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"Big Data and the Insurance Industry"

True or False Questions — Submit Answers Online

1. The 3 V's of Big Data were introduced as Volume, Velocity, and Value
2. A company's information security policies and risk mitigation strategies are becoming more important because of Big Data
3. Value is considered one of the most import "V" of Big Data
4. Price optimization is defined as using policy rating factors that are related to the risk of loss
5. One of the values of Big Data is to be able to better assign claims to claim adjusters

"Low Interest Rates and the Implications on Life Insurers"

True or False Questions — Submit Answers Online

1. The significant decline in interest rates has not been in response to the global financial crisis.
2. Interest rate risks for life insurers can impact earnings, capital and reserves, liquidity and competitiveness.
3. Asset liability management supports interest rate management for both assets and liabilities.
4. Increasing the duration of an insurer's assets to ensure better matching between assets and liabilities is not an effective strategy to address persistently low interest rates.
5. As part of asset and liability management, cash flow testing is not required under statutory valuation law.

CRE READING PROGRAM QUESTIONS

All quizzes MUST be taken online

(continued)

"Emerging Issues in the Accounting World that Examiners Need to Know"

True or False Questions — Submit Answers Online

1. Over a third of Americans have had their Personal Health Information ("PHI") breached since 2009
2. Executive compensation is a minimal concern and no new guidance is anticipated to accelerate commissions and bonuses to impact current periods.
3. Linking EMR to daily decision making by management is a key item of the Committee of Sponsoring Organizations ("COSO") recently published draft titled, "Enterprise Risk Management – Aligning Risk With Strategy and Performance".
4. Accounting Standards Updated ("ASU") #2013-12 Financial Instruments—Credit Losses; Measurement of Credit Losses in Financial Statements would require most companies to recognize losses on loans and other instruments based on an expected loss approach as early as 2017.
5. The Public Company Accounting Oversight Board adopted new rules making the names of lead audit partners and participating accounting firms more secretive, effective January 1, 2017.

"Best's Special Report: U.S. Surplus Lines"

True or False Questions — Submit Answers Online

1. Lloyd's Group is the top U.S. Surplus Line writer based on Direct Premiums Written.
2. The Nonadmitted and Reinsurance Reform Act was not created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
3. The National Flood Insurance Program (NFIP) was created in 1969.
4. The National Association of Registered Agents and Brokers(NARAB) is a new federal agency with a 13 member board
5. The Surplus Lines market is usually classified into five areas

Big Data and the Insurance Industry

By
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What is Big Data?

Big data is an evolving term that can be simply defined as data that is too large and/or too complex to analyze with traditional data processing technologies. Technology industry analyst Doug Laney introduced the concept of the 3 V's of big data in a 2001 research publication entitled "3-D Data Management: Controlling Data Volume, Velocity and Variety". More complex definitions have since developed, but the focus has remained on the "V" characteristics of big data:

1. **Volume:** Significant amounts of transactional and statistical data are generated through various sources that include:
   - Underwriting systems
   - Claims systems
   - Call center systems
   - Predictive modeling
   - Telematics devices
   - Credit reporting
   - Vehicle statistics
   - Bureau statistics
   - Climate statistics
   - Government statistics
   - Social media

2. **Variety:** Datasets are generated from numerous sources with varying data structures. Data may be highly structured and easily stored in a relational database, such as bureau statistics. Conversely, data may be highly unstructured, such as that captured through telematics devices or social media.

3. **Velocity:** Big data is continually being generated and stored, in real-time and at ever-increasing speeds, especially from internet connected devices. This contrasts with the still common practice of batch processing, where data is gathered during the day and processed overnight.

4. **Veracity:** The usefulness of any data analysis is dependent on the trust worthiness of its source data. Volumes of high-velocity data, flowing from a variety of sources, has limited value if inaccurate.

5. **Value:** Value is the most import "V" of big data. The ultimate objective of big data is to create an economic benefit. That benefit is derived from the business decisions and competitive advantage resulting from big data analytics. A cost/benefit analysis is also an important value consideration as the costs to implement and integrate a big data IT infrastructure can be significant.

How Can Big Data Create Value?

Big data can create value across the various functions of insurance organization:

Underwriting: Granular and real-time insights supplied by big data can be used by insurers to underwrite and price risks more effectively than competitors. An example of big data in action can be seen in the pricing of personal auto policies. These policies have been traditionally priced using 'small data' focused on cost-based rating factors such as driver age, type of vehicle, zip code and driving record. Big data analytics allow these policies to be priced using substantially more attributes, such as credit history, vehicle statistics, telematics and predictive modeling. This fine-grained underwriting may lead to more accurate pricing of individual risks than with traditional pricing models.

Claims Management: Big data analytics can be used to implement fast-track processes that shorten the claim cycle, leading to reduced labor costs and reduced claim expenses. An insurer's big data can be mined to identify additional opportunities for subrogation recoveries. Analysis of historical claims data can also be used to prioritize and assign claims to adjusters based on their experience, the type of loss, or likelihood of litigation.

Fraud Detection: Predictive analytics can be used during underwriting to identify applicants with a higher likelihood to commit fraud. Big data can also be used during underwriting to monitor for concealment or misrepresentation of applicant information. Claims origination data and historical claims data can be mined to identify claim notices with indicators of fraudulent activity. Big data can also be used during claims investigations to monitor social media for evidence of fraudulent behavior.

Customer Service: The ability to quickly access and mine relevant data for information on individual policyholders can help insurers tailor customer service responses to policyholder preferences. Social media data can be accessed in real-time to create targeted marketing campaigns, respond more quickly to consumer feedback, and to create new products and services based on consumer preferences.

Risk Appetite Management: Catastrophe policies can be designed using insights from big data, such as historical losses, geographic exposure data, climate statistics, and reinsurance treaty information. This data can also be used to monitor catastrophe exposures at more granular levels than just city and state. Predictive modeling from big data sources can also be used to design and stress an insurer's catastrophe reinsurance coverage.

How Can Big Data Create Risks?

The significant value potential in big data exists alongside significant inherent risks to both insurance consumers and insurance companies:

Data Security: As companies gather and store more consumer information, they become attractive targets for cyberattack and data exfiltration. Cyberattacks and data breaches are common, and impact even the largest companies with the most comprehensive information security controls. Due to the confidential nature of consumer information being stored, companies' information security policies and risk mitigation strategies are increasingly important. Companies and their cloud infrastructure providers are locked in an information security arms race with malicious hackers, including organized crime and government-sponsored entities.

Consumer Privacy: Companies now have the capability to track consumer preferences, habits, and behaviors at the individual level. Web browsing activity can be monitored and confidential information entered on web sites or online chat sessions can be retained. This can be incredibly convenient to consumers, such as when relevant recommendations are suggested while browsing insurer websites. However, the collection of this type of data, combined with inherent risks of data loss—whether from an accidental breach or a malicious exfiltration—put consumers at risk of identity theft and financial losses if that information is not properly secured.

Consumer Profiling: The accumulation, storage, and tracking of consumer data is often performed with consent of the consumer, though not necessarily with the consumer's full understanding of what the data could be used for. For example, fitness activity trackers, such as Apple Watches and Fitbit devices, monitor physical activity and lifestyle habits. Not only do consumers buy these products, some companies now offer these devices, along with performance incentives, to motivate workers to get fit and potentially lower medical expenses due to lifestyle-related illnesses.

Insurance companies are latching on to the trend, and many insurers now offer perks, such as discounted premiums and free devices, to encourage healthy habits. Consumers willing to reduce their insurance costs may voluntarily consent to having personal data logged, stored, and analyzed by their insurer. While this profiling data can be used to reduce prices for healthier consumers, it may find its way into underwriting models that increase prices or decrease product options for the less healthy.

