

## **SURPLUS LINES INSURANCE PRODUCTS: INTRODUCTION (164-1)**

EO 1. **THE SURPLUS LINES MARKET** is the distribution system consisting of surplus lines insurers and intermediaries that provides insurance from nonadmitted insurers when coverage is unavailable from admitted insurers. Surplus lines insurers help alleviate insurance unavailability problems by insuring individual risks that are unacceptable to admitted insurers.

**Without access to surplus lines insurers and brokers**, consumers would be limited to self-procurement in the nonadmitted market, self-insurance, *or* no insurance.

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.

### **KEY FEATURES OF SURPLUS LINES LAWS:**

1. **Exemption from rate and form regulation**--The surplus lines applicant and underwriter can negotiate price and contract terms because surplus lines insurance is *not* subject to state rate and form regulations.
2. **Licensing**--States do *not* directly regulate surplus lines insurers. Surplus lines insurers are not licensed in the state and are not subject to state jurisdiction. Instead, surplus lines laws require licensing of the intermediaries that export risks to the surplus lines market.
3. **Eligibility requirements**--States restrict surplus lines insurance placements to **eligible surplus lines insurers** (insurers that meet state-specified financial criteria and are permitted to write surplus lines insurance).

**States identify eligible insurers through three approaches:**

  - a. **Under the white list approach**, the state regulator drafts a list of insurers that meet the state's eligibility standards. Brokers are limited to insurers on that list.
  - b. **Under the broker responsibility approach**, the broker determines if the insurer meets the state eligibility requirements.
  - c. **Under the black list approach**, the state supplements broker responsibility with a list of ineligible insurers.
4. **Diligent search requirements**--Surplus lines laws typically require the producer to make a diligent effort to obtain coverage from an admitted insurer *and* to document that diligent search. Some states maintain **export lists** (lists of the types of risks or coverages that can be exported to surplus lines insurers *without* meeting the diligent search requirement).
5. **Premium taxes**--The surplus lines licensee is responsible for collecting the surplus lines premium tax and remitting the tax to the state.
6. **Alternatives to using surplus lines licensees**--Some states permit direct placement.
  - a. **Independent procurement**--allows the insured (usually a large commercial insured) to buy surplus lines insurance directly from the insurer without an intermediary.
  - b. **Industrial insured exemption laws**--let qualifying "sophisticated" insureds place their risks directly with nonadmitted insurers without having to meet regulatory requirements.

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

1. **Distressed risks**--have characteristics that are unacceptable to most underwriters.

*Examples:* an insured with too many recent losses; hazardous operations, such as crop dusting.
2. **Unique risks**--are so specialized or unusual that they are hard to evaluate and insurers often have no appropriate policy forms or previous loss experience.

*Example:* a combination bridge/tunnel that needs physical damage, business income, and extra expense insurance.
3. **High-capacity risks**--need high limits beyond the underwriting capacity of the admitted market.

*Examples:* a chemical manufacturer; a museum with \$1 billion of art.

**TWO OTHER METHODS OF CLASSIFYING SURPLUS LINES RISKS AND COVERAGES:**

1. **Market directories**--list different types of surplus lines risks and coverages and match them to appropriate intermediaries and insurers.
2. **Surplus lines export lists**--identify the risks and coverages that *may* be exported *without* fulfilling the diligent search requirement.

EO 3. **COVERAGE PROHIBITIONS AND EXEMPTIONS**--Many states' surplus lines laws do not restrict the types of insurance that can be placed with a surplus lines insurer.  
**But, some states prohibit the export of certain coverages, such as** personal auto, life, health, title, mortgage, surety, and workers' compensation.

**Most states' surplus lines laws exempt certain types of insurance from surplus lines laws.**

**Exemptions vary by state, but types of insurance that are typically exempt include**

1. ocean marine and transportation insurance,
2. insurance on subjects located or performed wholly outside the regulating state,
3. insurance on vehicles and aircraft owned and principally garaged outside the regulating state,
4. insurance on property and operations of railroads engaged in interstate commerce, **and**
5. **insurance on**
  - a. aircraft owned or operated by aircraft manufacturers,
  - b. aircraft operated in scheduled interstate flight,
  - c. cargo on such aircraft, **and**
  - d. liability arising from the ownership, maintenance, or use of such aircraft.

**Reasons for exemptions:**

1. Any property or operations located outside the regulating state are **not** subject to the state's regulatory jurisdiction.
2. Sophisticated insureds (railroads and airlines) do **not** need regulatory protection.
3. Certain types of insurance (aviation and marine) are highly specialized or complicated.

