Looking for The Next Hard Market

A roundtable held in conjunction with the National Association of Surplus Lines Offices focuses on pricing and availability for specialty coverage products.

The webcast, “Pricing and Availability in the Excess & Surplus Market,” was co-hosted by A.M. Best Co. and the National Association of Professional Surplus Lines Offices on June 11, 2009. This webcast was attended by more than 1,050 viewers. Industry leaders reviewed specialty insurance in light of a new survey conducted by NAPSLO. This is an edited version of the webcast’s transcript.

A video replay of the full webcast is available at www.ambest.com/excess09.

Webcast moderator: Lee McDonald, group vice president, A.M. Best. Co.
A.M. Best and Surplus Lines

McDONALD: A.M. Best does a report every year in conjunction with NAPSLO. It’s the state of the excess and surplus lines market in which we wrap up the leading writers, the developments in terms of underwriting and profitability and capitalization. So, Duncan, why don’t you just fill us in?

McCOLL: There’s been two major changes in the top 25 group surplus lines writers. The first—AIG—was downgraded from A+ to A last fall. Second, IFG companies were upgraded from A- to A this spring. So, two changes in the top 25 group.

McDONALD: How about the overall industry—surplus lines compared with the entire property/casualty industry. I know that you’ve been looking at even some newer numbers. What are you seeing?

McCOLL: If you look back at 2008, the surplus lines industry continued to have the performance advantage. Roughly 10 points on the combined ratio. The surplus lines combined ratio for our composite was 95 in 2008 versus 105 for the property/casualty composite. And we feel that’s reflective of the flexibility in rate and form that surplus lines companies have, that admitted companies don’t have.

McDONALD: Our official number for the P/C industry for ’08 was 105.1. I know there’s been a lot of discussion. I’ve seen anywhere from 102, 105 or higher. And for the surplus lines, 95 flat. We have advance financial results that we published and for the first quarter for the industry we’re saying 101. I guess for the first quarter combined?

McCOLL: Yes. It’s hard to make comparisons in the first quarter because we haven’t really had the catastrophe experience that surplus lines and the entire industry is exposed to, but again we’re seeing that same kind of margin—the profitability, the advantage that the surplus lines composite has versus the property/casualty index in the first quarter. It’s a favorable trend we expect to continue.

McDONALD: The other place that shows up is in terms of impairments and insolvencies.

**Surplus Lines vs. P/C Industry – Premiums Earned Growth**

![Graph showing premium earned growth comparison]

**Surplus Lines vs. P/C Industry – Combined Ratio**

![Graph showing combined ratio comparison]

Source: A.M. Best Co.
McCOLL: 2008 was the fifth consecutive year when there was not a surplus lines company that became insolvent. And that was in a tough year—in 2008, there were actually seven companies in the admitted markets, mostly in the title industry, that had become impaired.

McDONALD: There were some tough years for surplus lines. I guess we had five years of zero but before then you had two years of five?

McCOLL: That’s right. 2003 and 2002—each had five insolvencies of surplus lines companies.

The State of Surplus Lines

McDONALD:  Now I’d like to start picking the brains of our panelists. We're going to be doing that in conjunction with a survey that NAPSLO performed. Marla, what are we seeing there?

DONOVAN: In the property realm, all indicators showed that by now we would be seeing some substantial hardening of the market because of the catastrophes of last year, as well as the capital impairments due to the economic conditions last year. At the same time, the nonproperty lines have not cooperated as much. So a perfect storm of potential for rate increases hasn’t quite hit. But everybody seems to be in a holding pattern right now. The sense is that the capacity is pent up and waiting for an opportunity more commensurate with exposure.

McDONALD: Paul, what are you seeing, particularly in terms of cat and high-end exposed property? Where’s that going?

SPRINGMAN: It’s a real mixed bag right now. We have started to see some pricing increases on the catastrophe exposed business on wind- and probably to a lesser extent on quake-related business. Probably not to the extent that we believe where the marketplace should be relative to the loss experience in the last five to seven years, but it’s encouraging at least that they’re starting to go up. On the noncatastrophe-exposed business, in middle America it is still very, very price competitive right now with ample capacity, lots of players and lots of choices for buyers. But as we get a little further along in the economy, I anticipate that we’re going to see an uptick in claims frequency that will lead to claims severity. And sooner or later, underwriters are going to have to recognize that in terms of increased pricing.

McDONALD: Kevin. Where in property—vacant property, multifamily property, things like that—where’s that headed at this point?

