

# Flood Insurance and the Surplus Lines Market



## In the Consideration of Private Flood Insurance Options As Contemplated in the Flood Insurance Market Parity and Modernization Act of the 115th Congress

(See Appendix A)

### Is the surplus lines industry unregulated?

- **The surplus lines industry absolutely is regulated.**
- Each U.S. based surplus lines insurance company is licensed in at least one of the 50 states or other U.S. jurisdictions and must maintain threshold capital and surplus levels. Put another way – *a surplus lines insurer is an admitted insurer in at least one state*. Non-U.S. based surplus lines insurers are regulated by a Committee of state regulators through the NAIC.
- **Eight states and the NAIC’s International Insurer’s Department (IID) regulate roughly 80% of the surplus lines market: Delaware, Illinois, Nebraska, New Hampshire, New York, Ohio, Pennsylvania, and Texas.** For example:
  - All Lloyd’s syndicates that write surplus lines insurance in the U.S. appear on the NAIC Quarterly Listing of Alien Insurers (“IID List”), which is subject to regulatory oversight by the NAIC’s IID. The IID is governed by the NAIC’s IID Plan of Operation Review Group and the Surplus Lines Task Force, which is comprised of 19 states.
  - **DELAWARE** regulates W.R. Berkley, Fairfax Financial, Sompo Holdings, Everest Re, Munich-American, and AmTrust Group
  - **ILLINOIS** regulates Markel, Argo, AXIS, CNA, RLI Group, and IFG Companies
  - **NEBRASKA** regulates Berkshire Hathaway Insurance Group
  - **NEW HAMPSHIRE** regulates Alleghany, Western World Insurance Group, and Hanover Insurance Group
  - **NEW YORK** regulates AIG, Zurich, XL Catlin America, Navigators, and SCOR U.S. Group
  - **OHIO** regulates Nationwide, Great American, James River, State Auto Insurance Companies and The Cincinnati Insurance Companies
  - **PENNSYLVANIA** regulates Chubb INA Group, Tokio Marine U.S. P.C. Group, QBE Americas and Global Indemnity
  - **TEXAS** regulates Aspen U.S. Insurance Group, Starr International, HIIG Group, and Hallmark Insurance Group

(See Appendix B for other states.)

- Top 50 insurance groups write 90% of the U.S. surplus lines market. This 90% is regulated by 19 states and the NAIC (See Appendix C).

## Surplus Lines insurance is subject to substantial state regulation

- To obtain and maintain their licenses, both standard/admitted and surplus lines/nonadmitted insurers are subject to **ALL OF THE SAME rigorous rules and regulations** and must comply with all financial solvency requirements and market conduct standards and regulations of its jurisdiction of domicile.
- In a surplus lines transaction, both the nonadmitted insurer and the broker are regulated:
  - A surplus lines/nonadmitted **insurer** is regulated by the insurance department in their domestic state, submitting to all of the same rigorous rules and regulations as a standard/admitted insurer.
  - This means that their financial solvency and soundness is reviewed by regulators just as it is in the standard market.
  - The surplus lines **broker** is directly regulated by the insurance department of the home state of the insured. The state's insurance Commissioner can revoke the broker's license if necessary.
    - In a surplus lines transaction, the broker is responsible for placing the coverage with a financially stable, eligible surplus lines insurer, and assuring compliance with all of the requirements of surplus lines regulation.
    - Surplus lines brokers work directly with retail agents and brokers representing those insureds who are unable to obtain insurance through the standard market.
  - Finally, any Insurance Commissioner may issue a Cease & Desist Order against a nonadmitted insurer from doing business in their state if significant regulatory concerns arise.

## Surplus Lines has the Freedom of Rate and Form

- There is also a key difference in the regulation of admitted and nonadmitted insurers.
- Admitted insurers are subject to rate and form regulation at the state level. This regulation is done to facilitate easy comparison for consumers among similar products (e.g. auto insurance from Company A vs. car insurance from Company B).
- Surplus lines insurers, while still regulated at the state level, have freedom of rate and form.
- Freedom of rate and form means a surplus lines carrier can be more innovative, creative and responsive in developing a product that provides the level of coverage a consumer is seeking, while pricing the product in a financially responsible manner commensurate with the risk. Again, these products generally fall in the category of very unique and/or emerging risks.

### Do surplus lines policies lack consumer protections?

**The surplus lines policyholder/consumer is afforded extensive consumer protection with their state insurance commissioner and the proven state-based system of insurance regulation.**

- If the consumer's complaint is specific to the insurer, that Commissioner has the authority to investigate the complaint and coordinate its work and/or any regulatory action with the insurer's domiciliary state. The coordination of regulatory efforts among multiple states is a key strength of the state-based system of insurance regulation, which serves the consumer and the industry well.

