

AN INTRODUCTION TO THE  
**Surplus Lines Market**

## What is the Surplus Lines Insurance Market?

The surplus lines insurance market **operates as a supplement to the standard property and casualty insurance market and provides coverage options when the standard market cannot or will not** underwrite the type or level of coverage needed by an insured. Standard insurers occasionally cannot or will not take on risks that fall outside their underwriting appetite or don't have enough underwriting history. Risks are only presented to the surplus lines market after the standard market has declined to underwrite them, and it then serves as a safety valve that allows consumers to bring innovative business ideas to reality. These unique coverage options may include:

- Supplemental coverages
- Higher limits
- Unique terms and conditions

Risks typically written in the surplus lines market fall into three basic categories:

- (1) non-standard risks, which have unusual underwriting characteristics;
- (2) unique risks for which admitted carriers do not offer a filed policy form or rate; and
- (3) capacity risks where an insured seeks a higher level of coverage than most insurers are willing to provide.

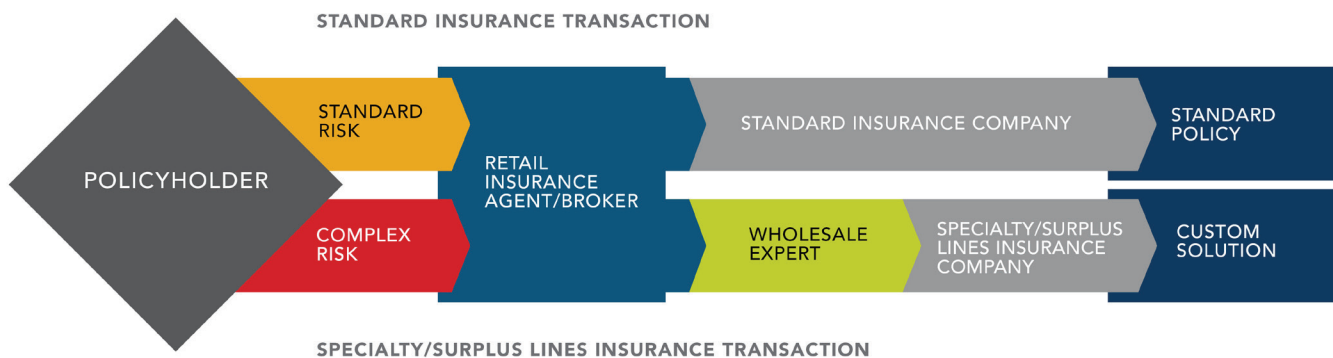
***In 2022, surplus lines insurance was a \$98.5 billion industry, which represents 11.2% of the total property & casualty industry. Surplus lines predominantly covers commercial insurance risks and has approximately 21.6% share of the total commercial lines market.***

Surplus lines insurers do this by focusing on underwriting for the specific risk to be insured. In order to ensure new or unique risks are underwritten appropriately, **surplus lines insurers are highly specialized and conduct specific research to understand the underlying exposure.**

As loss histories develop, the standard market will leverage data and experience from the surplus lines market to develop products, and business will typically migrate back to the standard insurance market. Conversely, when the standard market experiences significant or catastrophic losses in product lines or regions (e.g., catastrophic natural disasters), underwriting practices and risk appetites become more conservative resulting in a shift of these risks to the surplus lines market, completing a business cycle that has repeated for decades.

**Regulators have a successful record of ensuring that standard insurers can continue to provide appropriate coverage to consumers** in the wake of catastrophic events, and the surplus lines industry has been able to serve as an effective supplement, offering consumers options when they no longer exist in their standard market.

# How Does a Surplus Lines Insurance Transaction Work?



- 1** The consumer brings a risk to their retail insurance agent or broker. The retail agent helps determine if the consumer's risk is considered nonstandard. (Any risk that is new, distressed, high-capacity, a catastrophic exposure, emerging or otherwise unique.)
- 2** If the risk is nonstandard, coverage may be available to the consumer in the standard market, but it may not be adequate. In many instances, the standard market may decline the risk altogether.
- 3** If the standard market cannot or will not provide adequate coverage for the consumer, the retail agent may seek coverage through the surplus lines market with the help of a licensed surplus lines broker.
- 4** Skilled agents and brokers access the surplus lines market to create a custom solution for their insured's complex risk. The surplus lines industry's freedom from rate and form enables professionals to create tailored coverage with adequate coverage terms, limits and conditions for their risk.

