Surplus Lines Basics

Surplus Lines Basics – Part 1

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If you have been in the insurance business for long, you have probably heard of the Excess and Surplus Lines Market and have probably placed business there. If you are new to the industry, you may not have heard of it before. In this white paper, I will give you a brief overview of the basics of the excess and surplus lines market. I will define excess coverage and surplus lines coverage and talk about why it is different from the standard market. I will also show you some examples of surplus lines types of risks. Lastly, I will explain surplus lines regulations and standards for conducting business.

What is Excess and Surplus Lines?

If you have been working in the retail segment of the industry for any amount of time, I am sure you have heard these terms. You may also hear the market referred to as non-standard or non-admitted. These terms are interchangeable and mean the same thing.

Now let's break out the two terms "excess" and "surplus" and define each one:

Excess insurance is a policy that provides limits in excess of the primary liability coverage – this can include general liability, auto liability, employer's liability, worker's compensation, etc. When the limits of the underlying policy are exhausted, the excess policy will kick in for additional limits. I can hear you asking – how is that different from Umbrella coverage? Well, an Umbrella policy is also a policy that will kick in when underlying limits have been exhausted. However, an Umbrella is a stand-alone policy with its own terms and conditions. The terms may vary from the underlying primary terms. There may be additional coverages that are not included in the underlying terms. An excess policy is what we call "follow form" where it matches the terms of the underlying policies, and just offers an additional layer of limits. You would typically see umbrella policies in the standard market and excess in the surplus lines market.

The surplus lines market offers an alternative to the standard market and carriers are willing to take on higher risk exposure. These types of business can include risks with very high exposure, adverse loss experience, new ventures, unusual risks or newly introduced products, types of business where there is a shortage of capacity (or investment dollars) in the Standard Market. This can include higher risk industries or high-risk geographical areas.

Why does the insurance industry need an alternative to the Standard Market?

The insurance industry is regulated by the states. In order for a standard insurance company to do business in any specific state, they must submit all of their rates and forms with the state departments of insurance and they must be approved before they can use those rates and forms. This limits the flexibility their underwriters have in use of coverage forms and pricing. So, when standard market underwriters receive a submission for a risk that falls outside of the "underwriting box" they don't have a lot of flexibility to change forms or pricing to fit an unusual risk.

Another factor that can influence a standard market's risk selection is capacity. When we refer to capacity, we are talking about the amount of investment dollars that carriers want to put into a certain line or class of business. They also want to make sure they have a balanced portfolio of risk, rather than being heavy in one line or class of business. Sometimes we will see the results of this cycle through the market. For example, several years ago, carriers were shying away from worker's compensation and it was more difficult for agents/brokers to place. Currently, we are seeing this in the auto market and for some property in convective storm prone areas. Therefore, carriers decide they want to use their capacity to cover lines or classes of business on which they can make a profit.

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Surplus lines (or non-standard) markets do not have to file their rates and forms with the states. This allows them complete flexibility with pricing and covering unusual risks that do not fit into any "underwriting box." It also allows for more capacity in areas where it is drying up in the standard market.

So, what happens when you have a risk that all of your standard/ or admitted markets decline?

Have you come across the account that (seemingly) nobody wants? Well, the surplus lines market is here to serve those clients that have a higher risk exposure than the standard market wants to take on.

What are the differences between standard and non-standard policies?

Most surplus lines companies use ISO forms so you should be familiar with most of the general policy forms, as they are the same you would see on a standard policy. However, most surplus lines carriers also have a large library of their own proprietary forms that you may not be as familiar.

Why do surplus lines markets need additional proprietary forms?

Risks come to the surplus lines market because they have some kind of additional or unusual exposure that cannot be adequately covered or priced by the standard market. Surplus lines carriers utilize extensive forms libraries to help customize coverage solutions for these clients.

In surplus lines, we also utilize exclusion endorsements to control exposure. You might see more exclusions on a surplus lines policy than you would see on a standard market policy. For example, we might exclude prior damage from coverage when writing a building that has had wind/hail or flood damage. Surplus lines carriers use forms to customize coverage to fit the needs of the individual insured and their unique exposure while at the same time, controlling the risk they take on.

Let us look at some examples of surplus lines risks:

These are glaring examples so you should be able to easily discern what should be surplus lines, but I need to clarify, that not all surplus lines risks are as easy to identify. I also want to be clear that not all surplus lines carriers have the same appetite, some will operate in the "light E&S" realm and others prefer the very heavily exposed risks. Some write personal lines, others do not.

Vacant Dwellings

This first example is a vacant dwelling. If you look closely, you will also see that the home next door has broken out windows and a general lack of maintenance. This would suggest that this may a distressed neighborhood. That presents a number of unique exposures. No one is there to monitor the property for vagrants, vandalism or theft. Leaking pipes or mold growth could go un-noticed, increasing exposure to damage. The same would be true if there was a fire. Some surplus lines companies specialize in highly exposed homes and these two homes are good examples.