- Regarding the Flood Insurance Market Parity and Modernization Act, (H.R. 1422/S. 563 in the 115th Congress) in the event a consumer leaves the NFIP for the private market (be it admitted or nonadmitted) and is displeased with a rate increase during their annual renewal, **the consumer has the option of returning to the NFIP.**
  - In the specific example of the private market renewal, that consumer **could and should** go back to their agent to seek additional quotes from other insurers, both admitted and nonadmitted, where appropriate, as well as the NFIP.
  - Indeed, continuous coverage provisions in the Act would ensure that consumers may return to the NFIP at the subsidized rate at which they left.
  - This is exactly how it would work under any other private market insurance renewal and there is no reason to expect differently for private flood.

### **If the private market writes more Private Flood Insurance will they cherry-pick the best risks and leave the NFIP more vulnerable?**

- Terms like “cherry picking” offer a negative bias but the off-loading of exposure to the private sector is the exact intention legislators had when drafting BW12.
- Through the underwriting process, insurance companies, admitted and surplus lines companies alike, will evaluate potential policies on a case-by-case basis using sound financial models, actuarial data, capacity, risk appetite and experience to determine their ability to provide coverage options to a consumer.
- It is the responsibility of private insurance companies to ensure that they have the capital backing to cover the policies they are offering. This type of fiscal responsibility is what we expect to see out of businesses and ensures that the companies are prepared when paying out claims.
- The involvement of private insurance companies will reduce the overall exposure of the NFIP, enabling the program to instead focus on those properties that cannot be adequately priced – either because of repeated losses or affordability concerns related to current residents.
- As the GAO noted in its 2013 report, “subsidized properties count for the majority of the repetitive loss properties in the program.” Specifically, “properties that have experienced repetitive flood losses represent 1% of all NFIP policies but 30% of all claims paid.”
- In these cases, the private market will likely remain unwilling to insure those risks as insurance premiums are a reflection of risk and companies have a responsibility to ensure they can cover the claims made.

### **Will ensuring private insurers participate in the Private Flood market lead to increases in premiums?**

- The Flood Insurance Market Parity and Modernization Act was a consumer choice bill. If enacted, it would clarify the definition of “private flood insurance” to ensure lenders understand the types of policies they can accept. The bill PRESERVES the ability for consumers to seek policies in the private market, including the surplus lines market, IF THEY CHOOSE and/or NEED IT.
- The language in the Act does nothing to reduce or limit the ability for the NFIP to offer policy solutions at subsidized rates to consumers and they will always be able to choose the NFIP policy.

- The legislation would merely give consumers additional options to choose.
- Nothing in the legislation REQUIRES consumers to choose a surplus lines option and so they will continue to have the subsidized NFIP policy as an option.
- Enabling the participation of the surplus lines industry will encourage broader private insurer participation which will ultimately breed competition and LOWER premiums.

### Are industries, like the surplus lines market, pushing this legislation as a way to open up a new market and undercut the NFIP?

- No. **The legislation would preserve the ability for consumers to seek policies in the surplus lines market if they choose and/or need it.** *See Appendix C.*
- The preservation of the surplus lines option ensures that consumers will have an alternative choice to the NFIP and to ensure consumers have options when they do not qualify for the NFIP or when they need alternatives to the NFIP.
- **Without the existing surplus lines alternative, consumers who need it will be left with no option.**
- Remember – the surplus lines market is not a direct competitor to the admitted market but rather a supplement or alternative when the admitted market is unable or unwilling to provide coverage.
  - In most instances, brokers must TRY to get flood insurance from the admitted market first. This is called the “diligent search” requirement. Insurance coverage generally has to be declined three times by admitted carriers before the surplus lines market becomes an option.
  - In some states this requirement has been waived for certain products, including flood insurance, because the state insurance commissioner has determined that an admitted option does not exist or nonadmitted options are necessary and good for the consumer.
- In the event a more significant private flood insurance market takes off, the admitted market will become a more active participant and the normal market cycle and related ebb and flow of business between the two markets will result.
- Flood insurance is not new to the surplus lines market. Consumers whose risks have not fit within the terms and limits of the NFIP and whose risks have been declined by the standard market have leveraged the surplus lines market for many years.
- Based on data from 10 of the 15 states with surplus lines stamping offices (California, Florida, Illinois, Mississippi, New York, North Carolina, Pennsylvania, Texas, Utah and Washington), the surplus lines market generated flood insurance premium of \$284.1 million in 2018, \$66.1 million of which was for primary residential flood insurance coverage and \$30.9 million of which was for excess residential flood coverage.
- While these figures represent a very small proportion of the \$44.9 billion surplus lines market and the \$3.3 billion of premium written by the NFIP, they represent solutions for consumers who:
  - (1) need higher limits than the \$250,000 residential, \$100,000 personal contents and \$500,000 commercial limits offered by the NFIP;