## Why Do Consumers Sometimes Need Surplus Lines Insurance?

Sometimes referred to as the ‘market of last resort’ by the business community and the ‘safety valve’ of the insurance industry, surplus lines steps in to provide coverage where the standard market can't or won't. Surplus lines insurers allow consumers to purchase custom-tailored coverage that meets their needs, rather than forcing them into self-insuring against their risks, or going without the proper financial protection.

The wholesale, specialty and surplus lines business is immersed in current events and trends in the development of new products, new services, and in minimizing the risks of doing business in a world where the unforeseen is inevitable. New and innovative products for which there is no loss history are difficult, if not impossible, to price or rate for insurance purposes.

## Where Does Surplus Lines Insurance Impact Communities?

*Coverages first developed by the surplus lines market include employment practices liability, directors' and officers' liability, medical malpractice, cyber risks and economy-sharing risks.*

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**New business start-ups:** Business owners need insurance to protect their new investments, but without a track record, standard insurers may decline offering coverage. The ability to develop the track record of insurable risk in the surplus lines market allows the business to get off the ground.

**New technology and innovation:** Emerging technologies and innovative practices develop at lightning speeds that often outpace the process for developing new, standard insurance policies. The surplus lines market enables our economy to move forward by quickly tailoring a policy for new risks.

**Large risks:** Many risks would be devastating for businesses and the global economy, like data and cyber breaches. Standard insurers may decline to write these catastrophic types of exposures. The surplus lines market has knowledge and capacity to insure these significant business concerns.

**Catastrophic storm impacts:** Consumers in many states have been impacted by the downward shift in the standard market's appetite for providing coverage in the wake of catastrophic storm losses. The surplus lines industry is an effective supplement, offering consumers options that may no longer exist in the standard market.

**Evolving risks:** As businesses develop and grow, so do the types of risks they experience. The surplus lines market has developed coverages to address and protect these businesses and allow them to evolve.

## How is the Surplus Lines Market Regulated?

The surplus lines market is regulated by state insurance regulators. Some state statutes refer to the surplus lines market as the “unauthorized” or “unlicensed” market, which can mistakenly give the impression that the market is not regulated. This is untrue. **The surplus lines market is regulated!**

The way surplus lines transactions are regulated provides protections and allows the market the opportunity to provide coverages to consumers who might otherwise go without.

*Every state has rules and regulations within its insurance code that are specifically written to govern surplus lines insurance.*

*Many of the same rules that are applicable to licensed, admitted insurers also apply to surplus lines insurers.*

### HOW SURPLUS LINES INSURERS ARE LICENSED and REGULATED

- To obtain and maintain their licenses, standard and surplus lines insurers are subject to the same rules and regulations and must comply with all financial solvency requirements, market conduct standards and regulations of their state or jurisdiction of domicile.
- U.S.-based surplus lines insurance companies are domiciled and regulated as a domestic insurer in at least one of the 50 states or other U.S. jurisdictions and must maintain threshold capital and surplus levels.
- Surplus lines insurers domiciled outside of the U.S. are regulated, too. They may be included on the NAIC Quarterly Listing of Alien Insurers when they meet capital and surplus requirements and certain character, trustworthiness and integrity requirements. This process is overseen by state insurance regulators through the NAIC

### Key differences in the regulation of surplus lines insurers

- Surplus lines insurers generally do not write surplus lines in their state of domicile; rather, surplus lines coverage is written in other states where the insurer operates on a surplus lines basis. This is referred to as “exporting” the risk.
- Traditionally, surplus lines insurers might have established two separate companies in two different states in order to write business in all states, including their state of domicile. However, some states have implemented statutes that allow for a “Domestic Surplus Lines Insurer (DSLII)” designation, which allows an insurer to write surplus lines business (and only surplus lines business) in their domiciliary state if they have been granted DSLII status. Around 20 states have

***Surplus lines insurers do not file for approval of their rates and forms because the insurer is conducting business on a nonadmitted or unlicensed basis in the state where they write surplus lines insurance.***

***This regulatory system allows a surplus lines insurer to write a risk that has been declined by the standard market because they are able to individually tailor and underwrite each risk.***

implemented these statutes.

