AM Best
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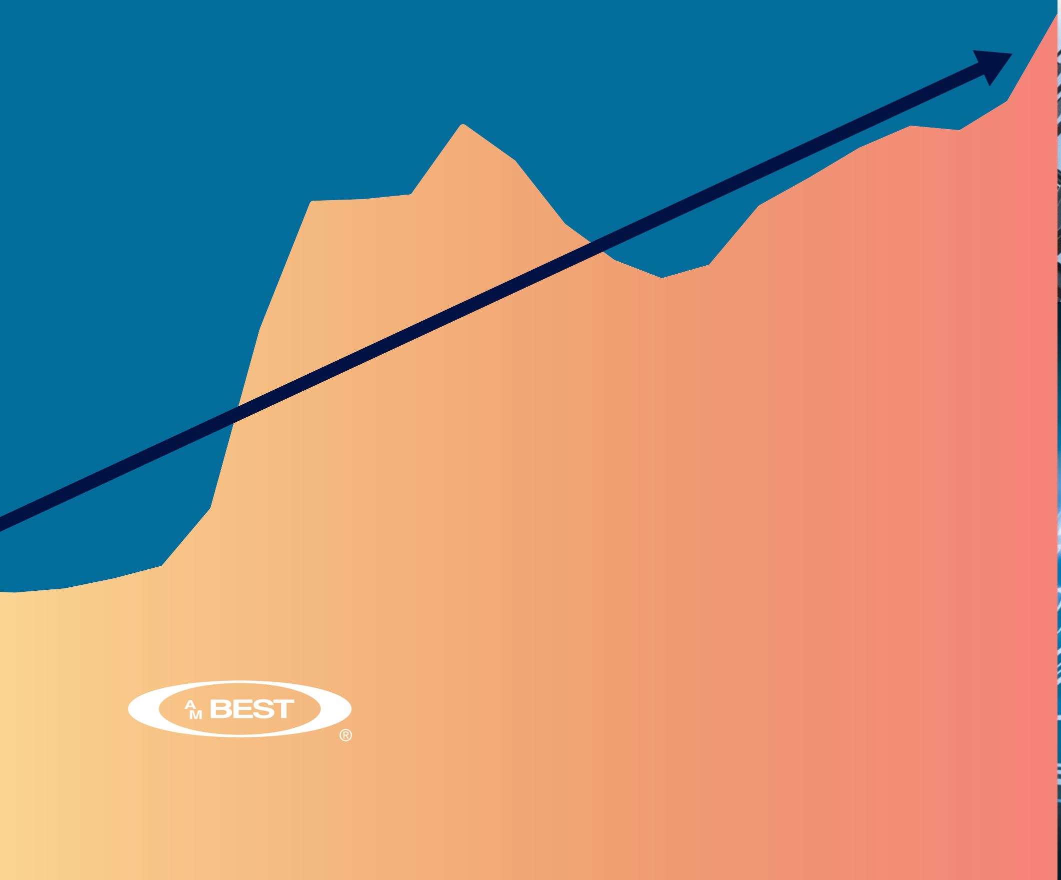
Best's Market Segment Report

Surplus Lines Insurers Achieve Impressive Growth, Improve Operating Profitability



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Surplus Lines Insurers Achieve Impressive Growth, Improve Operating Profitability

Underwriting profitability remained elusive in recent years, but the surplus lines market was still able to generate both pretax and net profits in 2018

The healthy US economy, growing complexity sparked by new technologies throughout different industries, and significant investments to improve operating platforms helped drive impressive growth in the surplus lines market in 2018. The elimination of diligent search requirements in some states for important product lines such as flood insurance helped boost premium growth.

The surplus lines market grew 11.2% in 2018, a notable increase from just under 6% in 2017. With the Lloyd's market accounting for more than 20% of total surplus lines market premium each year since 2014, the growth was very impressive given the strategic business review that Lloyd's announced midway through 2018 and uncertainty about its impact on the appetite of individual syndicates for surplus lines business. The impact of any significant decisions by syndicates regarding poorly performing classes of business and how those decisions will influence the pursuit of surplus lines is in question, as the strategic review continues.