Have Regulators Responded to Big Data?

This growth of big data will continue to challenge insurance regulators to understand complex underwriting and pricing models, and to define best practices around insurers' use of big data.

The NAIC and state regulators are already looking at insurers' use of big data, specifically regarding "price optimization" in policy pricing. Price optimization refers to the use of policy rating factors that are unrelated to the risk of loss. An example would be an insurer's mining of big data to identify policyholders who are less likely to change carriers if charged a higher premium. This "optimized" rate discrimination might apply to low-income customers and/or high-income customers, depending on the data mining techniques and pricing model used. Twenty states currently prohibit the practice of price optimization.

In December 2015, the NAIC adopted a charge to "explore insurers' use of big data for claims, marketing, underwriting and pricing…." This charge led to the 2016 formation of the Big Data (D) Working Group. During April 2016, the Working Group held a public hearing and subsequently established the following priorities regarding big data's impact on marketplace innovation and consumer protection:

- Develop a definition of "big data" for purposes of the Working Group's activities
- Discuss insurers' use of big data in rating and underwriting
- Discuss insurers' use of big data in claims settlement
- Discuss regulators' use of big data
- Discuss insurers' use of big data for marketing

The working group also met at the NAIC's 2016 Summer National Meeting in San Diego. The working group heard presentations from interested parties within the industry and discussed a proposed definition of Big Data.

The value potential created by big data exists alongside significant operational, legal, strategic and reputational risks. Insurers should perform risk assessments of their big data programs and establish best practices around the handling of consumer data, such as those described in the HealthIT.gov's Guide to Privacy and Security of Electronic Health Information, which provides guidance for HIPAA compliance, the PCI Security Standards Council, ISACA's COBIT framework, and the NAIC's Insurance Data Security Model Law.

April 2012

Low Interest Rates and the Implications on Life Insurers

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Introduction

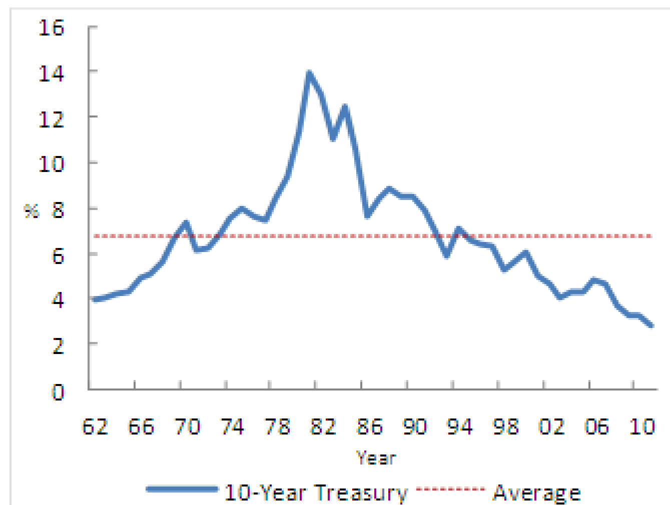
The prolonged low interest rate environment has had a notable impact on many segments of the economy, including the life insurance industry. Since 2007, interest rates have gradually declined to historical lows. Life insurers are adversely impacted by interest rates because of the guarantees and policyholder options in many of the products they sell. As a result, life insurers face a considerable amount of interest rate risk, particularly those with a high amount of interest-sensitive policies in their product mix. Moreover, with U.S. Treasury yields near historic lows, there is also concern that investment income could decline to a point where life insurers might not be able to fund guaranteed policy benefits. The prolonged low level of interest rates is rare, but not unprecedented. However, it does call for proactive regulatory monitoring and initiatives by insurance regulators.

Current Low Interest Rate Environment

Interest rates have declined significantly over the past several years in response to the global financial crisis. The Federal Reserve (Fed) began cutting interest rates in 2007 amid signs the economy was slowing and the housing market was under severe stress. The 10-year Treasury yield—which is the reference rate upon which many fixed-rate loans are based—has fallen to levels not seen since the 1960s. At year-end 2011, the yield on a 10-year Treasury note was 2.78%, compared with 3.22% in 2010 and 4.63% in 2007 (Figure 1).

Figure 1: Historical 10-Year Treasury Yield

Source: U.S. Department of the Treasury, Federal Reserve (H.15)



Low Interest Rates and the Implications on Life Insurers

(continued)

The Fed has implemented a number of unusual monetary policy measures aimed at keeping rates low, which it has described as "extraordinary measures." These have included a number of bond purchases, referred to as "quantitative easing," and lengthening the average maturity of treasuries held in its bond portfolio (dubbed Operation Twist[1] after a similar program the Fed instituted in the 1960s). The goal of these measures was to lower longer-term interest rates, resulting in a flatter yield curve, in hopes of avoiding deflation, reducing the unemployment rate, lowering mortgage rates and stimulating the U.S. economy.

Given the concern that low interest rates might be here to stay—supported by the Fed's pledge to keep short-term interest rates near zero at least until mid-2013[2]—questions have been raised about the long-term implications for life insurers. The current economic environment, coupled with the uncertainty about the future direction of interest rates, could pose unique challenges for life insurers.

Low Interest Rates Impact on Life Insurers'

Life insurance companies face considerable interest rate risk given their investments in fixed-income securities and their unique liabilities. For life insurance companies, their assets and liabilities are heavily exposed to interest rate movements. Interest rate risk can materialize in various ways, impacting life insurers' earnings, capital and reserves, liquidity and competitiveness. Moreover, the impact of a low interest rate environment depends on the level and type of guarantees offered. Much of the business currently on life insurers' books could be vulnerable to a sustained low interest rate environment (e.g., such as Japan has experienced).

Life insurers typically derive their profits from the spread between their portfolio earnings and what they credit as interest on insurance policies. During times of persistent low interest rates, life insurers' income from investments might be insufficient to meet contractually guaranteed obligations to policyholders which cannot be lowered.

Furthermore, interest rate risk can be greatly exacerbated when funds are continuously invested in a low interest rate environment that suppresses life insurers' earnings. Should interest rates continue to hover at low levels, life insurers' earnings could continue to be pressured for some time. At the same time, while it is true that life insurers' typical long-duration investments tend to increase their portfolios' duration risk, the current steepness of the yield curve means a long-duration strategy could produce a comparatively higher yield, compensating for this additional risk.

Low Interest Rates and the Implications on Life Insurers

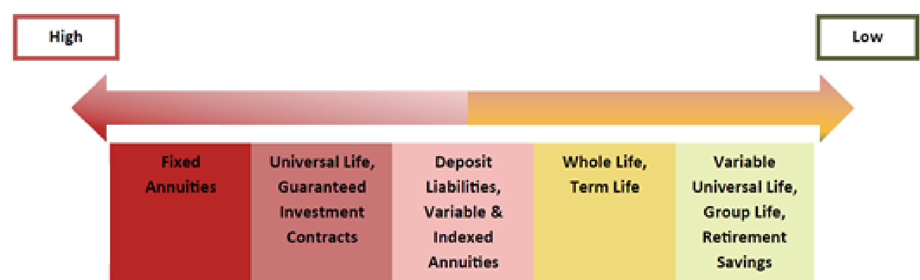
(continued)

Life insurers typically offer products that come with certain guarantees regarding the level of income over the life of the policy, which could be 30 years or more. Considering that a number of these products were written at a time when the economic outlook appeared dramatically different, life insurers are facing a potential mismatch between their assets and liabilities.