- (2) need enhanced coverage from that offered by the NFIP such as replacement costs of the damaged property rather than actual cash value of the property, additional sublimits, additional structures, or the ability to schedule multiple properties on one policy; and/or
- (3) need additional coverage such as additional living expense, basements, or business interruption for commercial entities.
- Legislation would amend the definition of private flood insurance to provide lenders with the certainty they need to accept surplus lines flood insurance policies and will ensure consumers have access to the options they need from the surplus lines market.

### Would a transition period for the surplus lines market allow flood insurance in the admitted market to develop?

- **No. Any prohibition against the surplus lines market is a prohibition to any private market insurance solutions for consumers and will leave the NFIP as the ONLY option.** This result will:
  - Be **bad for consumers**, because consumer choice and alternatives to the NFIP, including cases where the NFIP is not an option for the consumer, will be eliminated;
  - **Kill the development of a private flood insurance marketplace** by thwarting the private market's innovation and development of flood insurance products; and
  - Be **bad for the NFIP** which, without the private market, will be unable to transfer any of its exposure from the federal government's balance sheet to the private market and therefore remains exposed to the next significant flood event.
- **The surplus lines market facilitates the development of the admitted market for unique and emerging risks.** Preventing the participation of the surplus lines market now will completely thwart the development of the admitted market.
- A perfect example of the evolution of surplus lines products to the admitted market is medical malpractice insurance. When physicians first started looking for this product, the admitted market was unable to provide the coverage because there was not enough risk data and experience to understand how to price the product. Surplus lines carriers provided the coverage. As loss data became more available – off of the experience of these surplus lines policies – the admitted market began to move into the space and now offers the majority of medical malpractice insurance.

## Since surplus lines insurers are not subject to the state guaranty system, what happens if there is a financial impairment or insolvency?

- Surplus lines insurers have a proven track record of financial solvency. They typically do not participate in the state guaranty system.

### Track Record of Solvency

- The recent A.M. Best report highlighted that the surplus lines industry reported **zero financially impaired companies** for the 14th year in a row whereas the property/casualty industry experienced 230 disclosed financial impairments over the same period.
- The primary reason for an absence of impairments is due to the surplus lines industry's improved underwriting performance, driven by demonstrated underwriting discipline and adequate pricing overall. Additionally, states generally require surplus lines insurers to maintain a higher level of capital and surplus (compared to an admitted carrier) due to the lack of guaranty fund participation.
- As of September 2018, **96% of surplus lines companies have excellent, superior or exceptional ratings**, compared to 81% of the total P/C industry with similar ratings.

#### Best's Rating Distribution As of July 25, 2018

Best's Financial Strength Ratings Category	Rating Level	Domestic Professional Surplus Lines Insurers		Total Property/Casualty Industry	
		# of Companies	Percentage	# of Companies	Percentage
Exceptional	aaa	1	1.0%	3	0.4%
Superior	aa+	8	8.3%	19	2.4%
Superior	aa	6	6.3%	21	2.7%
Superior	aa-	19	19.8%	50	6.3%
Excellent	a+	15	15.6%	92	11.6%
Excellent	a	26	27.1%	185	23.4%
Excellent	a-	17	17.7%	267	33.8%
Good	bbb+	3	3.1%	35	4.4%
Good	bbb+	1	1.0%	48	6.1%
Good	bbb-	0	0.0%	42	5.3%
<b>Total Secure Ratings</b>		<b>96</b>	<b>100.0%</b>	<b>762</b>	<b>96.5%</b>
Fair	bb+, bb, bb-	0	0.0%	19	2.4%
Marginal	b+, b, b-	0	0.0%	5	0.6%
Weak/Very Weak	ccc+, ccc, ccc-, cc	0	0.0%	2	0.3%
Poor	c	0	0.0%	0	0.0%
Regulatory Supervision/Liquidation	e/f	0	0.0%	2	0.3%
<b>Total Vulnerable Ratings</b>		<b>0</b>	<b>0.0%</b>	<b>28</b>	<b>3.5%</b>
<b>Total Issued Credit Ratings</b>		<b>96</b>	<b>100.0%</b>	<b>790</b>	<b>100.0%</b>