The premium growth reflected many positives, but weather-related losses and competition resulted in an underwriting loss for surplus lines insurers for a fourth year running. Underwriting profitability has been elusive for the overall market in recent years as well. However, the surplus lines composite (as defined in this report) was still able to generate both pretax and net profits, both of which rose.

Consolidation in the excess and surplus lines and specialty market segment, particularly affecting wholesaler brokers and managing general agencies on the distribution side, remains a key aspect of the reshaping of the market. M&A focused on insurance intermediaries has been driven by the desire to obtain greater bandwidth to provide a wider array of products and services, along with a transformation in retail agents' buying trends. Acquisitions have played an integral part in the top three wholesale brokers being significantly larger in size than the rest of the market. Larger wholesalers have grown in scale and also expanded their profiles by acquiring smaller brokers and intermediaries.

Insurance company consolidations have slowed a bit during the past couple of years, although the Hartford Financial Services' 2019 acquisition of specialty insurer Navigators Group, along with the AXA Group acquisition of XL Catlin and AIG's acquisition of Validus Holdings (both of which closed in 2018), have created organizations with an expanded breadth and presence in the marketplace. Product and geographic diversification and effective use of advanced analytics have underpinned the ability of specialty market participants, such as Ace and Chubb, that have consolidated successfully. These market leaders have been able to

Analytical Contacts:
David Blades, Oldwick
+1 (908) 439-2200 Ext. 5422
David.Blades@ambest.com

Robert Raber, Oldwick
+1 (908) 439-2200 Ext. 5696
Robert.Raber@ambest.com

Contributors:
Greg Williams
Helen Andersen

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AM Best Surplus Lines Market Report – A Retrospective

In the early 1990s, we published Best's Insolvency Study: Property/Casualty Insurers 1969-1990, in an effort to bring clarity to active debates about insurers' solvency. Sparked by interest in this topic, in 1994 the Derek Hughes/NAPSLO Educational Foundation—now the WSIA Education Foundation—commissioned a similar study, on the solvency record of the domestic surplus lines industry. Although the segment was poorly understood at the time, data showed that the surplus lines market's financial stability and solvency were at least on par with the overall P/C industry's.

In the ensuing years, AM Best has published an annual report on the surplus lines market (commissioned by the foundation), documenting the following:

- The market's role in developing products to cover new or emerging risks, distressed risks, high-capacity risks, and other unique risks that cannot be insured in the standard P/C market
- The importance of surplus lines insurers' freedom of rate and form, which has allowed for creative insurance solutions to meet very complex or unique coverage needs
- The critical and still growing role of wholesalers in developing products and forging relationships with insureds that facilitate the placement of business in this market

Throughout its history, the surplus lines market has faced significant obstacles and intense competition—including periods of aggressive pricing during which standard market carriers seeking organic growth offered broader coverage—as well as the growing appeal of the alternative risk transfer market as another means of covering surplus lines risks. Throughout, surplus lines industry representatives have maintained a consistent, active presence in the states and in Washington, DC, tracking and addressing critical regulatory issues affecting the industry and helping advance key pieces of legislation, such as the National Association of Registered Agents and Brokers (NARAB) provision of the 1999 Gramm-Leach-Bliley Act, which led to the licensing of nonresident surplus lines agents and brokers and created a new landscape in wholesale distribution. More recent initiatives entailed advocating passage of (1) the Nonadmitted and Reinsurance Reform Act in 2010; (2) NARAB II as part of the Terrorism Risk Insurance Program Reauthorization Act of 2015; and (3) the Flood Insurance Market Parity and Modernization Act of 2017 (discussed in Section III of this report).

Despite numerous economic, regulatory, legislative and market-related challenges, surplus lines insurers' market share has more than doubled in size over the last 20 years, from 3.3% of total P/C direct premiums written (DPW) in 1998, to 7.4% at the end of 2018. As a percentage of commercial lines DPW, the surplus lines insurers' share grew from 6.7% at the end of 1998 to 15.7% at the end of 2018, further demonstrating the segment's importance as part of the P/C industry.

As of mid-year 2019, 98% of surplus lines insurers had AM Best long-term Issuer Credit Ratings (ICRs) of "a-" or higher, compared with 82% for the total P/C industry, further corroborating the segment's ongoing financial strength.

