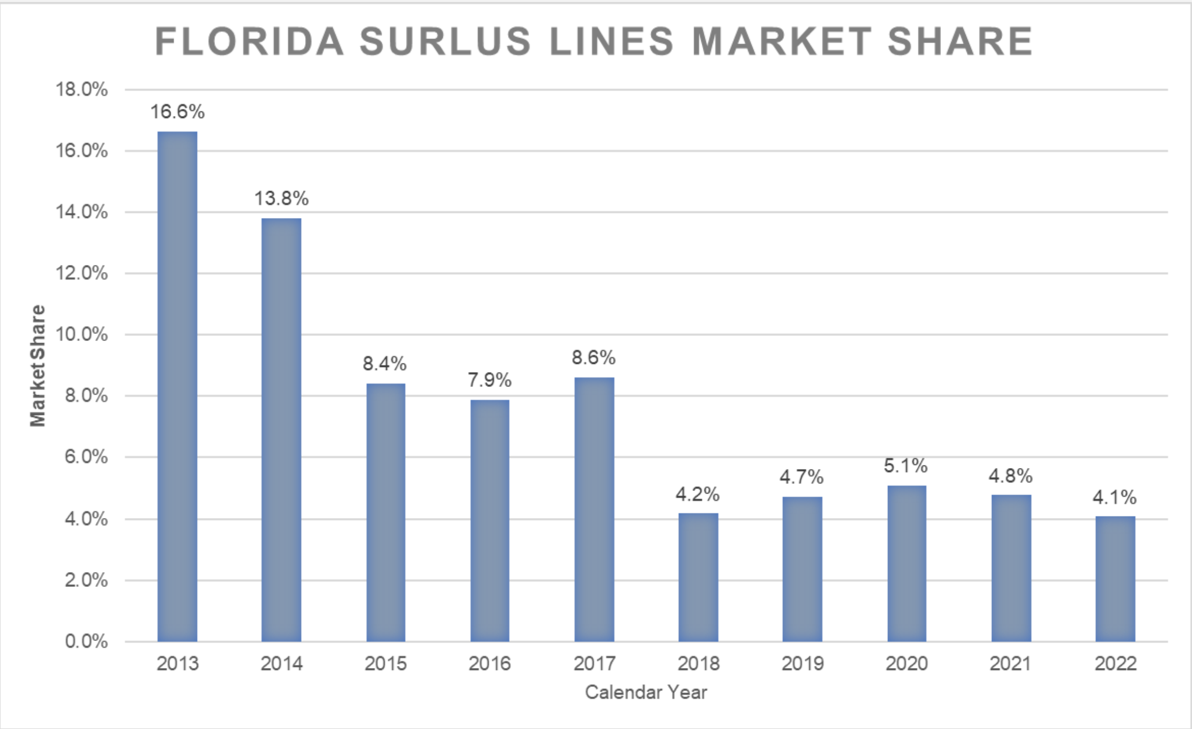
Note: FL and LA Citizens report DWP in NAIC Homeowners line; OH, TX FAIR Plan included in NAIC Homeowners line, but NAIC report appears to exclude other FAIR Plans such as CA FAIR Plan which is Dwelling Fire but does not prepare NAIC Annual Statement so manually added. Doesn't include earthquake or flood.

- Property includes:
  - NAIC Homeowners Line.
  - NAIC Dwelling Fire and Allied Lines.
  - Some Markets of Last Resort (e.g., CA FAIR Plan).
- All natural catastrophe states.

What Drives Surplus Lines Market Share?

- Catastrophe exposure (i.e., hurricane, flood, tornado, wildfire).
- Emerging risks until admitted market collects enough data comfortable going through regulatory filing process (i.e., cyber).
- Admitted market pressure:
  - Lack of adequate return on net worth.
  - Rate suppression and longer regulatory review times.
- When pressure builds up in admitted market, surplus lines acts like a relief valve providing bespoke coverage at a higher rate, until the industry sorts itself out.

Industry Trends
Florida Homeowners Line of Business Including Citizens



Surplus lines market share past 10 years driven down by:

-> FLOIR permitted reinsurance costs, cat models, and decreased approval time to < 3 months.

-> Reduced residual rate need < 5%.

-> Increased return to 15%+.

-> Reduced surplus to < 5%.