## When was the last impairment in the industry and why did it happen?

- The last reported financial impairment was in 2003.
- **Since that date, there have been ZERO reported financial impairments of surplus lines insurers.** During the same time-period, there were over 230 reported financial impairments of admitted/standard carriers.
- The 2003 impairment is attributable to the surplus lines subsidiary of a group of insurers, under common ownership, that operated primarily in the admitted market. The group's program operations were very poorly managed and the surplus lines subsidiary became part of the group's insolvency. The surplus lines business represented only a fraction of the group's total writings.
- The surplus lines insurer was placed in liquidation by its domiciliary state and an "estate" or trust fund was established to pay claims. The company was highly reinsured, which allowed for the continued payment of most claims, with a significant portion paid at 100%. In some cases, the insured successfully sued the surplus lines broker for the unpaid claim.

## Did taxpayers pay any of the losses or costs associated with the insolvencies?

- No. The claim costs as well as the costs of administering the estate were paid out of the insurer's remaining funds/assets.

## Were there any regulatory changes after the 2003 failure for surplus lines insurers?

- States such as California and New York have increased their minimum policyholder capital and surplus from \$15 million to \$46 million.
- The NAIC's IID Quarterly Listing of Alien Insurers also requires a minimum capital and surplus of \$45 million. Other states, upon implementation of the Nonadmitted and Reinsurance Reform Act of 2010, require a minimum capital and surplus of at least \$15 million.

## How has the surplus lines market been able to better withstand adverse market conditions?

- One of the hallmarks of the surplus lines insurance market is the development of new insurance solutions to address new or emerging risks, or to provide continually evolving coverage for known risks.
- The core competencies of the successful surplus lines carriers remain the same, focused on effective strategic analysis, innovation, product diversification and underwriting discipline.
- These companies typically concentrate more on bottom-line underwriting performance and profitability than top-line organic growth, while providing coverage for the varied, nonstandard risks that they underwrite.
- This focus gives these insurers the best chance to withstand adverse market circumstances and succeed over the long term.

## Appendix A – Definition of Private Flood Insurance from the Flood Insurance Market Parity and Modernization Act from the 115th Congress

**PRIVATE FLOOD INSURANCE.** — The term ‘private flood insurance’ means—

(i) an insurance policy that—

(I) is issued by an insurance company that is—

(aa) licensed, admitted, or otherwise approved to engage in the business of insurance in the State in which the insured building is located, by the insurance regulator of that State; or

(bb) eligible as a nonadmitted insurer to provide insurance in the home State of the insured, in accordance with sections 521 through 527 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (15 U.S.C. 8201 through 8206);

(II) is issued by an insurance company that is not otherwise disapproved as a surplus lines insurer by the insurance regulator of the State in which the property to be insured is located;

and

(III) provides flood insurance coverage that complies with the laws and regulations of that State;

or

(ii) an agreement with a mutual aid society for such society to cover expenses arising from damage to property of the members of such society caused by flooding, unless the State in which the property to be insured is located has—

(I) determined that the specific mutual aid society may not provide such coverage or provide such coverage in such manner; or

(II) specifically provided through law or regulation that mutual aid societies may not provide such coverage or provide such coverage in such manner.

(E) STATE. —The term ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, Guam, the Northern Mariana Islands, the Virgin Islands, and American Samoa.

