BEST'S REVIEW

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On the Edge

Excess and surplus lines writers specialize in writing business the standard market doesn't want. Premium growth is slowing in some states, but not in others, a sign the market is still uneven.

by Meg Green

AP/Wide World Photo/Don Long

A BIG HIT: Houses often end up in the surplus lines market if they are a standard home in a nonstandard location, such as these houses in Rodanthe, N.C., that were damaged by Hurricane Dennis on Sept. 1, 1999.

Personal lines business is growing swiftly for many excess and surplus lines writers in the wake of the quartet of major hurricanes that struck Florida last year.

"In the first quarter, we had in excess of double-digit growth," said John Moran, vice president, personal lines, for Lexington Insurance Co. "Florida has been particularly strong after the hurricane season last year. California has been very strong, and so has the Northeast, including Massachusetts and Cape Cod."

The advantage of the surplus lines market is it's able to react to market conditions quickly, said Bill McCord of Burns & Wilcox, a managing general agent and surplus lines broker. While standard lines companies may stop writing new business to wait for state approval of rate hikes and new exclusions or policy wording changes, surplus lines can change their operations overnight.

"Somewhere in the country, every day, someone is changing surplus lines," said McCord.

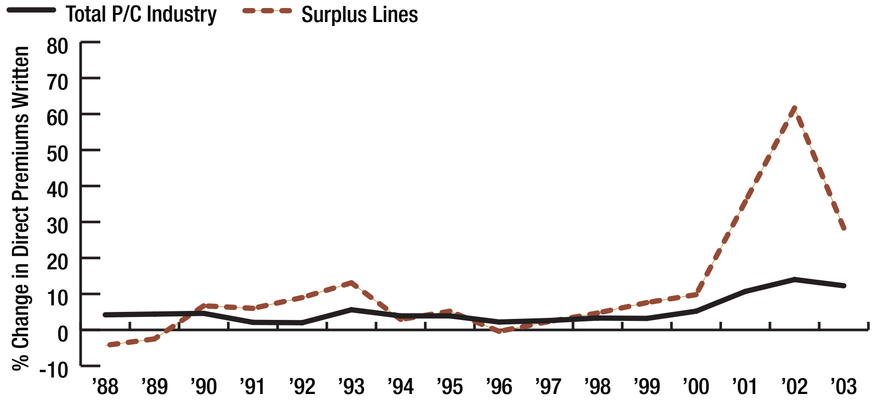
Lexington, a unit of American Insurance Group and the largest excess and surplus writer in the United States, according to A.M. Best Co. reports, has been able to take advantage of that.

"We're able to come in on various types of business: cat-exposed business, loss-exposed business, anything that the admitted markets have chosen or decided not to write going forward," Moran said.

Key Points

- The personal lines segment of the excess and surplus lines market is still showing strong growth in some areas, mostly due to more standard homes being built in riskier locations and homeowners with higher credit-rating risks.
- The E&S lines market is continuing to grow, but not at the breakneck rate seen during the hard market.
- Wide variations in E&S growth across the country indicate the market is uneven.

Premium Growth: Surplus Lines vs. Total Industry



Source: A.M. Best Co.

Lexington and other surplus lines writers go where the standard market fears to tread, but they don't write every risk that comes along. "We carefully monitor our exposures," Moran said. Lexington, which entered the personal lines market in 1993 after Hurricane Andrew, also tries to maintain profitable business by charging higher rates than the admitted market, and writing policies with higher deductibles and by excluding certain exposures and risks.

For instance, a home in Kansas with a history of water claims may have difficulty getting coverage in the admitted market. However, Lexington will offer coverage with an exclusion for certain water losses.

About 90% of Lexington's personal lines business is homeowners insurance, but it also writes personal umbrella and personal article floaters to cover such things as fine art, jewelry and furs.

In areas such as Florida where there's a state-run insurance fund, Lexington competes by covering high-value homes and by offering better service, Moran said. For instance, Citizens Property Insurance Corp. caps its coverage at $1 million. "The segment we focus on is the mid-to-high value segment," Moran said.

The personal lines area of the surplus lines market shows no signs of slowing its growth, Moran said. "A lot of people said 2004 was an anomaly, with four hurricanes. But we are hearing more and more people saying this could become more routine than we like to think."

Taking in the View

First, the sheer number of insurable homes keeps rising: last year a record 6.7 million homes were sold. "This hasn't been a one-year shot," McCord said. "With interest rates being low for about five years, there's been a tremendous increase in housing stock. And some of that falls into the surplus lines world."

McCord said personal lines are growing faster than commercial lines for Burns & Wilcox, accounting for about 13% of premium, up from 3% 10 years ago. Personal policies represent about one in every four policies written by Burns & Wilcox, and personal lines premium grew by 11.5% in the first quarter, compared with 4% growth in commercial policies written.