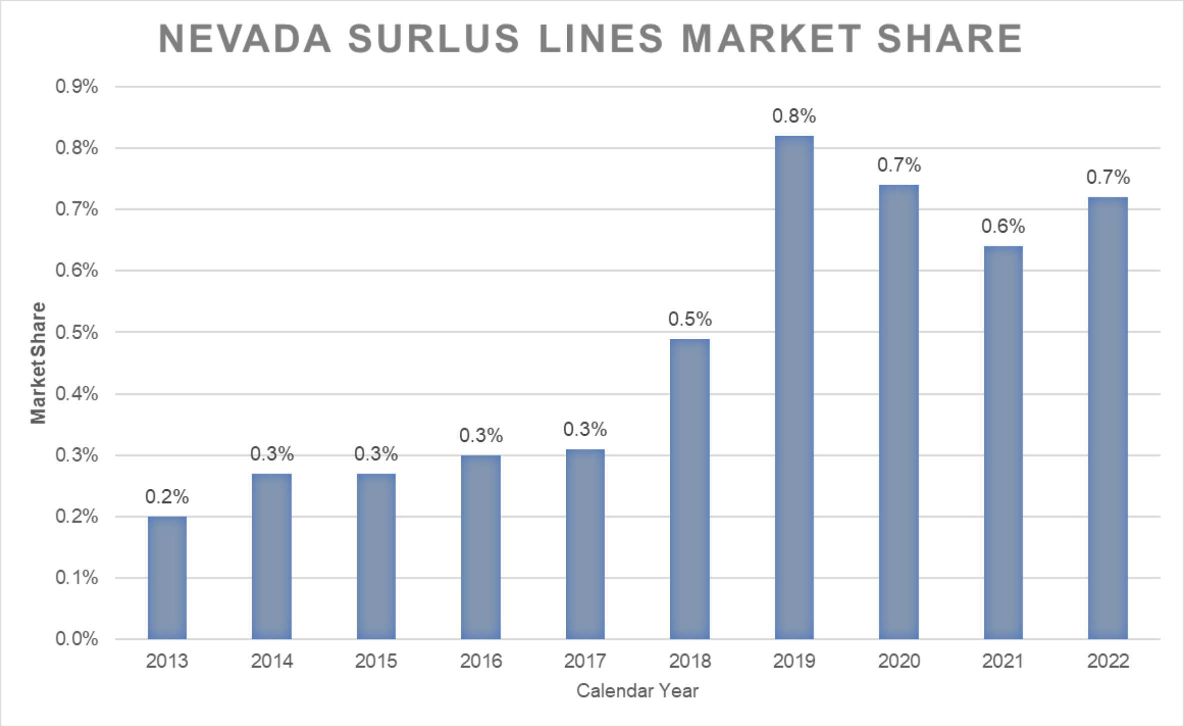
Likely surplus market increase in 2023/2024 driven by:

-> Uptick in days to approval since 2020 to > 4 months.

-> Increase in residual rate > 5%.

-> Reduced return below 5%.

