

## FUNDAMENTALS OF SURPLUS LINES INSURANCE OPERATIONS (163-1)

EO 1. **THE SURPLUS LINES MARKET** provides coverage from nonadmitted insurers when coverage is *not* available from admitted insurers.

**The surplus lines market supplements the admitted market** by providing insurance to those whose risks were rejected by the admitted market.

**An admitted insurer** is licensed to write insurance in the insured's state.

**The admitted (standard) market** is the distribution system of admitted insurers and their producers.

A **nonadmitted insurer** is *not* licensed in the insured's state.

A **surplus lines insurer** is a nonadmitted insurer that is eligible to write surplus lines insurance.

EO 2. **THREE TYPES OF RISKS INSURED IN THE SURPLUS LINES MARKET:**

1. **Distressed risks**--are unacceptable to most underwriters,
2. **Unique risks**--are hard to evaluate because
  - a. they lack an appropriate policy form,
  - b. there is no or inadequate previous loss experience, *and/or*
  - c. it would be unreasonably burdensome to generate a premium quote.
3. **High-capacity risks**--need very high limits, limits beyond the underwriting capacity of the admitted market.

**Surplus lines insurers are not subject to state rate and form regulation.**

Thus, they can write difficult exposures because they have the freedom to negotiate *both* price *and* contract terms that are appropriate for distressed, unique, *or* high-capacity risks.

**Common types of coverage for surplus lines insurers include** errors and omissions (**E+O**) liability, environmental impairment liability, excess and umbrella liability, kidnap and ransom coverage, difference in conditions (**DIC**) coverage, *and* event cancellation.

**Common business classes for nonadmitted insurance include** aircraft and airports, amusement parks, drug and alcohol treatment centers, hazardous waste facilities, medical centers, mobile home parks, railroads, security services, *and* sports facilities.

EO 3. **SURPLUS LINES LAWS** do *not* regulate surplus lines insurers.

Surplus lines insurers are *not* licensed in the state and are *not* subject to the state's jurisdiction.

Instead, surplus lines laws regulate the procurement of insurance through the surplus lines market.

States require licensing of the producers who export risks to the surplus lines market.

Licensed producers are typically called **surplus lines intermediaries, surplus lines licensees, and/or surplus lines brokers.**

States restrict surplus lines insurance placements to **eligible surplus lines (SL) insurers** (insurers that meet state-specified financial criteria *and* are permitted to write surplus lines insurance).

**At a minimum, each surplus lines insurer must be licensed in its home jurisdiction,** whether that's a US state or another country.

EO 4. **STATES IDENTIFY ELIGIBLE INSURERS THROUGH THREE APPROACHES:**

1. **Under the white list approach,** the state regulator drafts a list of insurers that meet the state's eligibility standards. Under the white list approach, brokers are limited to insurers on the list.
2. **Under the broker responsibility approach,** the broker determines if the insurer meets state eligibility requirements.
3. **Under the black list approach,** the state supplements the broker responsibility approach with a list of *ineligible* insurers.

EO 5. **DIRECT PLACEMENT** is an alternative to using licensed surplus lines intermediaries to access nonadmitted insurers.

## **TWO DIRECT PLACEMENT ALTERNATIVES:**

1. **Independent procurement**--lets the insured (usually a large commercial insured) buy surplus lines insurance directly from the insurer *without* an intermediary.
2. **Industrial insured exemption laws**--let qualifying "sophisticated" insureds place their risks directly with nonadmitted insurers *without* having to meet regulatory requirements.

EO 6. **THE UNDERWRITING CYCLE** refers to the periodic fluctuations in coverage availability, insurance premiums, *and* insurers' profits.

A **hard market** occurs when admitted insurers *tighten* underwriting standards and *raise* premiums.

**The nonadmitted market booms during a hard market.**

A **soft market** occurs when admitted insurers *loosen* underwriting standards and *lower* premiums.