EO 4. **EXEMPTION FROM RATE AND FORM FILING REGULATIONS**--Surplus lines insurers are **not** subject to the rate and form filing regulations of the states from which they accept exported risks. Thus, surplus lines insurers have the flexibility to adjust policy provisions and premiums in order to accept risks that cannot be insured in the admitted market.  
Freedom from rate and form regulation reduces the time and expense to create and market new products.  
**Note:** Surplus lines laws often require certain policy wording, such as a warning that the insurer is **not** subject to state regulation and is **not** covered by state guaranty funds.

EO 5. **FIVE COMPONENTS OF INSURANCE PRODUCTS:**

1. **The insurance policy**--is the tangible written contract that provides evidence of the insurer's intangible promise to pay specified losses.  
**A policy provision** is any statement in an insurance policy that describes the policy's coverage, exclusions, limits, conditions, **or** other features.  
Surplus lines insurers rarely invest the time and money to draft original policies from scratch. Instead, they usually modify existing policy forms (including the standard ISO and AAIS forms) to either broaden or to restrict coverage to meet the policyholders' specific needs.
2. **Risk control services**--seek to reduce the frequency and/or severity of losses.  
**The extent of risk control services offered by an insurer depends on**
  - a. the size of the policy premium,
  - b. the insured's operations,
  - c. the coverage,
  - d. the quantity and quality of the insurer's risk control personnel, **and**
  - e. the insurer's attitude toward risk control.

3. **Claim services**--fulfill the insurer's duty to investigate claims and to pay covered claims.
4. **Underwriting**--is the process by which an insurer screens applicants, selects risks, *and* determines the price and terms of insurance contracts.  
An insurer can differentiate its products through underwriting by using selection or eligibility standards that differ from other insurers or by pricing its policies differently from other insurers.
5. **Services provided by intermediaries--include**
  - a. providing certificates of insurance,
  - b. making policy changes,
  - c. handling claims, *and*
  - d. underwriting and pricing.

EO 6. **PRODUCTS THAT COMPETE WITH SURPLUS LINES PRODUCTS:**

1. **Admitted market insurance products--In theory**, admitted insurers and surplus lines insurers do *not* compete, *but* situations can occur when they pursue the same customers.  
***Example:*** If surplus lines insurers write certain risks at a substantial profit, an admitted insurer might change its underwriting and/or pricing standards to accept those risks.  
Also, in a soft market, admitted insurers lower their underwriting standards, broaden their coverages, and reduce their prices in order to retain insureds and, perhaps, to regain insureds who shifted to the surplus lines market during the hard market.
2. **Residual market insurance products--The residual market** is the shared market mechanism among licensed insurers to provide coverage for consumers who are unable to obtain essential insurance coverages in the voluntary market at premiums they are willing to pay.  
**Residual market programs typically provide** auto insurance, fire and allied insurance on buildings and their contents, windstorm insurance, *and* workers' compensation insurance.  
Most residual market plans offer only limited coverage.  
The surplus lines market offers broader coverage and/or higher limits.  
Some states let consumers that cannot get coverage in the admitted market choose between residual market plans and surplus lines insurance.  
**Some states require that the residual market decline coverage before the risk can be placed with a surplus lines insurer.** That requirement effectively eliminates surplus lines insurance as a competitor because most residual markets have liberal eligibility requirements.
3. **Government insurance products**--The US government and some states have developed programs in which the government acts as an insurer.  
***Examples:*** the National Flood Insurance Program (**NFIP**), the Federal Crop Insurance Corporation, and state workers' compensation programs.  
Surplus lines insurers do *not* want to compete with the rates offered by the NFIP, *but* a surplus lines insurer might write flood insurance in excess of the limits available from the NFIP.
4. **Alternative risk financing techniques--Firms are increasingly turning toward alternative risk financing techniques, such as**
  - a. insurance with large deductibles,
  - b. self-insurance,
  - c. **captive insurers** (subsidiaries formed to insure the loss exposures of their parents),
  - d. **group captives** (captive insurers owned by more than one parent),
  - e. **risk retention groups (RRGs)** (group captives formed to insure owners who are all from the *same* industry),
  - f. **risk purchasing groups (RPG)** (groups that use collective buying power to negotiate favorable coverage terms and conditions for group members), *and*
  - g. **pools** (groups of firms that insure each other's losses).

Competition between surplus lines products and alternative risk financing techniques is most intense during a hard market because consumers that are rejected by the admitted market are left with few options.