

Fundamentals of Surplus Lines Insurance Operations

1 CHAPTER

This text examines surplus lines insurance operations, which include all the functions—such as marketing, underwriting, and claim handling—that surplus lines insurers and their producers (intermediaries) perform to attain their goals. Surplus lines insurers and their intermediaries constitute a distribution system called the surplus lines market, which is a relatively small but important segment of the overall property-casualty insurance industry in the United States. The surplus lines market provides insurance to consumers who are unable to obtain insurance in the standard insurance market. The surplus lines market therefore performs a vital role in insuring U.S. businesses, families, and individuals.

This chapter reviews the fundamentals of surplus lines and property-casualty insurance operations. To accomplish their goals, surplus lines insurers and intermediaries must perform the same functions that insurers and producers in the standard market perform. However, the particulars of how surplus lines insurers and intermediaries perform these functions are unique, largely because of the special regulations that govern surplus lines insurance transactions. Unlike the insurers that provide insurance in the standard market, a surplus lines insurer is not licensed to do business in the insured's home state. Consequently, surplus lines transactions are regulated through licensed surplus lines intermediaries who are required by the applicable surplus lines laws to perform several key duties that regular (“retail”) producers are not.

Surplus lines insurance is distributed through licensed surplus lines intermediaries who submit applications to surplus lines insurers. These insurance producers are referred to as intermediaries because they place coverage for the customers of retail agents and brokers. In most jurisdictions, regulations prohibit surplus lines insurers from marketing directly to insurance consumers, so the intermediary serves as a conduit for retail agents and brokers. Two alternatives to using intermediaries to access the surplus lines market, independent procurement and industrial insured exemption laws, are also reviewed in this chapter.

Property-casualty insurers can be classified by legal form of ownership, place of incorporation, licensing status, and marketing systems used. There are similarities and differences in how these classifications apply for admitted and for nonadmitted insurers.

This chapter also discusses the goals of insurers and the constraints on achieving those goals as well as the methods used to measure insurer performance. The most widely used measurement of insurer performance is the combined ratio, which takes into consideration both losses and expenses to determine an insurer's overall profitability.

The three core functions performed by most insurers are marketing, underwriting, and claims. An overview of these functions is provided in this chapter. It is important that these core functions and the supporting functions within an insurer work together to ensure that the insurer's goals are met.

SURPLUS LINES MARKET

Surplus lines market

The distribution system of surplus lines insurers and intermediaries that provides insurance on risks for which insurance is not available from admitted insurers.

Admitted insurer

An insurer that is licensed to do business in the insured's home state.

Admitted market, or standard market

The distribution system of admitted insurers and their producers.

The **surplus lines market** is the distribution system of surplus lines insurers and intermediaries that provides insurance on risks for which insurance is not available from admitted insurers. An **admitted insurer** is an insurer that is licensed to do business in the insured's home state. The distribution system of admitted insurers and their producers is known as the **admitted market**, or the **standard market**.

The Meanings of "Risk"

Insurance professionals use the term "risk" to mean any of the following:

1. The person, organization, event, activity, location, or object that presents a possibility of loss or is insured under an insurance policy.
2. The possibility that a loss will occur, also referred to as a loss exposure.
3. The actual probability that a particular loss will occur.
4. A cause of loss, or peril.

In this text, use of the word "risk" is largely confined to definition 1. Using "risk" in this sense allows economy of expression, conveying all of the various meanings listed in definition 1. In general, this text does not use "risk" to mean possibility of loss, probability of loss, or cause of loss.

The surplus lines market supplements the admitted market by providing insurance to individuals or organizations that the admitted market rejects. For example, when the owner of a large shopping mall or a high-rise office complex applies for insurance from an admitted insurer, the insurer might not have the capacity to accept either risk. Or, for highly specialized loss exposures, such as space satellites, it might not be cost effective for an admitted insurer to develop the underwriting experience and skill needed to adequately analyze the risks related to such a loss exposure. Also, customers may be located in an area that is not effectively served by admitted insurers, such as in a small, sparsely populated, noncommercialized state.



Types of Risks Insured in the Surplus Lines Market

The types of risks insured in the surplus lines market have traditionally been classified using three broad categories that describe the characteristics of the risks that make them unacceptable in the admitted market.¹ The three categories are as follows:

- A **distressed risk** is characterized by unfavorable attributes that have made it unacceptable to admitted insurers. For example, an insured that has sustained many losses in recent years might be considered unacceptable by an admitted insurer.
- A **unique risk** is a specialized or an unusual risk that is difficult for an admitted insurer to insure because no policy form meets its particular needs, no previous loss experience is available for analysis, or generating a premium quote would entail unacceptable extra time or effort.
- A **high-capacity risk** requires high limits of insurance that may exceed the underwriting criteria of admitted insurers. A multi-billion-dollar building and an airline that requires liability insurance with multi-billion-dollar limits are examples of high-capacity risks that might not be able to obtain all of their insurance in the admitted market.

Surplus lines insurers can provide coverage for distressed, unique, and high-capacity risks partly because of their freedom from rate and form filing regulations. Because surplus lines insurers are not licensed in the insured's home state, they are not subject to that state's insurance regulations, including regulations that require admitted insurers to file their rates and forms with the state insurance commissioner. Because they are not subject to rate and form filing regulations, surplus lines insurers can charge rates that are appropriate for the distressed, unique, or high-capacity risks they are insuring and can modify existing coverage forms or develop new ones to meet the needs of customers with unusual or unique loss exposures.

Surplus lines business can also be described in terms of the types of coverage provided or the classes of business accepted. Examples of types of coverage written by surplus lines insurers include errors and omissions (E&O) liability, environmental impairment liability, excess and umbrella liability, kidnap and ransom, difference in conditions (DIC), and event cancellation. Classes of business that might be written by surplus lines insurers include airports, amusement parks, drug and alcohol treatment centers, hazardous waste facilities, medical centers, mobile home parks, railroads, security services, and sports facilities.

Surplus Lines Laws

Each of the U.S. states has a **surplus lines law** governing the procurement of insurance from surplus lines insurers. A key feature of these laws is that they allow insurance producers who have been licensed by the state for this purpose to obtain property and casualty insurance (on risks located within

Distressed risk

A risk characterized by unfavorable attributes that have made it unacceptable to admitted insurers.

Unique risk

A risk that is so specialized or unusual that admitted insurers are unwilling to insure it.

High-capacity risk

A risk that requires high limits of insurance that may exceed the underwriting criteria of admitted insurers.

Surplus lines law

A state law governing the procurement of insurance from surplus lines insurers.