Industry Trends
Nevada Homeowners Line of Business



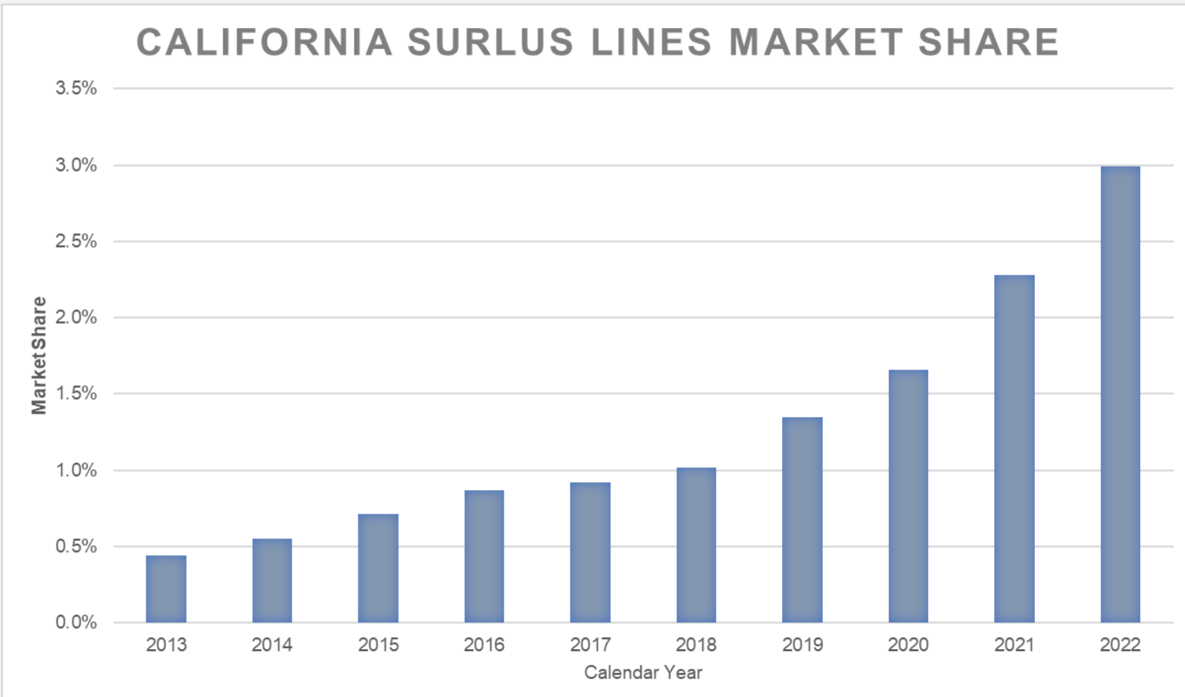
Surplus lines market share increasing driven by:

-> Increasing wildfire losses.

-> Longer days to get rate increases approved .

Surplus lines market share still < 1%.

Industry Trends
California Homeowners Line of Business Excluding FAIR Plan



Surplus lines homeowners increased to 3% (and over 10% when including FAIR Plan Dwelling Fire as opportunity). Driven by:

-> Inability to include cost of reinsurance and higher capital costs for wildfire.

-> More than 1 year for rate approval and > 15% residual rate still needed.

-> Past 5-year return on net worth < 1%.

-> Admitted carriers filing for rate increases, tightening underwriting, non-renewing, and leaving market so FAIR Plan DWP doubled in past year & surplus lines market share increasing.

Why Do You Care?

State	Property Surplus DWP (Millions)
California	$2,018.9
Florida	920.5
Alabama	404.9
South Carolina	153.3
Texas	163.0
Louisiana	152.9
New York	82.9
Mississippi	89.7
North Carolina	63.2
Other States	70.5
Countrywide	**$4,386.5**

Note: CY 2022 Property including NAIC lines including market of last resort for CA, FL, LA, OH, TX.

- $4 billion opportunity countrywide with half in California.
- Can charge adequate rates without regulatory limitations on net cost of reinsurance, higher expenses, capital charges, or profit.
- Can apply stricter underwriting eligibility, higher deductibles, bespoke coverage forms.
- Opportunity for InsurTech to transform surplus lines if can automate diligent search requirement.