Houses often end up in the surplus lines world if they are a standard home in a nonstandard location. While coastal counties in the United States make up just 17% of the nation's land, they are home to more than half of the nation's population, according to the Pew Oceans Commission.

Rooms with beach views are often in the paths of hurricanes on the East Coast, and can be in danger of mud slides and earthquakes on the West Coast. That flood of people moving to the coast shows no signs of stopping.

McCord said the North Carolina Rate Bureau recently approved a 15% rate hike for homeowners insurance for homes along the coast. Some of those homeowners will have to find coverage with a surplus lines carrier, as the standard market looks to limit their overall exposure in that area.

Extenuating Circumstances

Credit history also can shut homeowners out of the standard market. "People with bad credit scores get kicked out of the market and come

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—Ted Pierce,
Surplus Lines Association of California

E&S Definition Box:

Standard market—The insurance written by licensed, or admitted, carriers. Companies must have a license for each state they write in, and state regulators often oversee the premium rates that the company can charge as well as the policy forms used.

Surplus lines—Nonadmitted insurance companies that provide coverage that the standard market isn't willing to write. Typically, the premium rates and policies are not regulated by the states. While surplus lines writers don't need a license to do business in every state, they have to be an admitted carrier in at least one state.

Typical risks that surplus lines cover:

- distressed business (fire coverage for a business with high incidence of prior fire loss);
- complex (property and liability coverage for an offshore oil platform)
- unique (insurance on a professional football quarterback's throwing arm)
- capacity (exposure needing very high limits)

▼SLIPPING AWAY: Homes with beach views fall into surplus lines because they can be in danger of mud slides. This home lost its deck after wet, windy weather hit Southern California on Jan. 10, 2005.

AP/Wide World Photo/Denis Poroy

the various costs of the policy to show what the premium is, the fee, and local tax. Most standard market policies have all of those costs wrapped into a single premium amount. And surplus lines writers and brokers get to keep their fee, even if the policy is canceled after it's issued.

The Bigger Picture

The personal lines segment, although growing, is a small portion of the excess and surplus lines business. And, given the kaleidoscopic nature of the risks it covers, far-ranging statements about surplus lines premium trends are elusive. Market conditions in one state bring one type of risk into surplus lines, while capacity remains in another state.

For instance, Texas surplus lines business was down 18% in the first quarter, according to Phil Ballinger, executive director of the Surplus Lines Stamping Office of Texas. "Filings are down 9% to 10%. It's pretty clear the admitted market is aggressively trying to take back the business that flowed to the surplus lines market in the hard market."

But, Nevada's surplus lines market posted strong premium growth of 56.1% in 2004 over 2003, an indication that market is still hard, at least in some lines.

And, in New York, surplus lines premiums rose to $3.1 billion in 2004, up 23.4% from 2003, but less than a third of the 73.2% jump in 2003 from the previous year.

The Surplus Lines Association of California found 2004 premiums rose just 8.24% from the year before, compared to an increase in premiums of 43.1% in 2003 over 2002, and by 104.5% in 2002 over 2001.

The premiums are still increasing, but not at the rate they were in the hard market, said Ted Pierce, executive director of the Surplus Lines Association of California. "The strange thing is that the volume of policies is on the rise. More policies are being written for smaller size accounts."

McCord of Burns & Wilcox also has seen the average premium dropping. "That's the market softening," he said. "It has been the case in property lines, but it's now hitting casualty."

In California, the number of surplus lines policies processed in 2004 grew 18.7% from the previous year, according to the Surplus Lines Stamping Office of Texas, which tracks premiums and policies written from all 15 states that have a stamping office (see "What Is a Stamping Office?" pg. 4.)

Surplus Lines Policies, Premium Rise

Premiums in the surplus lines market continued to rise in 2004, although it's slowed from the 36.8% it grew in 2003 over 2002.

	Premium ($ Millions)			Policies		
State	**2004**	**2003**	**% Chg**	**2004**	**2003**	**% Chg**
Arizona	$509.2	$395.3	28.8	47,275	39,258	20.4
California	5,518.9	5,098.9	8.2	441,221	371,689	18.7
Colorado	489.2	470.0	4.1	49,119	43,792	12.2
Florida	2,980.3	2,821.6	5.6	1,182,984	1,214,025	-2.6
Idaho	66.2	57.4	15.3	13,847	12,231	13.2
Illinois	1,012.5	815.0	24.2	109,440	92,662	18.1
Mississippi	264.2	233.7	13.1	52,272	59,803	-12.6
Montana	47.9	36.8	30.2	8,686	8,419	3.2
Nevada	343.7	220.2	56.1	22,390	16,906	32.4
New York	3,134.9	2,540.5	23.4	187,593	158,770	18.2
Oregon	257.1	238.1	8.0	32,645	30,147	7.3
Pennsylvania	754.6	707.3	6.7	103,709	102,947	0.7
Texas	3,321.1	2,945.5	12.8	996,340	928,743	7.3
Utah	146.2	135.9	7.6	14,205	13,163	7.9
Washington	708.9	621.5	14.1	105,077	103,728	1.3
Total	**$19,554.9**	**$17,337.7**	**12.8**	**3,366,803**	**3,196,553**	**5.30**

