

THE RHA REVIEW

ROUTE TO:

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Excess and Surplus Lines The Exciting Insurance Market!

The Role of the Surplus Lines Market in Property/Casualty Insurance

By John T. Bogart

"Proceed carefully in that direction from which all others are fleeing." (old E&S maxim)

The surplus lines segment of insurance is important, even vital, to the health of the industry because it provides a market for hard-to-place risks that standard (i.e., licensed, admitted) carriers are unable or unwilling to cover. Sound simple? Basically, it is! I'm going to try to explain this as well as I can, given the limits of my space and your attention span.

The purpose of the surplus lines market is to supplement the standard market, not to compete with it. Not being subject to filed rates or policy forms or to prior approval of underwriting criteria by state regulatory authorities, the surplus lines market fills a genuine need for coverage by insuring risks which would otherwise go unprotected. A good example is the liability insurance crisis of 1986. For various reasons, the standard carriers sharply and abruptly constricted their writings of liability insurance, especially products liability. Seemingly countless numbers of risks were begging for a home and accepting restricted coverages and lower limits of liability at vastly increased premiums

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MERGER MANIA

by Donald W. Bendure, MBA, CPCU, ARM

Insurance "merger mania" has dominated the journals for the last year. Aon, one of the largest brokers in the U.S., agreed last December to purchase Alexander and Alexander, Inc., also one of the largest. Keep in mind that Aon was *not even ranked* in the top 20 brokers worldwide in 1994. The significance of this single purchase is not understood until it is clear that this purchase catapulted Aon to within 12 percentage points (based on gross revenue) of overtaking the *largest* broker in the world, Marsh & McLennan, Inc. Not to be outdone, Marsh & McLennan agreed this March to purchase another one of the largest brokers, Johnson & Higgins, Inc., stretching Marsh's lead over the Aon group to 39 percentage points. This will give the new J&H Marsh & McLennan, Inc., almost five *billion* dollars of market clout. It will create a bipolar world for the large commercial insurance consumer as well as for all of the insurance companies that try to compete for those consumers' dollars. As Mr. Rogers would put it, "Can you say *oligopoly*?" I thought you could. Better yet, can we see its effects?

I would postulate that we are seeing market effects in very definite and disturbing ways, which will accelerate into the near future. Those of you kind enough to be reading this have the right to ask, "How does this affect me?" You may have probably heard many of the boilerplate answers already: (1) "These mergers will lead to further reductions in pricing" — the problem is that this is not terribly interesting to anyone, including the consumer, (2) "These mergers will lead to further consolidations" — this only leads to the "who's next" game when

(MERGER, continued inside)

or were forced, unprepared, into self-insurance. The situation became so severe that even general news magazines such as *Time* featured cover stories bearing such titles as "America, Your Insurance Is Canceled!"

The surplus lines market responded in its historic role of "safety valve" to the larger insurance industry and relieved the pressure on the standard markets until the situation stabilized. Admittedly, surplus lines carriers and brokers made themselves a tidy profit performing their heroic role and now lazily dream of those halcyon days, vainly hoping for their unlikely return. But the system worked! The surplus lines market did proceed in that direction from which all others were fleeing.

Some years earlier, the reduced amount

of available fire insurance following the riots of the 1960s led to permanent solutions, such as the FAIR Plan, because of the joint intervention of industry and government, but the surplus lines market gave those entities the necessary breathing room in which to find those solutions. The same can be said of the severe contraction of medical malpractice insurance in the 1970s. The list is lengthy and filled with anecdotes, but you get the idea of the importance of this unsung market, populated with rugged individualists just brimming with creative solutions that the more staid standard markets sometimes view with suspicion.

The surplus lines market is relatively free

(Exciting, continued inside)

(*Exciting*, continued from cover)

from state regulation in the areas of rate and policy form. That does not mean that it is unregulated. Each surplus lines carrier must be admitted (licensed) in one of the 50 states and must meet all of its solvency requirements. Thus that state, called the *state of domicile*, becomes the regulator of that carrier. The other 49 states are not powerless to prevent a surplus lines carrier from writing in their states even though it has met the requirements of its state of domicile. Quite the contrary, states' rights is still a very viable concept in the insurance world. After receiving the blessing of its home (domicile) state to go forth and write amongst the multitudes, the surplus lines carrier solicitously asks permission of other states to be *whitelisted* (allowed to write business) in that state. Procedures have been implemented in recent years to streamline this lengthy system, but any state has the right to decline approval to write within its borders or to order a carrier to "cease and desist" binding risks.