**The nonadmitted market suffers during a soft market, sometimes severely.**

## EO 7. **FOUR WAYS TO CLASSIFY PROPERTY-CASUALTY INSURERS:**

1. **Legal form of ownership**--See below.
2. **Place of domicile**--  
A **domestic insurer** is domiciled in the state of status determination.  
A **foreign insurer** is domiciled in another state.  
A **alien insurer** is domiciled in another country.
3. **Licensing status**--  
An **admitted insurer** is licensed to do business in the policyowner's home state.  
A **nonadmitted insurer** is *not* licensed to do business in the policyowner's home state.
4. **Marketing system**--See below.

## **CLASSIFICATION BY LEGAL FORM OF OWNERSHIP:**

1. **Proprietary insurers**--are formed to earn profits for their owners.
  - a. A **stock insurer**--is a corporation owned by stockholders who elect a board of directors to appoint corporate officers and to set policy.  
Stock insurers are the most common type of proprietary insurer in these US.
  - b. **Lloyd's (formerly Lloyd's of London)**--is a market of syndicates providing coverage on a nonadmitted basis.  
Lloyd's is *not* an insurance company. Instead, Lloyd's is an insurance marketplace in which separate businesses (**syndicates**) insure risks on a shared (but competitive) basis.  
Lloyd's typically insures unusual or difficult loss exposures, such as global marine and aviation insurance.  
Regulatory requirements designed for corporate insurers are *not* applicable to Lloyd's structure, so requirements have been designed especially for Lloyd's.
  - c. A **insurance exchange**--acts as an insurance marketplace in which exchange members underwrite insurance.
2. **Cooperative insurers**--are formed to provide insurance at a minimum cost to their owners.
  - a. A **mutual insurer**--is a corporation owned directly by their policyowners who elect a board of directors which appoints the officers.  
The primary purpose of a mutual insurer is to provide low cost insurance for policyowners. If the premiums exceed the losses plus the expenses, any extra may be returned to the policyowners as dividends.
  - b. A **reciprocal exchange**--is a nonprofit, mutual association of insureds operated by a corporate, profit-seeking 'attorney-in-fact' who handle all the reciprocal's business matters. Each policyowner acts as both insurer and insured.  
A reciprocal differs from a mutual insurer because it is *not* incorporated *and* because its subscribers assume liability as individuals.
3. A **captive insurance company**--is formed to insure the loss exposures of its owners.

4. A **pool**--consists of several unrelated insurers that join to insure loss exposures that individual insurers are unwilling to insure.
5. **Government insurers**--provide coverage for workers compensation insurance, the Social Security system, the National Flood Insurance Program, deposit insurance for banks, crop insurance, *and* crime insurance.

#### **MARKETING SYSTEMS FOR PROPERTY AND LIABILITY INSURANCE:**

1. **Independent agency system--Independent agents**
  - a. **are independent contractors**--who market insurance on their own behalves and usually represent several insurers.
  - b. **own their policy expirations**--and have the exclusive right to solicit policy renewals.
  - c. **are paid by commission.**
2. **Exclusive agency system--Exclusive agents**
  - a. **are independent contractors**--representing only one insurer *or* one group of insurers under common ownership. (But exclusive agents are salaried employees during training.)
  - b. **usually do not own their expirations**--but this can vary among insurers.
  - c. **are paid by commission**--with higher commissions on new business than on renewals (to encourage solicitation of new business).
3. **Direct writer system**--sells insurance directly to customers using producers who are employees of the insurer and, thus, do *not* own their expirations.  
Producers may be compensated by salary, by commission, or by a combination of both.

#### **EO 8. THE FOUR MAJOR GOALS OF PROPERTY-CASUALTY INSURERS:**

1. Earn a profit.
2. Meet customers' needs.
3. Comply with legal requirements.
4. Fulfill social responsibilities.

#### **FOUR INTERNAL CONSTRAINTS ON ACHIEVING INSURERS' GOALS:**

1. **Efficiency--Lack of efficiency can be caused by** poor management, insufficient capital, obsolete information technology, *and/or* inflexibility when faced with change.  
An inefficient insurer loses its competitive advantage and impairs its ability to earn a profit.
2. **Expertise**--Successful operation, especially in a niche or specialty market, requires expertise.
3. **Size**--Large insurers can take advantage of economies of scale.  
**Large insurers have the financial resources to** update technology, to expand into additional markets, *and* to invest in market research and product development.
4. **Financial resources**--Financial resources can be reduced by underwriting losses and/or by investment losses.  
Financial constraints limit an insurer's ability to make new capital investments and to expand into new markets.