Central to a life company's strategy is the goal to match assets and liabilities. As most life insurance contract liabilities are long-duration contracts, it is not always easy to achieve a perfect match of long-duration assets. In a low interest rate environment, it is challenging to find relatively low-risk, high-yield, long-duration assets to match annuities that guarantee a minimum annual return (e.g., 4%). For many policies, low interest rates mean that some mismatch with assets is likely. For example, older fixed income insurance products that guarantee rates of around 6%—closely matching or conceivably even surpassing current investment portfolio yields—are likely to put a strain on life insurers as a result of spread compression or possibly negative interest margins.

While there is no straightforward method to aggregate interest rate risk for insurers, relative exposure to interest rate risk could be gauged by considering the type and the proportion of interest rate risk-sensitive products of each insurer. Figure 2 below presents the degree of interest rate sensitivity of each life product type, from high to low.

Figure 2: Interest Rate Sensitivity by Life Product



Generally, fixed annuity products are the most sensitive to interest rate risk because they are guaranteed to earn a fixed rate of return throughout the life of the product. Products that combine protection with asset accumulation guaranteeing minimum returns (e.g., universal life) have more interest rate risk than protection-oriented products (e.g., whole and term life). At the same time, companies offering universal life products can offset some of the interest rate risk with built-in non-guaranteed elements, such as fees and charges.

Low Interest Rates and the Implications on Life Insurers

(continued)

Life insurers depend on their capital and reserves to absorb risk. A prolonged period of low interest rates would not only negatively impact life companies' investment income (particularly those with more long-term exposure) but would also push reserves higher impacting their profitability and capital adequacy.

Persistent low interest rates can also affect earnings and life insurers' liquidity. Liquidity management is critical for life insurers. Asset/liability management (ALM) supports interest rate management for both assets and liabilities. Most life insurance companies strive to match liability cash flows with asset cash flows to avoid setting up an additional asset/liability mismatch reserve. While most life companies' essentially employ buy-and-hold strategies with well-matched liabilities and assets, spread volatility risk and prepayment risk can undermine the best asset/liability management strategy if it is grounded entirely on duration.

During adverse economic conditions (e.g., declining credit spreads, low interest rates), assets and liabilities can be significantly mismatched by cash flow, exposing insurers to losses from uneconomic asset sales to meet current obligations. While it is true that, in a prolonged low interest rate environment, increased pressure on earnings is a significant risk, life insurers' liquidity demands also tend to diminish as policyholders are more likely to keep their money in annuities and other accumulation products due to the scant availability of higher-yielding alternatives.

Furthermore, life insurance companies rely on long-term rates to be competitive and benefit from a steep yield curve because they can offer more attractive returns for their long-term investments (Figure 3, page 14). The steepness of the yield curve gives fixed annuities a great advantage over comparable conservative investments, such as certificates of deposit (CDs). This advantage becomes particularly pronounced during volatile and uncertain times, when demand for conservative investments tends to be higher. Fixed annuities registered record sales in 2008 during the peak of the financial crisis before they gradually retreated as the equities markets started to recover and their credit spread over CDs rates declined.

Low Interest Rates and the Implications on Life Insurers

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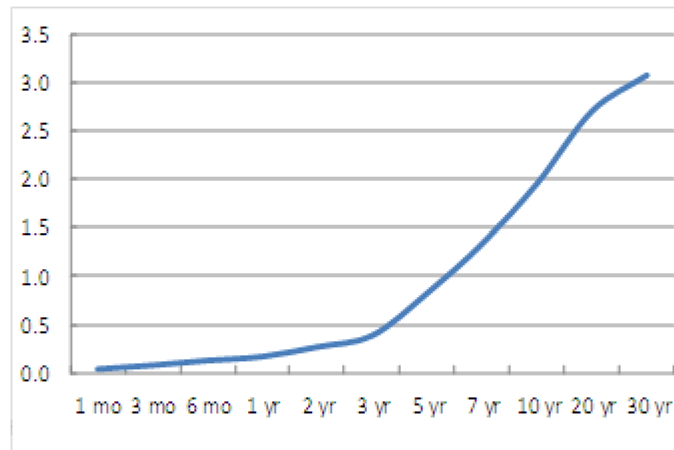
Figure 3: Treasury Yield Curve *(4/23/12)*

Source: U.S. Department of the Treasury



Life insurance companies with well-established asset-liability management programs are best prepared to manage through a low interest period. Furthermore, the utilization of new sophisticated enterprise risk management (ERM) techniques, can enhance insurers' ability to monitor their asset/liability positions by employing cash-flow analysis, duration, convexity, earnings and capital at risk and focusing on tail returns and expected shortfall. Also, life insurance companies can take action before rates drop and effectively hedge interest risk through interest rate floors or forward cash flow hedging.

How Insurers Counter Low Interest Rates

Insurers have various tools to address the risk of persistently low interest rates. Increasing the duration of their assets to ensure better matching between assets and liabilities is at the core of life companies' interest rate risk strategies as part of their overall ALM. Insurers also can lower the terms of new policies (i.e., by lowering guaranteed rates), thereby progressively lowering liabilities.

Generally, in times of low interest rates, the main challenge for insurers' ALM is that current lower-yielding investments cannot meet past return assumptions (reinvestment rate risk). As higher-yielding investments mature and roll over into lower-yielding assets, the degree of risk faced by an insurer depends on the extent of the duration mismatch between assets and liabilities. The duration of some life insurers' liabilities exceed the longest duration assets that may be available for purchase and, as a result, companies could be exposed to reinvestment rate risk.

Low Interest Rates and the Implications on Life Insurers

(continued)

At the same time, while the strategy of duration match seems straightforward enough in theory, in practice it is much harder to achieve a perfect hedge against interest rate risk. Most life insurance liabilities have been incurred from long duration contracts and as a result can lead to a less-than-perfect match between asset and liability cash flows.

Life insurers also can try to offset low interest rates by diversifying their products and investment portfolios. Companies with diversified books ordinarily tend to have less overall exposure to interest rate risk if their interest-sensitive product lines are well-balanced with non-interest-sensitive lines. Furthermore, adjusting the pricing and/or the features and terms of new policies (i.e. by lowering guaranteed rates) can help progressively lower liabilities providing a relief to insurers that face spread compression for existing products.

Investing in higher-yielding assets to improve investment income and counter the impact of low interest rates, albeit at the cost of potentially assuming more credit risk, might be another option that life companies could exercise. However, as a word of caution, this strategy could result in material realized and unrealized losses. The NAIC Capital Markets Bureau has begun analyzing changes in asset mix from year-end 2010 to year-end 2011 and found significant dollar increases in two areas; structured securities and investments in commercial real estate, either through mortgage loans or equity. In the case of structured securities, the increase is largely attributable to additional investments in agency-backed Residential Mortgage-Backed Securities (RMBS), which are effectively supported by the Federal government. In the case of commercial real estate investments, growth was higher than overall growth in invested assets. However, the increase as a percent of invested assets was modest and the current percentage remains below the recent high in this category in 2008.

Some life insurers implement interest rate hedging strategies based on derivatives that allow them to manage and mitigate risk by "locking in" higher interest rates. On the other hand, hedging with derivatives could also pose certain risks, such as counterparty risk, which increases substantially with the length of time required for the hedging strategy.

- The Gross Portfolio Yield was determined as (two times Gross Investment Income)/(Invested Assets Beginning of Year plus Invested Assets End of Year minus Gross Investment Income).
- The Net Portfolio Yield was determined as (two times Net Investment Income)/(Invested Assets Beginning of Year plus Invested Assets End of Year minus Net Investment Income).