This is not just theory — it's done all the time. In addition to operating under the not-always-benevolent gaze of the various insurance commissioners, surplus lines carriers are subject to thorough financial scrutiny by organizations such as A.M. Best, among others. So while we can say that these carriers have nontraditional ways of underwriting and marketing, they must, and usually do, operate from a solid financial base and in harmony with sound business practices.

Where does this relatively small number of carriers get its business? The sheer number of insurance agents and brokers precludes them from dealing with all or most of them, even those who hold the required surplus lines brokerage license. These few carriers would be overwhelmed by the number of risk submissions and would be unable to control their sources of business.

They have solved this logistical problem by appointing only specialty surplus lines brokers called wholesalers. These producers deal only with retail insurance agents and brokers who actually control the risk or are bidding on it. Wholesalers rarely, if ever, deal directly with the insured. Their client is the insured's agent or broker. Wholesale E&S

brokers range in size from a small single office to large regional, national and international firms.

Sometimes these brokers may hold a binding authority granted them by one of their surplus lines carriers for a specific class of business. The jargon for this is "having the pen." Thus, in addition to being surplus lines brokers, they are also managing general agents. To further complicate things for you, a surplus lines carrier may give the broker authority, within rigid guidelines, to arrange facultative reinsurance on its behalf. Now the broker is acting as a reinsurance intermediary.

In addition to frequently changing hats, the broker is also responsible for arranging the state filings for risks placed in the nonadmitted market and for the submission of these filings to the stamping offices of various states. Most jurisdictions require a special surplus lines license in addition to the standard agents and brokers license as well as a separate surety bond. Almost all brokers and carriers exclusively engaged in surplus lines belong to a professional organization of their peers called NAPSLO (National Association of Professional Surplus Lines Organizations).

In the interests of simplicity, I'm writing about the largest segment of surplus lines carriers, those that A.M. Best calls the domestic professional surplus lines companies. These companies are licensed in at least one state (remember the state of domicile) and write at least 50 percent of their total book of business on a nonadmitted basis. This segment wrote \$6.5 billion of direct premiums, or 70.3 percent of the total market share, in 1995.

Then comes Lloyd's of London, whose premium volume for this business was at a reduced \$1.3 billion, accounting for 14.1 percent of the surplus lines market, down from 23 percent at its peak a decade earlier.

The third segment consists of regulated alien companies, those which are domiciled outside the United States but which write business in accordance with the standards of the National Association of Insurance Commissioners. They racked up premiums of \$1 billion, or 11 percent of the market.

The remaining market share came from U.S. carriers, which wrote only a small per-

centage of their volume in surplus lines and from the unregulated alien market, a segment having virtually no financial reporting requirements and which are subject to no U.S. regulatory authority.

In closing let me share with you an anecdote which will give you insight into the excess and surplus risk selection process.

Twenty-five years ago, after serving nine years as a standard market underwriter, I showed signs of chafing under the necessarily slow and measured pace of an industry giant. My supervisor, not meaning it as a compliment, observed that I probably should be in the nonadmitted market with the other mavericks. Within a month I was sitting in a premier surplus lines company, puzzled by the absence of manuals, directives and referral sheets on my desk. Observing two of our seasoned underwriters chatting at the water cooler (yes, we had water coolers in those days), I timidly approached and asked them just how they decided which was a good risk and which should be declined. After informing me outright that damned few risks should be declined, that almost anything can be written at some kind of price and on these terms, the property underwriter gave me his example. "Look, rookie, suppose you're offered a local restaurant for a package policy including business interruption. After you've determined that it has at least conformed to the minimum fire code, drive by on a Monday or Tuesday night. Count the cars in the parking lot. If it's more than half full, it ain't gonna burn. Write it!" I turned to the casualty underwriter, who told me that that very morning he was offered a fireworks display exhibitor. "My only questions were these," he said. "Has he been doing fireworks displays for five years? If his answer is yes, does he have 10 fingers and 10 toes? If yes again, he knows what he's doing. I wrote it!" And thus to this day the surplus lines underwriter and his equally inscrutable broker carefully proceed in that direction from which all others are fleeing. **RHA**

John T. Bogart is an associate of Robert Hughes Associates and a former underwriting officer, reinsurer and O of an excess and surplus lines brokerage firm.

(MERGER, continued from cover)

we need to concentrate on what *these* mergers mean first. Here are some thoughts that I have been tossing around in my head for some time which I hope will, in turn, be food for thought for you and your clients.