## Appendix B – Top 50 Insurance Groups and 2017 Market Share

### Top 50 Insurance Group and 2017 Market Share

Insurance Group	Rank	State of Domicile/Lead State	2017 SL Premium	% Market Share
Lloyd's	1	NAIC's IID/Quarterly Listing	\$ 10,325,000	23.0%
American International Group	2	New York	3,239,996	7.2%
Markel Corporation Group	3	Illinois	2,167,568	4.8%
Nationwide Group	4	Ohio	1,737,150	3.9%
W. R. Berkley Insurance Group	5	Delaware	1,698,541	3.8%
Berkshire Hathaway Ins Group	6	Nebraska	1,503,234	3.3%
Chubb INA Group	7	Pennsylvania	1,445,248	3.2%
Fairfax Financial (USA) Group	8	Delaware	1,305,476	2.9%
Liberty Mutual Insurance Companies	9	Massachusetts	1,288,834	2.9%
XL Catlin America Group	10	New York	1,142,292	2.5%
Zurich Financial Svcs NA Group	11	New York	1,135,953	2.5%
Alleghany Ins Holdings Group	12	New Hampshire	790,305	1.8%
Argo Group	13	Illinois	723,869	1.6%
Tokio Marine US PC Group	14	Pennsylvania	688,481	1.5%
AXIS Insurance Group	15	Illinois	681,015	1.5%
Sompo Holdings US Group	16	Delaware	671,194	1.5%
QBE Americas Group	17	Pennsylvania	642,289	1.4%
Great American P & C Ins Group	18	Ohio	600,356	1.3%
CNA Insurance Companies	19	Illinois	568,441	1.3%
Aspen US Insurance Group	20	Texas	539,155	1.2%
James River Group	21	Ohio	530,077	1.2%
Swiss Reinsurance Group	22	Missouri	485,098	1.1%
Arch Insurance Group	23	Missouri	469,965	1.0%
Starr International Group	24	Texas	425,901	0.9%
Navigators Insurance Group	25	New York	411,553	0.9%
Everest Re U.S. Group	26	Delaware	403,903	0.9%
Travelers Group	27	Connecticut	389,700	0.9%
Western World Insurance Group	28	New Hampshire	381,901	0.9%
RLI Group	29	Illinois	275,378	0.6%
SCOR U S Group	30	New York	260,008	0.6%
Allianz of America Companies	31	Minnesota	250,587	0.6%
HIIG Group	32	Texas	233,675	0.5%
The Cincinnati Insurance Companies	33	Ohio	229,850	0.5%
State Auto Insurance Companies	34	Ohio	226,020	0.5%
GeoVera U.S. Insurance Group	35	California	225,529	0.5%
Kinsale Insurance Company	36	Arkansas	222,419	0.5%
Global Indemnity Group	37	Pennsylvania	208,524	0.5%
Selective Insurance Group	38	New Jersey	208,116	0.5%
OneBeacon Insurance Group	39	New York	207,347	0.5%
Munich-American Hldng Corp Companies	40	Delaware	204,948	0.5%
Hallmark Insurance Group	41	Texas	203,634	0.5%
AmTrust Group	42	Delaware	187,310	0.4%
IAT Insurance Group	43	North Carolina	184,644	0.4%
Hartford Insurance Group	44	Connecticut	181,334	0.4%
Assurant P&C Group	45	Florida	179,311	0.4%
IFG Companies	46	Illinois	163,480	0.4%
Hanover Insurance Group	47	New Hampshire	122,364	0.3%
ProSight Specialty Group	48	New York	115,006	0.3%
ProAssurance Insurance Group	49	Alabama	99,505	0.2%
Atain Insurance Companies	50	Michigan	95,467	0.2%
			<b>\$ 40,676,951</b>	<b>90.6%</b>
		<b>2017 U.S. Surplus Lines Market</b>	<b>\$ 44,879,000</b>	<b>100%</b>

Appendix C – 20 States and the NAIC Regulate the Top 50 Surplus Lines Insurance Groups, Representing 90% of U.S. Surplus Lines Market

State of Domicile/Lead State	Surplus Lines	% Share of Top 50	% Share of 2017 SL
NAIC's IID/Quarterly Listing	\$ 10,325,000	25.4%	23.0%
New York	6,512,155	16.0%	14.5%
Illinois	4,579,751	11.3%	10.2%
Delaware	4,471,372	11.0%	10.0%
Ohio	3,323,453	8.2%	7.4%
Pennsylvania	2,984,542	7.3%	6.7%
Nebraska	1,503,234	3.7%	3.3%
Texas	1,402,365	3.4%	3.1%
New Hampshire	1,294,570	3.2%	2.9%
Massachusetts	1,288,834	3.2%	2.9%
Missouri	955,063	2.3%	2.1%
Connecticut	571,034	1.4%	1.3%
Minnesota	250,587	0.6%	0.6%
California	225,529	0.6%	0.5%
Arkansas	222,419	0.5%	0.5%
New Jersey	208,116	0.5%	0.5%
North Carolina	184,644	0.5%	0.4%
Florida	179,311	0.4%	0.4%
Alabama	99,505	0.2%	0.2%
Michigan	95,467	0.2%	0.2%
	<b>\$ 40,676,951</b>	<b>100%</b>	<b>90.6%</b>
2017 U.S. Surplus Lines Market	<b>\$ 44,879,000</b>		

## Consumer Options for Flood Insurance

The current definition of private flood insurance causes uncertainty regarding the role that surplus lines insurance can continue to play in fulfilling a consumer's obligation to purchase flood insurance. H.R. 1422/S. 563 was introduced in the 115th Congress to ensure consumers continue to have surplus lines options when securing flood insurance from the private market.