- Net Investment Income equals Gross Investment Income less Investment Expenses and Investment Taxes, Licenses and Fees.
- Guaranteed Interest Rate was determined as the Weighted Average Valuation Interest Rate.
- Net Spread over Guaranteed Interest Rate equals the Net Portfolio Yield less the Guaranteed Interest Rate.
- Gross and Net Investment Income was taken from the Exhibit of Net Investment Income from the NAIC Life Annual Statement Blank for each company in the study.
- Invested Assets at the Beginning and End of the Year was taken from the Assets Page 2 of the NAIC Life Annual statement Blank for each company in the study.
- The Weighted Average Valuation Interest Rate was calculated from data in Exhibit 5—Aggregate Reserve for Life Contracts from the NAIC Life Annual Statement Blank for each company in the study.
- The Guaranteed Credited Rate of Interest was set equal to the Weighted Average Valuation Interest Rate for each company in the study. Therefore the Weighted Average Valuation Interest Rate was used as a proxy for the Guaranteed Credited Rate of Interest.

The most common risk hedged by the insurance industry is interest rate risk. According to 2010 year-end NAIC data, about 64% of insurers' total notional value of outstanding over-the-counter (OTC) derivatives and futures contracts is used in mitigating risks resulting from volatility in interest rates. Interest rate swaps[3] were the most common swaps derivative instrument utilized by insurers in their hedging strategies, representing approximately 75% of the swaps exposure. Furthermore, interest rate swaps comprised about 73% of the hedges with maturity dates of 2021 and beyond, and 45% of the hedges with maturity dates between 2016 and 2020.

Other derivative instruments utilized by life companies to mitigate interest rate risk, are fixed-income futures (which obligate the insurer to sell a specified bond at a specified price to a counterparty at a future date), floors (which entitle the insurer to receive payments from a counterparty if interest rates drop under a specified level) and "swaptions" (which give the insurer an option to enter into a fixed swap with an above-market coupon if rates decline).

NAIC Low Interest Rate Study and Methodology

The NAIC conducted a study of the impact of the low interest rate environment on the life insurance industry in the United States. The data used in the study was gathered from the financial annual statements filed by life insurance companies for the years 2006 through 2010. The objective of the study was to determine the effect the low interest rate environment has had on the net investment spread[4] of the life insurance industry between 2006 and 2010. The results of the study include data from 713 life insurance company legal entities that had submitted data for all five years of the study (2006–2010). Exhibit 5 reserves by year are shown in Figure 4. The reserves from these 713 legal entities represented 99.99% of the total industry life insurance reserves.

Figure 4: Total Exhibit 5 Reserve by Year

Year	Number of Legal Entities	Total Reserve
2010	713	$ 2.57 Trillion
2009	713	$ 2.46 Trillion
2008	713	$ 2.30 Trillion
2007	713	$ 2.10 Trillion
2006	713	$ 1.98 Trillion

The data in Figure 5 (page 18) shows the decline in the life insurance industry's gross portfolio yield from 2006 through 2010. This drop in yield reflects the lower interest rate environment within which the industry had to invest any positive cash flows (premiums plus investment income less policy claims). The industry lost 66 basis points of gross yield between 2006 and 2010 (89 basis points of gross yield between the high in 2007 and the low in 2009). The 17 basis point increase in yield between 2009 and 2010 might be due to industry hedging activity and due in part to the slow recovery from the financial crisis, which hit bottom in the first quarter of 2009. It is also interesting to note that the smaller-size companies (i.e., those with reserves of less than $5 million) had a larger decline in gross portfolio yield. Smaller-size companies are less able to leverage their investment activities and must purchase smaller-sized assets than larger competitors. In addition, small insurers might be less likely to hedge interest rate risk.

Low Interest Rates and the Implications on Life Insurers

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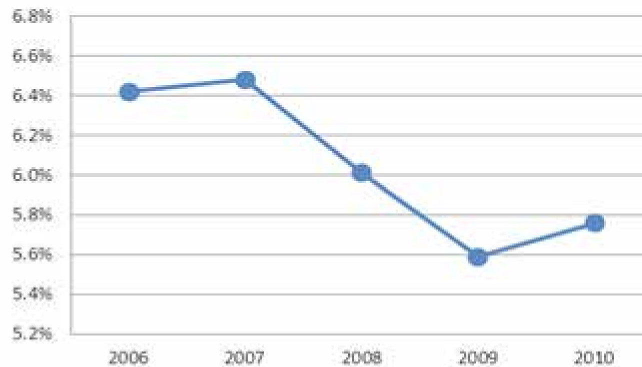
Figure 5: Gross Portfolio Yield by Year



Company Size	Gross Portfolio Yield				
Reserves	2006	2007	2008	2009	2010
< $5 Million	5.26%	5.30%	5.12%	5.02%	3.76%
$5 M–$50 M	5.58%	5.72%	5.43%	5.04%	4.83%
$50 M–$500 M	5.98%	6.15%	5.88%	5.60%	5.59%
$500 M–$5 B	6.34%	6.42%	6.01%	5.83%	5.79%
> $5 B	6.44%	6.50%	6.01%	5.56%	5.76%
Total	**6.42%**	**6.48%**	**6.01%**	**5.59%**	**5.76%**

The data in Figure 6 (page 19) looks at net portfolio yield. Again, the data show a decline in the life insurance industry's yield between 2006 and 2010. The industry lost 49 basis points of net yield between 2006 and 2010 (71 basis points of net yield between the high in 2007 and the low in 2009). The drop in net portfolio yield is less than the drop in gross yield which could be due, in part, to cost-cutting measures companies have taken as spreads have declined and a shift to less asset-intensive securities. The difference between the gross and net portfolio yields reflects investment expenses, as well as investment taxes, licenses and fees. These expenses were approximately 48 basis points in 2006 and dropped to 31 basis points in 2010.

Low Interest Rates and the Implications on Life Insurers

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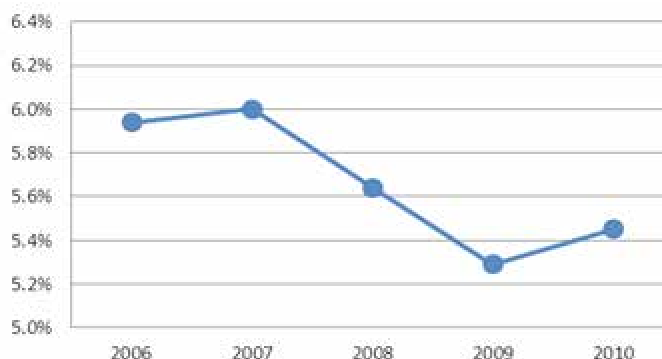
Figure 6: Net Portfolio Yield by Year



Company Size	Net Portfolio Yield				
Reserves	2006	2007	2008	2009	2010
< $5 Million	4.47%	4.53%	4.44%	4.60%	3.45%
$5 M–$50 M	5.06%	5.18%	4.88%	4.47%	4.27%
$50 M–$500 M	5.44%	5.74%	5.51%	5.25%	5.22%
$500 M–$5 B	5.92%	6.04%	5.68%	5.56%	5.53%
> $5 B	5.95%	6.00%	5.64%	5.25%	5.44%
Total	**5.94%**	**6.00%**	**5.64%**	**5.29%**	**5.45%**

As was stated earlier in this report (see sidebar), a proxy for the guaranteed credited rate of interest was used. The proxy was the weighted average valuation interest rate. Credited interest rate guarantees may be less than the valuation rate of interest; however, state insurance law dictates the minimum valuation interest rate that must be used in valuing insurance liabilities (policy reserves). This, in effect, means that the insurance company must have a net portfolio yield at least as great as the minimum valuation interest rate in order to fund the growth in policy reserves. Valuation interest rates for life insurance are determined each calendar year and apply to business issued in that calendar year. These valuation interest rates are locked in at policy issue and do not change. The calendar year statutory valuation interest rate IR shall be determined as follows and the results rounded to the nearer one-quarter of 1%:

$$IR = .03 + W(R_1 - .03) + \frac{W}{2}(R_2 - .09)$$

where

R_1 is the minimum of R and .09

R_2 is the maximum of R and .09

Low Interest Rates and the Implications on Life Insurers

(continued)

R is the lesser of the average over a period of 36 months and the average over a period of 12 months, ending on June 30 of the calendar year preceding the year of issue, of the monthly average of the composite yield on seasoned corporate bonds, as published by Moody's Investors Service, Inc.