WESTROPE: Particularly in the multifamily business, we are beginning to see a fairly significant uptick in rate restriction and capacity. That is a class of business that generates a lot of premium volume, but consistently also generates a pretty significant loss pick as well. So, we’re seeing fewer carriers willing to jump in on a primary basis in that line of business and we write a very significant book of that. Not only do you have just the day-to-day exposure of normal fire losses, etc., but you also generally will have some significant catastrophe exposure as well. Those two things combined make that tend to be a difficult class of business from time to time and we’re beginning to see a fairly significant uptick there.

McDONALD: Is it that the pricing is hardening? Is it hard to place?

WESTROPE: The pricing is definitely hardening and there are fewer players chasing the primary layers in that business, which tends to be where the bulk of the premium is.

Workers’ Compensation

McDONALD: OK. Just moving along to a line that I know is very important to your business, Richard, which is workers’ comp. Has that been changing at all?

KERR: We expected workers’ compensation to start changing by this time, but it’s not. I mean it’s still a very, very competitive market and it’s even gotten to the extent where you would expect some risks such as asbestosis or chemical blending to have a very limited number of potential markets. However, a lot of the class codes that used to be restricted are being broadened and carriers are still clamoring for premium and broadening their scope. So we see insurance companies doing class codes today that they wouldn’t have been doing several years ago. Now, admittedly, some of the big, strong players in the workers’ comp arena of two or three years ago are pulling back and changing their price strategy and that will ultimately have an impact. Perhaps, their view is we’ll come in and write billions of dollars whenever the pricing is right and when it’s wrong, we’re going to pull back. So, as a broker I don’t like it, but as a shareholder I would commend them for that strategy.

McDONALD: OK. And Marla, you see workers’ comp as tomorrow’s story. How so?

DONOVAN: We’re in a time of unprecedented economic disruption and we have the greatest unemployment that we’ve had in 25 years. What
tends to happen with workers’ compensation is that it almost becomes the unemployment insurer of last resort. As workers are laid off, they will file claims for back strains and things that are very difficult to prove. The workers’ compensation mechanism ends up being a support system. People are going to be out of work for longer and have more difficulty finding work. So, they’ll be looking for solutions and one of them is the workers’ compensation system. I think that’s a differentiator, too, between the surplus lines market and the standard market when we talk about the difference in results. In surplus lines we don’t do workers’ compensation. It tends to be the single largest product line for many carriers and as those results start to come in, there may be some reserving issues and a need to acknowledge the negative economic impact of workers’ compensation in the standard markets.

There may be some reserving issues and a need to acknowledge the negative economic impact of workers’ compensation in the standard markets. —Marla Donovan

McDONALD: So you see that shooting way up?

DONOVAN: I see it shooting up. I absolutely do. And I think it’s something that has not necessarily been factored into the current results.

McDONALD: One thing. You don’t believe 105 is where it’s probably at in actuality for combined ratio either, do you?

DONOVAN: I do not. Unfortunately, so much happened so quickly last year and nobody can afford to acknowledge everything at once. It’s very difficult. So, acknowledging what was going on in the capital markets, acknowledging what went on with cats is one thing, but workers’ comp results are a little more insidious. We saw the wild swings back in the ’90s from one extreme to another. I think that’s the next big story—is workers’ comp is going to start to catch up?

McDONALD: And the tail is going to come back on this year and there might be some adjusting there?

DONOVAN: I believe this to be true. And I believe it’s a broader group, as well, because the problems are more serious in the employment area than they have been in the last 30 or so years.

Professional Liability

McDONALD: Let’s talk about professional liability. I know Markel is very deeply involved in that market and particularly in the med mal part. Why don’t we start with med mal, Paul? What are you telling people is the story these days?

SPRINGMAN: Well, here again, it’s similar to a lot of the other specialty classes. It’s a real mixed bag. There seems to be a lot of competitors that have wandered into the specialty arena in the hard to place—we refer to them as “physicians with special needs.”

SPRINGMAN: There seems to be a lot more competition for no apparent reason other than some cash flow underwriting and we’ve seen some of the medical mutual companies become a little bit more aggressive. We’ve seen some of the standard stock companies start to wander their way back into what they perceive to be as standard medical covers on some relatively hard to place-type physician exposures. On the other hand, on our allied medical or specified medical—some people refer to it as miscellaneous medical—we see that as a tremendous area of opportunity. Things like day spas, and one of the things we get lots of calls on today, tattoo removals, and things like that. But clinical trials and new and emerging medical technologies are a great place for wholesalers and surplus lines underwriters when they have the opportunity to partner.