Source: Surplus Lines Stamping Office of Texas

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—John Moran, Lexington Insurance Co.

Pierce said he didn't think the growth in policy count stemmed from personal lines there, where homeowners multiperil business represented about 0.73% of the policies processed in California in 2004, the 17th most common coverage written by the state's surplus lines market. The top three coverages were general liability, with 34.7% of all policies; errors and omissions, with 9.9%; and all-risk commercial property, with 7.7%.

For all 15 states with stamping offices, premium rose an average of 12.8% in 2004 over 2003, and the number of policies processed grew by 5.3%. But there were wide variations in results. Premium growth in the market ranged from a low of 4.1% in Colorado to a high of 56.1% in Nevada. Policies processed ranged from a drop of 12.6% for Mississippi to a 32.4% jump in Nevada.

“We're writing more policies than ever, but the premium isn't growing very fast because the average premium is dropping,” McCord said. “We borrowed a lot of business from the standard market, starting in 2000, when losses drove the standard market to stop writing certain kinds of business in certain parts of the country. Now the market has returned to a traditional soft market, so business is returning to the standard market.” BR

What Is a Stamping Office?

Stamping offices do not have anything to do with the U.S. Postal Service, or angry people who walk loudly.

The first stamping office was launched in 1938 in California, the year after the state commissioner suggested surplus lines brokers form an association to self-regulate the industry.

The surplus lines industry in the United States had been active since the 1800s, when brokers, unable to find coverage for high limits or unusual risks through American insurers, began to place coverage with British insurers.

As the business grew, U.S. regulators became concerned that they did not have adequate oversight over the surplus lines industry.

The stamping office's original duty was to stamp every surplus lines policy before it was allowed to go into effect, said Ted Pierce, executive director of the Surplus Lines Association of America.

“We'd look at it, see if the placement was legal, and then stamp it as approved,” he said. “It was a way of regulating the brokers.”

Unlike the standard admitted market, no regulator, nor the stamping office, had approval over the rates or forms used.

“That's the key to surplus lines,” Pierce said. “The policy language is not regulated by the state and the price is not regulated by the state.”

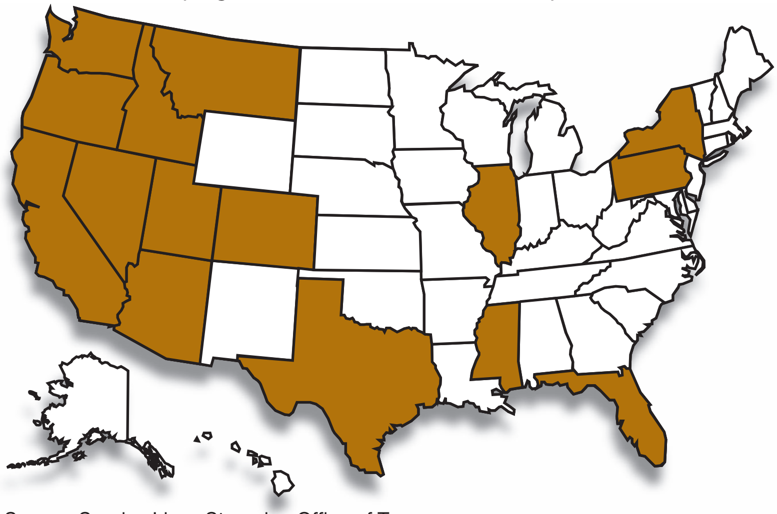
However, all excess and surplus writers must be licensed in at least one jurisdiction, and it's that state or country that regulates the companies' solvency, said Phil Ballinger, executive director of the Surplus Lines Stamping Office of Texas.

Today, the volume of policies is so great that the stamping office began to give approval after the policy goes into effect—although it no longer uses a physical stamp, Pierce said.

Today, 15 states have stamping offices to help regulate the surplus lines industry.

Who Has Stamping Offices?

Stamping offices are the self-regulated arm of the surplus lines industry. Fifteen states have stamping offices, which oversee the surplus lines market.



Source: Surplus Lines Stamping Office of Texas