W is the weighting factor based on guarantee duration from the table:

The guarantee duration is the maximum number of years the life insurance can remain in force on a basis guaranteed in the policy or under options to convert to plans of life insurance with premium rates or non-forfeiture values, or both, and that are guaranteed in the original policy.

Guarantee Duration in Years	Weighting Factor
10 or less	.50
More than 10 but not more than 20	.45
More than 20	.35

Figure 7 shows that the proxy for the guaranteed interest rate declined by 13 basis points between 2006 and 2010. This is due in part to the decline in the composite yield on seasoned corporate bonds as published by Moody's Investors Service, Inc., and due in part to a change in the mix of new business written by the insurance industry.

Figure 7: Guaranteed Interest Rate by Year

Low Interest Rates and the Implications on Life Insurers

(continued)

Company Size	Guaranteed Interest Rate				
Reserves	2006	2007	2008	2009	2010
< $5 Million	3.47%	3.39%	3.33%	3.31%	3.32%
$5 M–$50 M	3.70%	3.69%	3.60%	3.61%	3.61%
$50 M–$500 M	4.07%	4.09%	4.10%	4.14%	4.08%
$500 M–$5 B	4.35%	4.27%	4.27%	4.18%	4.16%
> $5 B	4.20%	4.19%	4.09%	4.13%	4.08%
Total	**4.22%**	**4.20%**	**4.11%**	**4.14%**	**4.09%**

Looking at the difference between the net portfolio yield and the guaranteed interest rate (Figure 8), we can see the impact the low interest rate environment has had on the insurance industry. Investment net spreads declined 36 basis points between 2006 and 2010 (65 basis points of spread between the high in 2007 and the low in 2009). This is a significant drop in spread over a five-year period of time, amounting roughly to $8.2 billion of lost spread revenue over the five-year period on average reserves of $2.283 trillion.

Figure 8: Net Spread Over Guaranteed Interest Rate by Year

Company Size	Net Spread over Guaranteed Interest Rate				
Reserves	2006	2007	2008	2009	2010
< $5 Million	1.00%	1.14%	1.11%	1.29%	0.13%
$5 M - $50 M	1.36%	1.49%	1.28%	0.86%	0.66%
$50 M - $500 M	1.37%	1.65%	1.41%	1.11%	1.14%
$500 M - $5 B	1.57%	1.77%	1.41%	1.38%	1.37%
> $5 B	1.75%	1.81%	1.55%	1.12%	1.36%
Total	**1.72%**	**1.80%**	**1.53%**	**1.15%**	**1.36%**

While this is significant, the life insurance industry is still in a position of positive net investment income spread of around 136 basis points. So, to date, the low interest rate environment has created spread compression on earnings, but has not yet impacted insurance company solvency, which would begin to occur when the spread compression drops below zero. It is important to note that the pricing of life insurance products in the United States not only contains an investment spread margin, but also a spread margin built into the mortality rates and the expense component (e.g., contract fees and policy expense charges).

Asset/Liability Management

As previously noted, one tool life insurers use to manage interest rate risk is the matching of asset and liability cash flows. In fact, statutory valuation law requires insurance companies to perform an annual cash flow testing exercise where the life insurance company must build a financial model of their in-force assets and liabilities. The company must run the financial model for a sufficient number of years, such that any remaining in-force liability at the end of the projection period is not material.

At each duration, the financial model calculates the difference between liability and asset cash flows and accumulates this difference forward under a given interest rate scenario. The metric analyzed is typically the ending market value of surplus or the present value of the ending market value of surplus.

At the start of the model, assets are set equal liabilities so surplus is zero. Most companies run both a set of stochastically generated interest rate scenarios (typically 1,000+ scenarios), as well as a set of seven deterministic interest rate scenarios that are prescribed by state insurance regulators (referred to as "the New York 7"). The American Academy of Actuaries (AAA) has developed an economic scenario generator that randomly generates interest rate scenarios as well as market rate scenarios. Companies typically use the AAA's economic scenario generator to develop the stochastic interest rate scenarios they use in the asset adequacy analysis process.

The deterministic interest rate scenarios that were prescribed by state insurance regulators are as follows:

1. Level interest rate scenario
2. Uniformly increasing over 10 years at 0.5% per year and then level
3. Uniformly increasing over five years at 1.0% per year and then uniformly decreasing over five years at 1.0% per year and then level
4. An immediate increase of 3% and level forever
5. Uniformly decreasing over 10 years at 0.5% per year and then level

Low Interest Rates and the Implications on Life Insurers

(continued)

6. Uniformly decreasing over five years at 1.0% per year and then uniformly increasing over five years at 1.0% per year and then level
7. An immediate decrease of 3% and level forever

Such interest rate scenarios provide a good set of stress tests to help ensure that life insurance companies have either well matched asset and liability cash flows or have established additional reserves that are available to cover any interest rate or reinvestment rate risk that is embedded in their balance sheets. The Standard Valuation Law (#820) requires life insurance companies to post an additional reserve if the appointed actuary determines that a significant amount of mismatch exists between the company's asset and liability cash flows. As part of this study, the NAIC pulled the additional reserves liabilities that were established by companies at year-end 2010. The life insurance industry posted an additional asset/liability cash flow risk reserve of $6.5 billion.

Conclusion

Persistent low interest rates are challenging in many ways. The impact of low interest rates on the life insurance industry is something that bears watching. There are policy implications regulators must consider if the low interest rate environment persist over a long period of time. Financial regulators must closely monitor the efforts of life insurers to match assets with corresponding liabilities. The impact of past guarantees must be mitigated in ways that do not create volatility or inordinate risks through aggressive hedging activity. Life insurers and their regulators need to work together to assure policyholders are protected in the most efficient ways by balancing the challenges brought about by the low interest rate environment with safe and effective risk management solutions.

We welcome your questions and comments. Please contact us at:
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[1] On September 21, 2011, the Federal Reserve revealed its intention to shift $400 billion of short-term treasury holdings into longer-term treasury notes and bonds by the end of June 2012. The goal of the program, dubbed Operation Twist, is to lower long-term interest rates in an attempt to promote economic growth and increase employment.

[2] On August 9, 2011, the Federal Open Market Committee (FOMC) of the Federal Reserve announced its intention to keep the Federal Funds Target Rate at 0.00%-0.25% until at least mid-2013, which was the first time the Fed ever gave a specific date rather than using the term "extended period." On December 13, 2011 the Fed reiterated that economic conditions are likely to warrant exceptionally low interest rates until at least mid-2013.

[3] In an interest rate swap, one party typically exchanges a stream of floating rate interest payments for another party's stream of fixed rate interest payments (or vice versa).