Insurance Agent's E&O

As a result of these and other mergers, the past year has been witness to the largest turnover of personnel handling sophisticated insurance programs in U.S. insurance history. And it isn't over. Those consumers who have not changed brokerage organizations will in all likelihood see a change of broker internally within their brokerage organization. As these brokers that are kept within brokerage organizations are reassigned to different accounts, experience gaps will be created that will be difficult to fill. Learning curves take time. Brokers without sufficient expertise in their area of insurance must be trained quickly and be adequately monitored or they will become the E&O casualties of tomorrow. The insurance industry has suffered 10 years of a slow, agonizing brain drain since the liability insurance crisis of 1986. Now with further consolidations, more talent will no doubt be lost at the altar of corporate economics and efficiency.

Employment Practices Liability (EPL)

Of course, many of those lost will not be very happy about it. Human resource departments have learned many defensive techniques and as a result have limited much of the damage that can befall an organization in rapid, massive transition. But if history is any teacher, the upward trend in EPL claims will not go down because of these mergers. The insurance industry is more exposed than it ever has been to EPL losses because of compromises that inevitably result from economic deci-

sions. As they say, "There's many a slip between the cup and the lip." And what's in the cup may not be tea.

Coverage Clout

Here's where I get on my soapbox. Insurance pricing *is* an issue. The insurance market has been cheap for years, and barring some unforeseen event, will remain so for the foreseeable future. Most insurance companies have forgotten what it feels like to get a rate increase at renewal. But the *real* battle for market share is being waged on the field of enhanced coverage and new coverage combinations. The large brokers are gathering so much clout in the marketplace that the insurance companies are being forced to provide coverage in areas that would have been *unthinkable* only a year ago. "And oh, by the way, Mr. Insurance Underwriter, just go ahead and also lower that premium by another 20 percent just to show good faith to your longtime client of one year." Be still, my heart.

The disturbing issue in my mind is not that many of the coverage enhancements and new coverage combinations are given. It's the casual way in which they are given that creates issues. Sometimes the same insurance company has many versions of the same coverage, which differ for no readily apparent reason. Variance in language from one company to another can lead to differing interpretations from one layer of insurance to another. Some of the more mistaken attempts lead to coverage broadened beyond the original intent. Other attempts beg the question of original intent from the first sentence. And where does a lot of this wording come from? Much comes from the brokers themselves, who demand the coverage, verbatim, as submitted. *Now* try to define original intent. Coverage interpretation just became a little more difficult.

But even after these coverage combinations are written and put to bed, my question is, "Where will these pearls of underwriting wisdom and brokerage persuasion lead us?"

More Suits??

The short answer to those questions, in my opinion, is that we will see more litigation over coverage issues in the coming years than we have seen in possibly any period of time in our professional past. There is, quite simply, too much being written into policies with too little thought being placed behind the wording and the interdependency of coverage parts. Underwriters may be tempted to resist writing any of the coverage enhancements, but the prudent underwriters will recognize that market forces now demand a different insurance product. Those insurance companies that do not respond to the market call for fundamental change in coverage will be left in the dust. One has only to look at the clout that has been created this year, and the clout that is yet to come. I don't think that there is any going back to a kinder, gentler insurance product. In order to assure that those companies that *do* respond to the market are *not* left in the dust or covered by ashes, what must be done is to create an environment which is *faster* and more *thorough* with regard to coverage wording. These two concepts are not mutually exclusive. This environment must combine the core disciplines of underwriting, actuarial, legal, claims, and claims litigation, all of which work synergistically and with speed. Together we all can answer the call of Captain John Luke Picard and "make it so." **(RHA)**

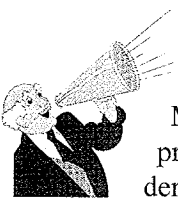
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ANNOUNCING . . .

Ms. Michele S. Martin, CPCU, ARM, CIC, has been named a vice president of RHA. Robert Hughes said, "Making Michele a vice president was not a difficult decision. She has always exhibited the qualities that any company would look for in its leadership."

Michele also serves as the company treasurer, the lead consultant on all company management projects and the lead on a large number of general consulting engagements. She has been with Robert Hughes Associates since 1989.



Michele S. Martin



FROM NEAR & FAR



Floods in Central Europe may have caused as much as \$7 billion in damages. Insured losses could reach \$1 billion. The Czech Republic, Poland and Germany were hardest hit.



Parts of the United Kingdom and Ireland suffered through the wettest June this century. Flood damage in southern Ireland was estimated at more than \$20 million, with the rain continuing to fall.



There was extensive flooding in Colorado in July and August. Damages to Colorado State University alone were estimated at about \$50 million.

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