McDONALD: OK. Any other within professional lines? Is that pretty stable at this point?

SPRINGMAN: We’re starting to be successful with some pricing increases on architects and engineers and some of our lawyers’ professional offerings. The financial institution covers are off the charts. I would hate to be a risk manager at a large financial institution, like a bank, going into the marketplace today to purchase my directors and officers cover, or just my bank fidelity cover. Very, very difficult. Capacity has shrunk significantly, prices are going up exponentially and it’s a tough time to be in any sort of the financial arena.

McDONALD: And Kevin, I know you do a pretty good book of allied medical. What are you telling your producers?

WESTROPE: We’re seeing lots of opportunity with day spas and surgery centers and lots of outpatient-type situations. We do some of the other people’s docs, but the books of our business tends to be what they term miscellaneous medical and in the hospital arena. But also it comprises today probably 50% or maybe slightly more than our overall book of what we term professional executive liability business.

Environmental

McDONALD: One thing that I think we’re all involved in here is environmental. And I keep hearing that that is a growth area. Are there new types of environmental coverage? And what are you seeing in terms of pricing?

KERR: In probably the last six months we’ve seen insurance carriers moving into environmental that weren’t there in the past. And perhaps some of this is because the carriers were in the energy business. That market contracted with the price of oil going down and the payrolls and the
receipts going down, so there’s less premium. I think they’ve broadened their appetite to pick up some of these environmental exposures and it’s actually a pretty nice fit. Additionally, we’ve seen some specialty companies coming into the environmental area and provide a good alternative. Particularly for those accounts which are in the $40,000, $50,000, $60,000 premium range, because that’s a tough placement. The big guys like to do the multiline accounts in the multimillion dollar level, so you have specialty carriers that will come in and help you out perhaps even with the auto, but certainly with the general liability and the excess. However, it does create a bit of a challenge in getting the workers’ compensation placed that we were discussing earlier.

**DONOVAN:** Burns and Wilcox feels so strongly that environmental is a growth area we have actually set up an environmental practice as of January of this year. And to Richard’s point, we have found a wealth of carriers who were very interested in getting into the business and startups or quasi-startups and we have seen that as definitely a growth area and also a real need for our retail agents who don’t necessarily have the expertise. That’s the value of the wholesaler who can go out and really talk that language. It’s very different from straight casualty or straight property. And I would also add that we see at least four, if not eight more years of need for demand just because of the climate we’re in politically and economically. So, we definitely think that’s a major growth area for the surplus lines market.

**SPRINGMAN:** From our perspective as a surplus lines underwriter I’d say there’s some good news and some bad news. The bad news is there’s three, four, maybe five new competitors for a company like Markel that we didn’t have this time a year ago. The good news is that it’s an industry, like allied medical, that continues to grow very rapidly. And we’re seeing more and more project owners specifically require dedicated limits of liability for jobs. We’re also seeing much more sophisticated operators in the environmental arena. Where maybe five or six years ago you might have a contractor that did a little bit of this and a little bit of that—and, oh, by the way, I do some asbestos removal on the side. Now you have truly dedicated asbestos removal environmental contractors. You have environmental consultants that do nothing but environmental consulting and it’s become a very, very sophisticated industry.

**Transportation**

**McDONALD:** What are you seeing in transportation and are we talking about more than trucking?
WESTROPE: Our book of business in that arena is not all trucking. It tends to be local, intermediate and then anything related to that—motor truck cargo and various lines that go along with it. What we’re seeing is there is a change beginning to occur. I can’t say that we see it across the board at this point. You know, it’s kind of carrier-by-carrier. In the long-haul trucking market, which is not an area that we’re doing a lot in right now, there’s definitely a change afoot. I think there will definitely be increases in that arena. I think there’s just no way around it.

McDONALD: What’s driving change? I mean overall deliveries are down so you get a little bit of hit on premium.

WESTROPE: I think pricing had been driven to the point that is difficult to sustain. Yes, deliveries are down but at the end of the day it is not an exponential lessening of exposure if you have fewer deliveries going on. You still have an opportunity every time a delivery is made for a loss to occur.

AIG Fallout

McDONALD: Last time when we had this panel with different panelists one of the things that dominated the conversation was AIG. They were in the midst of the first round of the bailout and there’ve been several after that. At that time everyone was telling us that submissions were up like crazy and there were concerns about what’s going to happen to pricing. And my question is how did that play out and where does AIG and AIU Holdings sit in today’s market?