[4] Net portfolio yield less the guaranteed credited rate of interest.

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Emerging Issues in the Accounting World that Examiners Need to Know

By
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Several recent articles in the *Journal of Accountancy* highlighted anticipated changes and emerging issues in the accounting world. They gave me pause to consider how these changes would affect the future examinations our firm would perform and recent findings that emerged in completed examinations that pointed to current weaknesses in the audit process. This article contains both proposed changes in audit approaches and considerations for examiners to evaluate during review of the auditors' workpapers.

Cyber Security

According to a Washington Post article in March of 2015, personal data on more than 120 million people has been compromised in more than 1,100 separate breaches at organizations handling protected health information (PHI) since 2009. In simple numbers, more than 1/3 of the US population has had their PHI breached! Of even larger concern is the ability to misuse data to fraudulently file tax returns and access credit since the quality of information in claims files is a fraudster's dream. Accordingly, the largest threats to insurers is a combination of reputational and financial risks. Reputational, because negative coverage can seriously damage an insurance company's reputation; financial risk in that remediation could cost upwards of $1,000 per record, plus possibly significant additional amounts related to a class action lawsuit for damages.

For all you Exhibit C people out there, renewed focus on the components of securing data, data retention/destruction, and intrusion detection/monitoring are key. Even more importantly, what does the insurer do to ensure disaster recovery plans are current and tested, that security patches and software are kept current, user access is updated to prevent terminated employees from creating havoc, and most importantly, does the insurer have breach response and insurance coverage suitable for potential exposures?

Executive Compensation

Executive compensation has been in the government's sights for quite some time. Concerns about manipulation of earnings related to revenue metrics has brought about review by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB); expected adoption of the new guidance would start January 1, 2018. The adoption would accelerate commissions and bonuses so the impact would apply to current periods and other related financial plans (i.e.: budgets and rate filings). This application would be for SEC registrants at this juncture.

Emerging Issues in the Accounting World that Examiners Need to Know

(continued)

Updated Enterprise Risk Management (ERM) Approaches

The Committee of Sponsoring Organizations (COSO) laid out the original ERM framework back in 2004. They just recently published a new draft entitled *"Enterprise Risk Management—Aligning Risk With Strategy and Performance"* which can be viewed at **http://erm.coso.org/Pages/viewexposuredraft.aspx**. Since ERM is key to an examiner's review of risks, it would behoove you to take a look at the draft. Key items include:

- updating of the "COSO Cube";
- focusing on misalignments of mission, values and strategy and the execution of said strategy;
- refining risk appetite and performance measures to reflect dynamic vs. static situations;
- linking ERM to daily decision making by management; and
- new emphasis on risk versus value propositions.

Credit Losses

Accounting Standards Update (ASU)# *2013-13 Financial Instruments-Credit Losses; Measurement of Credit Losses in Financial Statements* requires preparers to estimate and recognize losses on loans and other financial instruments based not only on historical experience but will also take into account current conditions and reasonable supportable forecasts, virtually moving from an occurred loss approach to an expected loss approach. This guidance will not take effect for most companies until calendar year 2020. Since many insurers have debt securities and investments that are subject to this guidance, it would make an interesting question during your examination to ask how the insurer will comply with the new standard, if applicable.

Partner Disclosure

The Public Company Accounting Oversight Board adopted new rules in December that were approved by the SEC to disclose the name of the lead audit partner and participating accounting firms for audits after January 31, 2017! For all you examiners that tried to get to the bottom of who was the responsible partner to contact, there will now be a database that you can access. The database will be fed by information provided by public accounting firms that requires disclosure of the lead partner on the audit and also information as to the names, extent of participation, and locations of any firms which participated in the audit to the extent that their work constituted more than 5% of total audit hours.

There are many proposals that have not reached fruition yet, put hopefully you will read about them soon enough!

Segment Review
September 19, 2016

Surplus Lines Financially Sound Despite Market Pressures and Economic Challenges

Proven underwriting discipline, product creation, diversification, and considerable balance sheet strength expected to drive future success.

For 2015, underwriters of surplus lines generated growth in direct premium of 2.5%, the smallest increase of the last five years, attributable to competitive market conditions and sluggish growth in some industry sectors that impacted exposure bases. Despite the lower growth and the inability to sustain what had been two straight years of underwriting gains entering 2015, surplus lines underwriters still notably generated both pretax and net profits.

A.M. Best believes the surplus lines market is financially sound and should remain solid for the foreseeable future despite competitive market pressures and challenging economic factors. Future success for the market is expected to be driven by proven underwriting fundamentals and discipline, product creation and diversification, and considerable balance sheet strength, particularly true for the leading writers of surplus lines business.

The zero trend of surplus lines impairments for the past decade extended through 2015; however, an impairment was recorded in late July 2016. Absent any specific drivers of surplus lines impairments, persisting sluggish economic conditions and a prolonged soft market could tighten profit margins. With interest rates remaining low, combined with the volatility experienced in U.S. and global financial markets, surplus lines companies must resist relaxing risk selection standards and lowering rates for the lure of premium growth and maintaining market share.

On May 2, 2016, the Nonadmitted Insurance Multistate Agreement (NIMA) was dissolved after its two largest members, Florida and Louisiana, withdrew from the tax-sharing system. NIMA's wind-down plan anticipates conclusion of the agreement by December 2017. On or after that effective date, no new multistate renewal or reinstatement transactions will be accepted through the Surplus Lines Clearinghouse (SLC) multistate reporting platform.

As surplus lines intermediaries navigate through the current market and look into the future, they remain focused on providing a broad array of products across different states and territories, enhancing data analytics capabilities and investing in new technology to better serve both broker/agency partners and insured clients. Finding ways to recruit and retain younger talent to effectively deal with the demographic challenge of an aging workforce will also be critical, particularly considering that many experienced workers may lack some skills needed to meet the challenges involved with utilizing data and technology. In addition, consolidation of both surplus lines carriers and brokerages is expected to remain prevalent, with the potential adverse impact on existing relationships and response time being chief among the concerns of surplus lines intermediaries.

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A.M. Best Surplus Lines Market Report – A Retrospective

More than two decades ago, A.M. Best published Best's Insolvency Study: Property/Casualty Insurers 1969-1990, in an effort to inform then-active debates over insurers' solvency. Sparked by interest in this topic, the Derek Hughes/NAPSLO Educational Foundation commissioned a similar study in 1994, on the solvency record of the domestic surplus lines industry. The segment was poorly understood by many at the time, but the data showed that, conventional wisdom aside, the surplus lines market's financial stability and solvency were at least on par with the overall property/casualty (P/C) industry.

In the ensuing years, A.M. Best has annually published a special report on the surplus lines market, commissioned by the Foundation, which has documented:

- The market's role in covering new or emerging risks, distressed risks, high-capacity risks, and unique risks that cannot be insured in the standard P/C market.
- The importance of surplus lines insurers' freedom of rate and form, which has allowed for creative insurance solutions to meet very complex or unique coverage needs.
- The role of surplus lines distributors, including wholesalers and managing general agents (MGAs), which have played a critical and still growing part in developing products and forging relationships with insureds that facilitate the placement of business in this market.

Throughout its history, the surplus lines market has faced significant obstacles and intense competition. This includes aggressive pricing and broader coverage from standard market carriers seeking organic growth, and the appeal of the alternative risk transfer market as another means of covering potential surplus lines risks. Meanwhile, surplus lines industry representatives have been active in Washington D.C. and individual states on critical regulatory issues affecting the industry, advancing key pieces of legislation. Among these were the National Association of Registered Agents and Brokers (NARAB) provision of the 1999 Gramm-Leach-Bliley Act, which led to nonresident surplus lines agent and broker licenses and a new landscape in wholesale and MGA distribution. More recent actions include passage of the Nonadmitted and Reinsurance Reform Act in 2010, passage of NARAB II as part of the Terrorism Risk Insurance Program Reauthorization Act of 2015, and the introduction of the Flood Insurance Market Parity and Modernization Act of 2016 (discussed in Section III of this report).