- Surplus lines insurers must be “eligible” in the home state of the consumer to underwrite coverage. To be deemed “eligible,” the surplus lines insurer must meet capitalization thresholds. In most cases, these thresholds exceed those of their standard market counterparts.
- They are not subject to guaranty fund participation. As a supplemental market, policymakers have determined that guaranty fund participation would provide an additional barrier to placing risks that are already difficult to place. The surplus lines industry has an impeccable solvency record, attributable in part to the heightened statutory responsibility of the surplus lines broker and the underwriting discipline demonstrated by surplus lines insurers.

#### **HOW SURPLUS LINES BROKERS ARE LICENSED and REGULATED**

- The surplus lines broker is a licensed insurance producer, either on a resident or nonresident basis, that is directly regulated by the insurance department in the home state of the transaction.
- In accordance with the Nonadmitted and Reinsurance Reform Act of 2010 (NRRRA), the insured’s home state requires a surplus lines broker to be licensed in order to sell, solicit, or negotiate surplus lines insurance with respect to such insured.
- In the typical surplus lines transaction, the surplus lines broker (often a wholesale broker with a high level of expertise in the underlying risk) works directly with the consumer’s agent/producer that is seeking the insurance solution on behalf of their client. Distinct from the standard market, the licensed surplus lines broker is responsible for:
  1. placing the coverage with a financially strong, eligible surplus lines insurer;
  2. reporting the surplus lines transaction to insurance regulators;
  3. remitting the premium tax due on the transaction to state tax authorities; and
  4. assuring compliance with all the requirements of the surplus lines regulations for that state.

Surplus lines brokers have a heightened level of responsibility for assessing the financial strength and soundness of the surplus lines insurer. In fact, **in some states they can be held liable for certain unpaid claims if they failed to properly vet the insurer's financial condition.** State insurance commissioners have the authority to take administrative action and/or revoke the surplus lines broker's license for failure to comply with these statutory responsibilities.

## Additional Regulatory Tools For Surplus Lines Insurance

There are other regulatory tools and consumer protections in place for surplus lines transactions.

- **Diligent Search Requirements and Export Lists** – State insurance regulators leverage these to monitor and control the types of coverages that can be placed in the surplus lines market – both regulating the flow of business between the standard and surplus lines markets.
- **Unfair Trade Practices Act** – Surplus lines insurers are subject to market conduct oversight consistent with the standard market. As an example, surplus lines insurers are subject to the NAIC's Model Unfair Trade Practices Act, which has been adopted in nearly all states and outlines prohibited unfair or deceptive practices including:
  - **General misrepresentations to the public**, including misrepresentations and false advertising of insurance policies, and the benefits, advantages, conditions or terms of any policy;
  - **Dissemination of false advertisements or information;**
  - **Unfair discrimination** of policyholders;
  - **Violations of state rebating laws;**
  - **Failure to maintain complaint handling procedures;** and
  - **Failure to provide claims histories** and loss information to policyholders.

These laws also give Insurance Commissioners authority to examine and investigate insurers to determine if they are or have been engaged in unfair trade practices.

- **Complaints Handling and Claims Processing** – Surplus lines insurers and brokers have a successful record of responding to consumer complaints and processing claims from insureds of commercial lines and personal lines products. Treating the policyholder fairly is not only important for the consumer but for the surplus lines broker's relationship with its retail

agent clients. The risk associated with treating consumers unfairly would be very high and contrary to a successful long-term business strategy.