DONOVAN: Things have definitely calmed down and I think that’s good for the whole industry. Nobody was prepared for what happened last fall and obviously it was so destabilizing and so disconcerting. Clearly AIG’s been identified as the institution that is too big to fail. Whatever you feel about that, whatever your politics, that is a fact. So, AIG as we knew it, however, will no longer be around. AIU Holdings, the special-purpose vehicle to separate AIG property/casualty operations from the toxic area of the company is a good thing for the business and it seems to be stabilizing. And I believe that AIG—AIU—in a much smaller form will continue to serve a vital role in the marketplace and I think that’s good for all of us. There have been reports of some artificial suppression of rate, if you will, by AIG in their attempts to keep business, but we haven’t personally experienced that in our market space.

McDONALD: Paul, Tony Markel was here and he talked about the fact that everyone was seeing increased submissions. Apparently that hasn’t gone back to quite normal. What are you seeing in terms of just the submission turn?

SPRINGMAN: Our submission counts continue to remain at historically high levels. Part of it’s due to AIG shoppers as accounts come up for renewal and we’re starting to see some risk managers perhaps pare down limits that used to be at $25 million or $50 million with an AIG company to perhaps a limit lower than that. But what we anticipated would happen last September simply has not materialized.

McDONALD: Throughout the whole AIG saga there was a whole lot of sniping about possible irrational pricing or just stupid pricing, but from what I’m hearing from you, that’s really not the case?

KERR: Not from what we’ve seen. And, as you know, we monitor that pretty carefully. On occasion there may be a very competitive position but now it’s gotten to the extent because of complaints that have come to Congress from various other CEOs that AIU Holdings is, in my view, fearful to be too competitive.

—Richard Kerr

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surplus lines of business or NAPSLO members, frankly. But, we place more business with AIG companies currently than we do anywhere else and they’re kind of the 800-pound gorilla. My hope, as they move forward, and we have begun to see it, is that we will see a kinder, gentler organization without some of the arrogance that I think was really emanating from the financial side of things.

**Surplus Lines Outlook**

**McDONALD:** Richard, instead of looking back, let’s look forward. We’re almost at the halfway point of the year. What’s going to change, if the surplus lines market is going to change in the second half of 2009, what’s going to make it change and where is it going to change?

**KERR:** If it’s going to change, it’s going to be because the admitted market is going to back up and start to realize that they have transformed over into arenas that are really outside their skill sets. Over the course of the last three or four years you’ve seen large, admitted carriers that previously didn’t do these things start to creep into that arena and I think the pain is coming. And as that happens, when they pull back, that will begin to turn the market. So it’s not necessarily just a swing in classing, it’s going to be a swing in philosophical underwriting on the admitted market side which will then come back and benefit the specialty market.

**McDONALD:** Paul, let’s try your crystal ball here. If anything is to change, what will it be and what’s it going to do?

**SPRINGMAN:** I think it’s a matter of ‘when’ rather than ‘if’ and that might be the only thing I disagree with. If we look at three or four or five different related factors and clearly we believe the economy is driving that in the right direction, we’ll start to see an uptick in pricing.

Marla commented on the claim frequency for workers’ compensation coverage. We’re starting to see the same sort of phenomena in employment practices liability insurance.

**DONOVAN:** I couldn’t agree more with what both Richard and Paul have said. I frankly think we would already be in a harder market but for the fact that the demand side of the curve, namely exposure bases, are down so much because of the economy. The supply side has already been definitely affected by the capital markets activities and by the loss activities and, as Paul said, any profitability of last year was using a prior year’s back accounts, which are pretty now capped out. As the economy starts to rebound we will start to see demand for the conventional products, GLs, workers’ comp increase and also some of the specialty areas that we’ve been talking about where the demand is going up due to aging baby boomers going to health spas, the environmental products. I think EPLI will start to grow
because it’s definitely affecting more than just the larger accounts. There’s a lot of dynamics that are pointing to a hardening of the market, certainly by the fourth quarter of this year, if not sooner.

Managing General Agents

McDONALD: What do you see for the rest of the year for the industry, and then what do you see for the MGA, wholesaling community?

WESTROPE: Our expectation is that overall our company will grow this year somewhere in the 10% to 15% range, driven primarily by property lines. We really haven’t talked about third party business and in particularly just general casualty umbrella business but rate levels are such in that arena that I just can’t believe that as in industry we’re making money in doing casualty business right now. I mean rate levels are ridiculously low and continue to fall, it has to follow at some point. We haven’t seen anything approaching rate increases or growth in our third-party business at this point. As to my view on surplus lines, wholesalers and MGAs and what our future is, I think certainly it’s a very bright future.