Questions

Follow up with me using Sheri.Scott@milliman.com or scan my QR code

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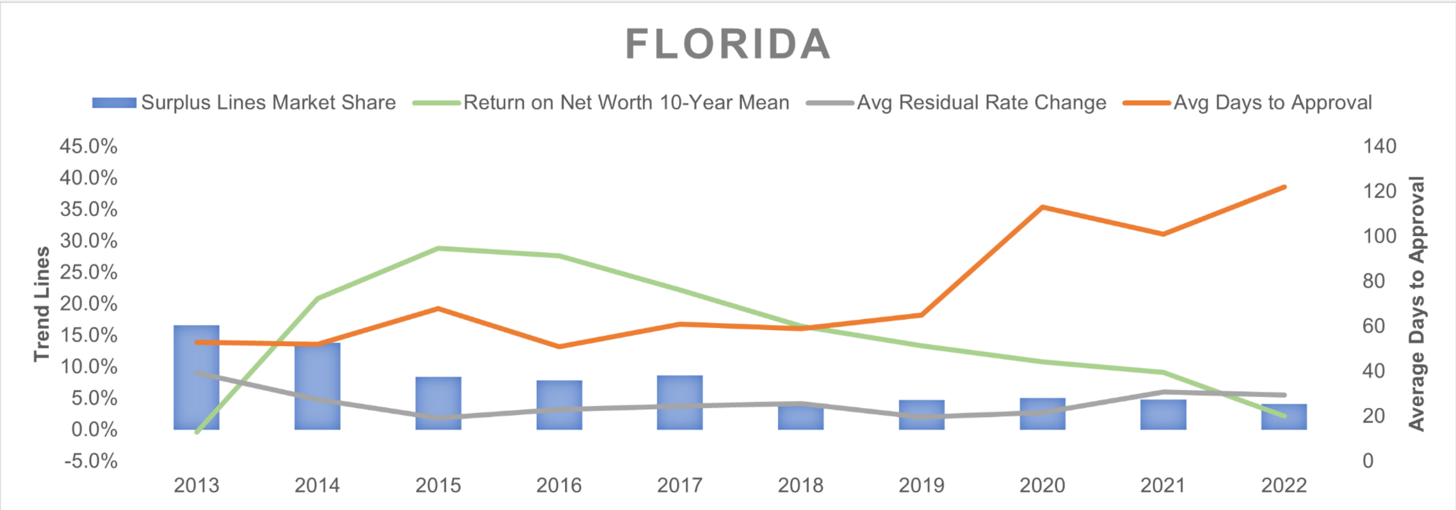
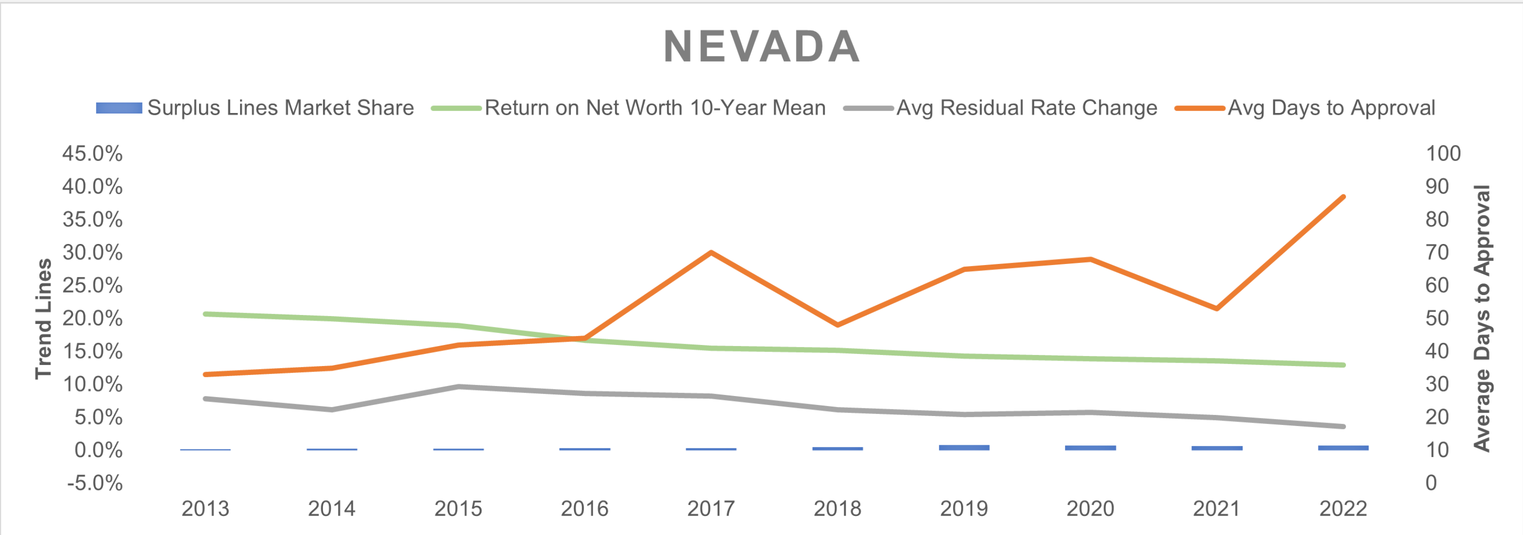
Appendix