- **Policy Cancellation/Nonrenewal Requirements** – Many states require surplus lines insurers to comply with the cancellation and nonrenewal notice requirements that apply to admitted insurers, and several states have cancellation and nonrenewal requirements that are specific to surplus lines business. Even in states where surplus lines business is not subject to the cancellation/nonrenewal requirements, surplus lines insurers typically adhere to the admitted requirements as a best practice
- **Disclosure Requirements** – All but one state requires a specific notice to be clearly provided to the insured when placing a surplus lines policy. These notices disclose that the insured is purchasing a surplus lines policy, that the policy is not covered by the state’s guaranty fund and other various regulatory disclaimers
- **Cease & Desist Order** – Any Insurance Commissioner may issue Cease & Desist Orders against nonadmitted insurers from doing business in their state if they have evidence of solvency concerns or market conduct violations.

***Surplus lines policies are subject to the same consumer complaint process as admitted policies. Complaints are addressed directly by the insured’s broker and/or the insurer.***

***If a complaint is escalated to the state, the consumer’s home state Insurance Commissioner may work with the insured’s retail agent and surplus lines broker and has authority to coordinate any action with the insurer’s domiciliary state.***

## Surplus Lines Market Financial Solvency

The surplus lines market has a stellar financial reputation. AM Best, an insurance industry-focused credit rating agency that has monitored and reported on the surplus lines insurance market for over thirty years, publishes an annual report providing data and an overview of the market for those the insurance industry as well as insurance regulators and legislators. According to **AM Best's 2023 Market Segment Report**:

- In 2022, **100% of surplus lines insurers have a good or better rating**, and that they have a higher outlook rating than their admitted counterparts — an important factor for businesses whose unique and innovative risks bring them to the surplus lines market.
- Domestic professional **surplus lines insurers' underwriting and operating profits have both improved over recent years**, despite an increase in natural and weather-related events. These carriers tend to provide coverage for higher-risk properties but still have **combined ratios under 100**, with an impressive **91.1 in 2022**.
- Since 2004 there has only been **one impairment** (a monoline insurer writing surety bonds for private student loans), which was highly specific and limited in nature, compared to **291 admitted companies**.
- 89 out 90 insurers are rated between Exceptional to Excellent, with one rated Good. Additionally, 98.9% of surplus lines carriers are within a- or better ratings, compared to 84.4% of the P/C industry and 100% of the ratings above Good (b+ or better) compared to 97.1% of the P/C industry.

## U.S. DPSL vs. U.S. P/C Industry

### AM Best Ratings by Rating Unit

Category	Rating Level	DPSL		Total P/C Industry	
		Rating Units	%	Rating Units	%
Exceptional	aaa	1	1.2	3	0.4
	<b>Subtotal</b>	<b>1</b>	<b>1.2</b>	<b>3</b>	<b>0.4</b>
Superior	aa+	8	9.4	15	2.2
	aa	7	8.2	14	2.0
	aa-	16	18.8	45	6.6
	<b>Subtotal</b>	<b>31</b>	<b>36.5</b>	<b>74</b>	<b>10.8</b>
Excellent	a+	14	9.4	15	2.2
	a	18	8.2	14	2.0
	a-	20	18.8	45	6.6
	<b>Subtotal</b>	<b>52</b>	<b>36.5</b>	<b>74</b>	<b>10.8</b>
Good	bbb+	0	9.4	15	2.2
	bbb-	0	8.2	14	2.0
	bbb-	1	18.8	45	6.6
	<b>Subtotal</b>	<b>1</b>	<b>36.5</b>	<b>74</b>	<b>10.8</b>
Fair	bb+, bb, bb-	0	0.0	13	1.9
Marginal	b+, b, b-	0	0.0	4	0.6
Weak/Very Weak	ccc+, ccc, ccc-, cc	0	0.0	2	0.3
Poor	c	0	0.0	0	0.0
<b>Subtotal</b>		<b>0</b>	<b>0.0</b>	<b>19</b>	<b>2.8</b>
<b>Total Issuer Credit Ratings</b>		<b>85</b>	<b>100.0</b>	<b>686</b>	<b>100.0</b>