The surplus lines market functions as a healthy and viable safety valve for the insurance industry, as emerging issues and developing exposures continue to drive the demand for new, creative, and comprehensive insurance solutions. AM Best believes that, given the surplus lines market's proven ability to effectively assess new exposures and its flexibility to tailor terms and limits to meet coverage demands, the market's critical role and value to the P/C insurance marketplace will continue to grow.

gain and defend solid market positions. Over the near term, we may see fewer consolidations of large global multiline insurers and reinsurers, and more strategic acquisitions of niche, specialty insurers, possibly insurers that have a well-established market presence or advanced technological capabilities. The M&A-conducive environment could lead to a marked change in the surplus lines and specialty market's competitive landscape, with a smaller number of companies with greater specialty capabilities and greater market capacity.

Surplus lines intermediaries sharing their view of the market with AM Best report that admitted carriers continue to entertain some risks requiring creative coverage solutions—a trend likely to persist, given the challenges of growing organically in an industry awash with available capital, including capital from private equity firms looking for an avenue into the surplus lines and specialty market. Favorable conditions have attracted new entrants presenting themselves as alternatives to established players; although some of these new entrants are structured as surplus lines carriers, they function more as transformers and fronting entities. Regardless, AM Best expects that the footprint of surplus lines carriers will continue to grow as technology adds levels of complexity to manufacturing and other types of risks.

In July 2018, AM Best become aware of the impairment of a small surplus lines insurer—the first such impairment in more than 14 years. The dearth of segment impairments in recent history highlights the remarkable resilience of surplus lines and specialty market companies through different market cycles and during a period of numerous P/C market-impacting events.

For this report, AM Best has divided surplus lines insurers into four segments:

- **Domestic professional** companies (the largest segment) are US-domiciled insurers that write 50% or more of their total premium on a nonadmitted or surplus lines basis.
- **Domestic specialty** companies are US-domiciled insurers that operate to some extent on a nonadmitted basis but whose direct nonadmitted premium writings amount to less than 50% of their total direct premiums written.
- **Regulated alien insurers** and **Lloyd's syndicates** are non-US domiciled insurers that must file financial statements and auditors' reports, the names of their US attorneys or other representatives, as well as information on their US trust accounts, with the International Insurers Department (IID) of the National Association of Insurance Commissioners (NAIC). Regulated aliens must also meet IID criteria relating to capital and surplus, as well as underwriting and claims practices, and have a reputation of financial integrity. The NAIC publishes a Quarterly Listing of Alien Insurers naming the alien insurers that meet its criteria. In this report, we capture the premium written by the group of non-Lloyd's alien insurers, and the premium written by the Lloyd's syndicates separately.

Note: Lloyd's is not an individual insurer but a market of many risk bearers. According to the IID, in 2018, there were 88 Lloyd's syndicates transacting surplus lines business. The premium totals attributed to the Lloyd's market in this report reflect the aggregation of the market activities of those 88 syndicates and logically cannot be compared to the market activity of any one surplus lines group or company referenced in the report.

AM Best's Outlook for the US Surplus Lines Market

AM Best is currently maintaining its Stable outlook on the surplus lines market. The established surplus lines market participants proactively manage their risk-adjusted capitalization to protect and preserve their policyholders' surplus, implementing clearly defined risk tolerance and appetite levels that take into account underwriting and other risks to their balance sheets, which allows them to maintain, and even expand, their capacity for risks declined by the admitted market. These positions also allow surplus lines carriers to thrive in competitive or soft markets. Catastrophe events in 2018 had a minimal to moderate effect on the balance sheets of surplus lines carriers.

The most successful surplus lines carriers have historically demonstrated an underwriting proficiency that captures the nuances of the market. These carriers do not stray from their deep-rooted philosophies. Their success in underwriting is complemented by the diversity of product offerings as well as significant geographic diversification. In addition, their risk-adjusted capitalization is quite strong, providing the necessary support for underwriting. These carriers' balance sheets also feature diversified investment portfolios, providing net investment returns that, in the aggregate, are better than the P/C industry's as a whole. The strength of their balance sheets allows these carriers to weather competitive market conditions.