McDONALD: We did see some phases in the wholesale and MGA market. You saw spin-outs a couple of years ago when the biggest brokers divested. You also saw some private equity money there. Now you see to be in a stable, competitive phase. But how long will that last and what’s ahead in that market?

WESTROPE: It’s difficult to say right now. I mean you referenced there was a lot of private equity money that entered the wholesale broker arena in the past five years and much of that money is looking for a return and looking to exit quickly. Unfortunately for those guys I think they’re in it for a little longer than they had anticipated being in. This is an industry that continually seems to recreate itself and has to, given the dynamics of what’s happening in the marketplace at any given time, so I think we’re going to see some spin-offs.

DONOVAN: I definitely agree with Kevin that we’ll see some shifting with many of the wholesalers that do have private equity money behind them. The reality of the last nine months is some of these smaller players have struggled with some of the day-to-day issues that you face in running a small business. So I do think there will be some consolidation. With that said, the largest growing area of our economy is always the small entrepreneurial business in this country. And one of the things that wholesalers and MGAs do very well is meet those needs. There will be some consolidation and I think a bit of a financial flight to quality—not flight to quality, that sounds desperate—in movement to economies of scale.

Advice for Agents

McDONALD: And Richard, we have quite a number of agents registered for this webcast and that’s your primary audience and everybody here ultimately. What do they need to know about where the opportunities are in playing in this market and this point and what should they be paying attention to?

KERR: If you’re in the wholesale business, the world is definitely changing. There absolutely is a bright future for the wholesale broker. But our determination is that it’s going to be broken down into three somewhat new categories—your traditional wholesale broker that you have today, which will assist these retail agents in placing the large, difficult accounts; and then there’s a new element that I will call the aggregators. And they are aggregating smaller opportunities and putting them into program situations. So, aggregators are doing commodity products that largely will be done in an electronic online fashion because that’s the only way you can make any money at it. And then lastly, sort of a combination of everything will be the exchanges. So that a retailer can join in an exchange and literally get access to everything they need and no one company can do that. So, there will be assimilations of companies in exchange number one, two or three. Exchange number one might be populated by specialty companies such as Markel and others; and Westrope would be the anchor tenant, so to speak, for wholesaling; and maybe for the commodities stuff...someone else.

SPRINGMAN: I think in terms of specific opportunities, three classes and we’ve talked about two of those—allied medical because of its growth, because of the new and emerging technologies that are associated with that, clearly one of Markel’s top initiatives. We’ve also talked about environmental opportunities because of some of the growth in that particular field. We’re also very high on all sorts of IT-related
E&O, be it cyberspace liability or data-breach liability, anything related to that and IT consultants. Those are areas that are really growing in this economy. But I think in general, if I was just to draw a box for a retail agent or one of our wholesale partners and say, anything that’s new, anything that’s different, anything that’s not in the book is where we can do our best work. Because when you think about the creativity and you think about the entrepreneurial-ship of the E&S industry historically. We combine with that freedom of rate and form.

KERR: Well, I think the market is going to come back and a lot of these agents have migrated over and many of them you talk to and we deal with thousands and thousands of them all across America, basically over the past two or three years they’ve said, ‘well we don’t really have an E&S business.’ Well, that’s about to change. So, as it changes they need to start aligning with the appropriate wholesale sources because they can get to those appropriate-type markets. In the next two or three years, the retail agents across America, their book of business will go from maybe 95% admitted down to 70%.

DONOVAN: Agents should definitely be thinking E&S because the traditional coverages, the straight property/casualty and what have you have always been what their customers need; but their customers, the small-business person, the entrepreneur, they, too, are having exposures now that will require some of these E&S products that we’ve all talked about. Anybody who handles data on a customer or a patient, for example, has an exposure to data breach. EPLI is not just for the Fortune 500 anymore. We have a very active and robust EEOC right now. So, environmental concerns that weren’t necessarily on everybody’s minds a few years ago. All of these kinds of exposures that are historically associated with large multinational companies really have come to Main Street and our retail agents need to service those needs and they need to be talking to their customers about those exposures and educating them about those exposures. Buying higher limits of liability—we’re entering a very litigious age in my view. So that’s where the value add is for the retailer is to make sure they’re partnering with wholesalers and their suppliers to bring these products that really are going to be very necessary for the average business person in the next decade.

We’re also very high on all sorts of IT-related E&O, be it cyberspace liability or data-breach liability.
—Paul Springman

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