Despite the challenges, the surplus lines market more than doubled from 3.4% of total P/C direct premiums written (DPW) in 1995 to approximately 7.0% at the end of 2015. As a percentage of commercial lines DPW, surplus lines insurers grew from a 6.3% share to 14.2%, further demonstrating the sector's importance as part of the overall P/C industry.

As of mid-August 2016, 96.6% of surplus lines insurers had A.M. Best long-term Issuer Credit Ratings (ICRs) of "a-"or higher, compared with 75.6% for the total P/C industry. This further corroborates that the financial strength of the surplus lines sector has been sustained over a long period of time.

The surplus lines market clearly is a healthy and viable safety valve for the insurance industry, particularly in hard markets. Emerging issues and burgeoning exposures continue to drive more demand for creative and comprehensive insurance solutions. With the demonstrated capability to effectively assess new exposures, and the flexibility to tailor terms and limits to meet coverage demands, A.M. Best believes the surplus lines market will continue to assert its value in the P/C insurance marketplace.

Section I – State of the Market

The surplus lines sector once again generated profits on both a pretax and after-tax basis in 2015, albeit reduced by more than 30% from the above average levels achieved in 2013 and 2014. Although the sector has historically benefited from favorable prior year loss reserve development, in 2015, adverse loss reserve development was a primary contributor to the drop in operating profits. Despite instability remaining in the capital markets and interest rates remaining low, growth in investment income helped surplus lines companies again add to their bottom lines.

During the year, price momentum continued as direct premiums in this sector grew by a little under 3.0% (**Exhibit 1**) despite competitive pressures domestically and abroad, robust balance sheets seeking to put capital to work, as well as new entrants. Insurers

Exhibit 1

U.S. Surplus Lines – Direct Premiums Written (DPW) by Segment (1988-2015)

($ millions)

	Total P/C Industry		Total Surplus Lines		DOMESTIC PROFESSIONALS				LLOYD'S			REGULATED ALIENS (excluding Lloyd's)				DOMESTIC SPECIALTY			
Year	DPW	Annual % Chg	DPW	Annual % Chg	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.	*DPW	Annual % Chg	Surplus Lines Market Share	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.	DPW	Annual % Chg	Surplus Lines Market Share	No. of Cos.
1988	211,270	4.2%	6,281	-4.3%	3,704	-10.4%	59.0%	86	1,237	-7.5%	19.7%	1,012	31.3%	16.1%	104	328	2.2%	5.2%	128
1989	220,620	4.4%	6,123	-2.5%	3,530	-4.7%	57.7%	88	1,182	-4.4%	19.3%	1,050	3.8%	17.1%	101	361	10.1%	5.9%	123
1990	230,757	4.6%	6,532	6.7%	3,882	10.0%	59.4%	117	1,241	5.0%	19.0%	1,013	-3.5%	15.5%	85	396	9.7%	6.1%	149
1991	235,627	2.1%	6,924	6.0%	4,081	5.1%	58.9%	117	1,322	6.5%	19.1%	1,111	9.7%	16.0%	85	410	3.5%	5.9%	151
1992	240,410	2.0%	7,549	9.0%	4,491	10.0%	59.5%	120	1,388	5.0%	18.4%	1,220	9.8%	16.2%	74	450	9.8%	6.0%	151
1993	253,847	5.6%	8,540	13.1%	5,270	17.3%	61.7%	123	1,631	17.5%	19.1%	1,183	-3.0%	13.9%	70	456	1.3%	5.3%	138
1994	263,653	3.9%	8,786	2.9%	6,089	15.5%	69.3%	115	1,196	-26.7%	13.6%	992	-16.1%	11.3%	64	509	11.6%	5.8%	141
1995	273,929	3.9%	9,245	5.2%	6,511	6.9%	70.4%	112	1,300	8.7%	14.1%	1,022	3.0%	11.1%	57	412	-19.1%	4.5%	144
1996	279,990	2.2%	9,205	-0.4%	6,668	2.4%	72.4%	108	1,354	4.2%	14.7%	818	-20.0%	8.9%	57	365	-11.4%	4.0%	125
1997	287,196	2.6%	9,419	2.3%	6,569	-1.5%	69.7%	106	1,609	18.8%	17.1%	802	-2.0%	8.5%	59	439	20.2%	4.7%	114
1998	300,309	4.6%	9,861	4.7%	6,763	3.0%	68.6%	107	1,574	-2.2%	16.0%	1,196	49.1%	12.1%	58	328	-25.3%	3.3%	113
1999	308,671	2.8%	10,615	7.6%	7,265	7.4%	68.4%	105	1,912	21.5%	18.0%	1,140	-4.7%	10.7%	55	298	-9.1%	2.8%	116
2000	327,286	6.0%	11,656	9.8%	7,884	8.5%	67.6%	98	2,499	30.7%	21.4%	941	-17.5%	8.1%	46	332	11.4%	2.8%	106
2001	367,798	12.4%	15,813	35.7%	10,773	36.6%	68.1%	104	3,368	34.8%	21.3%	1,362	44.7%	8.6%	44	310	-6.6%	2.0%	91
2002	422,703	14.9%	25,565	61.7%	19,572	81.7%	76.6%	108	4,082	21.2%	16.0%	1,600	17.5%	6.3%	46	311	0.3%	1.2%	76
2003	463,033	9.5%	32,799	28.3%	25,662	31.1%	78.2%	115	4,492	10.0%	13.7%	2,400	50.0%	7.3%	45	245	-21.2%	0.7%	63
2004	481,588	4.0%	33,012	0.6%	25,744	0.3%	78.0%	115	4,596	2.3%	13.9%	2,400	0.0%	7.3%	53	272	11.0%	0.8%	59
2005	491,429	2.0%	33,301	0.8%	25,968	0.9%	78.0%	111	4,675	1.7%	14.0%	2,400	0.0%	7.2%	50	238	-12.5%	0.7%	57
2006	503,894	2.5%	38,698	16.3%	29,410	13.3%	76.0%	117	5,989	28.1%	15.5%	3,100	29.2%	8.0%	55	199	-16.4%	0.5%	54
2007	506,180	0.5%	36,637	-3.5%	27,675	-5.9%	74.1%	120	6,360	6.2%	17.0%	3,100	0.0%	8.3%	55	202	1.5%	0.5%	56
2008	492,881	-2.6%	34,365	-6.2%	24,612	-11.1%	71.6%	130	6,062	-4.7%	17.6%	3,403	9.8%	9.9%	53	288	42.6%	0.8%	70
2009	481,410	-2.3%	32,952	-4.1%	22,830	-7.2%	69.3%	139	6,090	0.5%	18.5%	3,735	9.8%	11.3%	55	297	3.1%	0.9%	69
2010	481,120	-0.1%	31,716	-3.8%	21,882	-4.2%	69.0%	143	5,789	-4.9%	18.3%	3,758	0.6%	11.8%	56	287	-3.4%	0.9%	66
2011	501,555	4.2%	31,140	-1.8%	22,582	3.2%	72.5%	146	5,790	0.0%	18.6%	2,537	-32.5%	8.1%	53	231	-19.5%	0.7%	60
2012	523,360	4.3%	34,808	11.8%	25,490	12.9%	73.2%	142	6,270	8.3%	18.0%	2,747	8.3%	7.9%	61	301	30.3%	0.9%	53
2013	545,760	4.3%	37,719	8.4%	26,818	5.2%	71.1%	140	7,099	13.2%	18.8%	3,362	22.4%	8.9%	59	440	46.2%	1.2%	49
2014	570,187	4.5%	40,243	6.7%	28,274	5.4%	70.3%	135	8,157	14.9%	20.3%	3,311	-1.5%	8.2%	60	501	13.9%	1.2%	58
2015	591,186	3.7%	41,259	2.5%	29,333	3.7%	71.1%	139	8,645	6.0%	21.0%	2,974	-10.2%	7.2%	58	307	-38.7%	0.7%	53