#### **FOUR EXTERNAL CONSTRAINTS ON ACHIEVING INSURERS' GOALS:**

1. **Regulation**--Regulators monitor insurers' formation, rate making, policy forms, solvency, *and* liquidation.  
The personnel and financial resources devoted to compliance with both federal and state regulation limit every insurer's ability to meet its profit goals.
2. **Public opinion**--Customer dissatisfaction and negative public perception can lead to increased regulation.
3. **Competition**--The level of competition fluctuates with the insurance cycle.
4. **Economic conditions**--Investment income falls during economic downturns.  
Inflation increases the cost of insurance losses, but *not* the premiums to pay for those losses.

EOs 9 + 10.      **THE METHODS USED TO MEASURE INSURER PROFITABILITY:**

1.    **Premium growth**--must be evaluated relative to the current market conditions.  
Premium growth that's lower than the industry average usually indicates a problem.  
Premium growth substantially higher than the industry average could result from a competitive advantage, lax underwriting, *and/or* inadequate rates.
2.    **The expense ratio**--measures an insurer's operating efficiency by showing the ratio of underwriting expenses to premiums during a specified period.  
The expense ratio can be calculated on a financial basis or on a trade basis.  
**The financial basis expense ratio** equals underwriting expenses (other than loss adjustment expenses) divided by *earned* premiums.  
**The trade basis expense ratio** equals underwriting expenses (other than loss adjustment expenses) divided by *net written* premiums.
3.    **The loss ratio**--measures the quality of an insurer's underwriting decisions.  
**The loss ratio** equals (incurred losses + loss adjustment expenses) divided by earned premiums.
4.    **The combined ratio**--measures an insurer's overall results from its insurance operations.  
The combined ratio is the sum of the expense ratio plus the loss ratio.  
A combined ratio *under* 100% indicates a *profit* on insurance operations.  
A combined ratio *over* 100% indicates a *loss* on insurance operations.  
**The financial basis combined ratio** equals (incurred losses + incurred loss adjustment expenses + incurred underwriting expenses) divided by *earned* premiums.  
**The trade basis combined ratio** equals [(incurred losses + incurred loss adjustment expenses) divided by earned premiums] + (incurred underwriting expenses divided by *written* premiums).
5.    **Investment income**--is derived from the investment of funds from loss reserves, loss adjustment expense reserves, *and* unearned premium reserves.
6.    **Operating profit or loss**--is the sum of
  - a.    **underwriting profit or loss and**
  - b.    **investment profit or loss, which consists of**
    - 1)    **investment income** (interest, dividends, rents, and royalties from investments),
    - 2)    **realized capital gains** (when assets are sold for more than their original costs), *and*
    - 3)    **unrealized capital gains** (when an asset's market value exceeds its original cost, *but* the asset has *not* yet been sold).

**OTHER METHODS OF MEASURING AN INSURER'S PERFORMANCE TOWARD ITS GOALS:**

1.    **Meeting customer needs**--It is hard to measure how well an insurer meets its customers' needs because insurers typically get feedback primarily from dissatisfied customers.  
Insurers should investigate all customer complaints to identify legitimate problems.
2.    **Complying with legal requirements**--In general, an insurer's compliance with legal requirements is reflected in the number of criminal, civil, and regulatory actions filed against that insurer.
3.    **Meeting social responsibilities**--There are no standards for evaluating how well an insurer upholds its social responsibilities.  
An insurer can consider how well it treats its employees and the extent to which it engages in humanitarian and charitable endeavors.  
*[I would consider it a breach of fiduciary duty for any for-profit entity to donate even to my favorite charity, unless that for-profit entity somehow received greater benefit in return.]*

EO 11.      **THE THREE CORE FUNCTIONS WITHIN A SURPLUS LINES INSURER:**

1.    **Marketing**--involves determining the goods and/or services that customers want and delivering those goods and services to customers.
2.    **Underwriting**--involves evaluating applications and deciding if an applicant meets the insurer's guidelines.
3.    **Claims**--involves investigating claims and making fair loss settlements for covered losses.