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Retail Fireworks Operations

A retail fireworks operation is also a more obvious example of something that would be placed in the surplus lines market. Fireworks are inherently dangerous. Not only do they have the exposure of their contents blowing up, they also have the liability exposure of someone miss-reading instructions and harming themselves during use. There is also a product liability exposure if the product does not operate as expected. This is a type of risk that most standard markets would decline.

Damaged Building

This building has had some sort of fire, is vacant and it appears that part of the building has been cleared out for construction. This risk would likely be placed in the surplus lines market, due to the additional exposure. A prior damage exclusion would be added to the policy to exclude any of the existing damage from coverage. A surplus lines company might also be able to write a policy when the building owner decides to renovate, or if they decide to demolish the building. It would depend upon the individual carrier's underwriting appetite.

Autonomous or Self-Driving Vehicle

An autonomous or self driving vehicle is a great example of an emerging risk. Since there are so few on the road and we still don't know all of the exposures that might arise, this would be something that would need to be placed in a surplus lines market. Most likely, it would end up with a carrier that specializes in emerging risks.

Coastal Properties

Coastal properties, whether personal or commercial, present a challenge for insurers, due to severe weather exposures. Many markets, both standard and non-standard, use sophisticated weather analytics that help them with underwriting and risk selection. They look to find risks right in a specific

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zone or zip code that they feel poses a lesser amount of risk. Those at higher risk are usually placed in the surplus lines market.

Rental Dwellings

In this example, the home for rent appears to be a nice, well-maintained home. If an individual homeowner decides to rent a home, the standard market would typically be interested in providing coverage on a personal lines form. However, if an investor rents a large schedule of homes and operates as a primary business, they would likely decline. The surplus lines market could consider a schedule of rental dwellings and would provide coverage on a commercial form.

Roofing Contractor

A roofing contractor is one that is not so easy to determine where to place coverage. The standard market might consider a variety of roofing contractors, but certain aspects of the risk may kick it outside of their underwriting guidelines.

For instance, the contractor may be working on multiple story, or high-rise buildings. They might use torch down techniques or may have had past claims. In these cases, the surplus lines market could come in and provide coverage.

Concrete Contractor

For the last example, we have a concrete contractor. Again, this is a risk that could be placed either in the standard or surplus lines market, depending on the individual characteristics of the risk. If it is a new venture, has claims, or they are trying a new product or technique, the surplus lines market would likely be the right placement.

Surplus Lines Regulation

As I mentioned earlier, insurance is regulated by the states. Standard markets are required to file their rates and forms and the state departments of insurance must approve them. Surplus lines markets do not have to file their rates and forms. However, they do have to provide their financials and prove their solvency to the states before they can be approved to do business in that state. Once approved, they are added to the state's White List, which is the list of all approved surplus lines insurers for that state.

Fifteen states require that retail brokers go through a due diligence process before placing something in the surplus lines market. This process includes receiving at least three declinations from standard markets. Then the retailer completes a due diligence affidavit, certifying that the risk cannot be placed in a

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standard market. A copy of each affidavit is kept in our underwriting file.

Each state also compiles an Export List. This is a list of lines or classes of business that have been pre-approved by the state for surplus lines placement. These risks do NOT require a affidavit to be placed in the surplus lines market. These typically include highly exposed risks, such as medical mal-practice or types of environmental risks. The Export List might also include lines of business where overall market capacity is drying up.

Special taxes and fees are also required when placing surplus lines. You will see additional line items for surplus lines taxes and stamping fees on the quote. 15 states have stamping offices that are responsible for collecting the surplus lines tax, compiling them and submitting them to the state. The stamping fee is the fee that the stamping office collects for providing the service. As mentioned earlier Aspire files these taxes and fees as a value added service. Lastly, states also require that professionals that are involved in placing surplus lines have an additional surplus lines broker license. In addition to having a property and casualty broker's license, surplus lines brokers must be tested on surplus lines placement and regulations.

How are surplus lines products distributed?

Most E&S companies are accessed through the wholesale brokerage system. However, there are a few companies out there that work directly through a retail (or independent agent) distribution system. Berkley Aspire is one of the few surplus lines markets that independent retail agents can access without using a wholesaler.

Last Thoughts:

Remember, just as no two risks are alike, no two surplus lines companies are alike. Each has their own underwriting appetite. Get to know the surplus lines companies where you place business, their appetite and guidelines. Make sure you know and understand the unique exposures of your insured client and discuss it with your underwriter. Also, make sure to thoroughly review to understand the coverage terms the company is offering, as each risk is different. There are no cookie cutter risks, nor cookie cutter policies in the surplus lines market.

Find out more about Berkley Aspire:

To find out more about Aspire's underwriting appetite and value added services, click here: https://www.berkleyaspire.com/media/1413/advantages-of-working-with-berkley-aspire.pdf