Industry trends
Florida Homeowners Line of Business Incl. Citizens



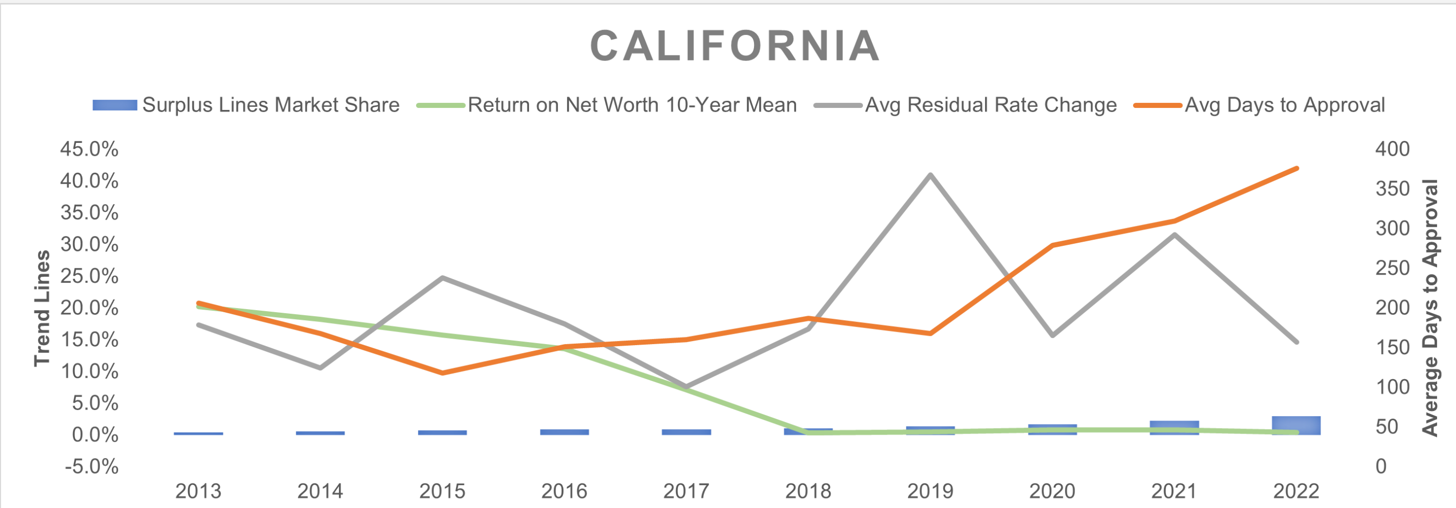
	Calendar Year									
Measure	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Avg Days to Approval	53	52	68	51	61	59	65	113	101	122
Avg Residual Rate Change	9.0%	4.8%	1.9%	3.2%	3.8%	4.2%	2.0%	2.7%	6.0%	5.5%
Return on Net Worth 10-Year Mean	-0.4%	20.9%	28.9%	27.6%	22.2%	16.5%	13.4%	10.8%	9.1%	2.2%
Surplus Lines Market Share	16.6%	13.8%	8.4%	7.9%	8.6%	4.2%	4.7%	5.1%	4.8%	4.1%

Industry trends
Nevada Homeowners Line of Business



	Calendar Year									
Measure	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Avg Days to Approval	33	35	42	44	70	48	65	68	53	87
Avg Residual Rate Change	7.9%	6.2%	9.7%	8.6%	8.2%	6.2%	5.4%	5.8%	4.9%	3.6%
Return on Net Worth 10-Year Mean	20.7%	20.0%	19.0%	16.7%	15.5%	15.2%	14.3%	13.9%	13.6%	12.9%
Surplus Lines Market Share	0.2%	0.3%	0.3%	0.3%	0.3%	0.5%	0.8%	0.7%	0.6%	0.7%

Industry trends
California Homeowners Excluding FAIR Plan



	Calendar Year									
Measure	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Avg Days to Approval	206	168	118	151	160	187	168	279	310	376
Avg Residual Rate Change	17.4%	10.6%	24.8%	17.5%	7.6%	16.7%	41.0%	15.6%	31.6%	14.6%
Return on Net Worth 10-Year Mean	20.2%	18.2%	15.7%	13.6%	7.1%	0.4%	0.5%	0.8%	0.8%	0.5%
Surplus Lines Market Share	0.4%	0.6%	0.7%	0.9%	0.9%	1.0%	1.4%	1.7%	2.3%	3.0%