The 2014 total DPW for Regulated Alien Insurance Companies was updated to $3.311 billion from $3.302 billion following a company revising the total it reported to the NAIC in September 2015, after the publication of the 2015 Surplus Lines Special Report.
The 2015 total DPW for Regulated Alien Insurance Companies represents the total premium reported by companies that reported 2015 premiums to the NAIC as of August 16, 2016.
Source:

– Best's Statement File - P/C, US, A.M. Best data and research

and underwriters have resigned themselves to the reality of the current low interest rate environment and are devising strategies that presume little change over the near-term.

Nonetheless, the market position of surplus lines insurers continues to be favorable overall, with most carriers being well-capitalized and consistent performers. For long-term surplus lines market stalwarts, these attributes are the result of effective strategic analysis, product diversification, underwriting discipline, advantageous market conditions, and an environment conducive to opportunistic mergers and acquisitions. With a business profile that those inside the industry often refer to as "counter-cyclical", these carriers have extended the trend of favorable, overall operating profitability in spite of the challenges that can arise from emerging liability exposures, or increases in loss costs. Such challenges can make it more difficult to generate underwriting profits and, in some years, contribute to unfavorable prior year reserve development. Although some individual carriers have encountered difficulties, in general, the surplus lines carriers remain strong performers and in good shape to meet current and forthcoming market challenges.

A.M. Best's View of the Surplus Lines Market

A.M. Best's overall outlook on the surplus lines insurance market remains stable. While we expect the vast majority of rating actions over the coming year for companies in this market will be affirmations, we also expect the number of rating upgrades and rating downgrades to be about even.

This view considers our expectation that economic factors within the U.S. will remain stable, interest rates will remain low, insurance pricing of surplus lines companies will remain rational, and reserve development patterns of prior years' losses will reflect the more historically favorable position, albeit with the level of favorable development expected to dissipate. Factors that could adversely impact this view include fast-developing soft market pricing conditions, questionable underwriting behavior by organizations expanding their footprint into the surplus lines market or new market entrants, a sharp deterioration in the investment market climate, natural catastrophe frequency, or incidents of terrorism.

Over the last ten years, the overall surplus lines sector has recorded six years of underwriting profit. Initially, it appeared that 2015 would be another year of underwriting profitability until the final quarter of the year, when insurers in aggregate experienced adverse loss reserve development. Through the first quarter of 2016, initial results show the sector to be back on track, reporting significant underwriting and operating profits. Nonetheless, that will still have to be proven out through the rest of the year.

Market Conditions

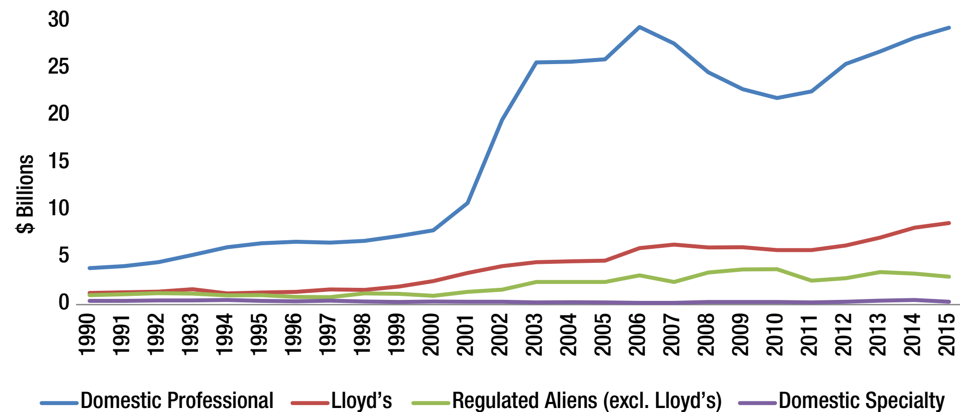
A.M. Best believes the surplus lines market is financially sound at present and, considering the overall balance sheet strength of the sector's insurers and opportunities for surplus lines market participants to develop coverage solutions for emerging liabilities and exposures, the market should remain strong for the foreseeable future. The ability of the participants to maintain sound balance sheets and sustain favorable operating performance has been the hallmark of this segment. While operating under the same general economic factors that face the entire industry, surplus lines carriers have capably established their importance and preserved their position in the industry.

The total surplus lines market displayed top line growth for 2015, growing its direct premium written by approximately 2.5% compared to 2014. **Exhibit 1** illustrates direct premiums written across four categories of insurers: domestic professional companies, Lloyd's syndicates, regulated aliens, and domestic specialty companies.

The majority of the overall market's premium continued to be generated by those companies referred to as domestic professional companies, which write more than 50% of their total direct

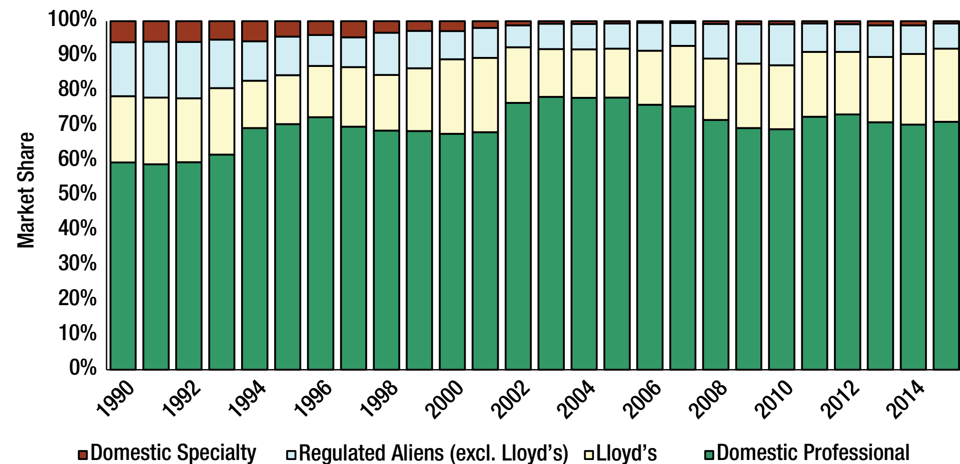
business on a surplus lines basis. Through its 84 syndicates that wrote surplus lines business in 2015, Lloyd's generated the second largest percentage of direct premiums written, while regulated non-Lloyd's alien insurers also contributed a meaningful percentage of premium despite the recent downward trend for this segment (**Exhibits 2 and 3**). Domestic specialty companies, those companies writing 50% or less of their business on a nonadmitted basis, generate a very small percentage of the total surplus lines direct premium annually.

Exhibit 2
U.S. Surplus Lines – DPW by Segment
(1989-2015)



Source: A.M. Best data and research

Exhibit 3
U.S. Surplus Lines – Market Share by Segment
(1989-2015)



Source: A.M. Best data and research

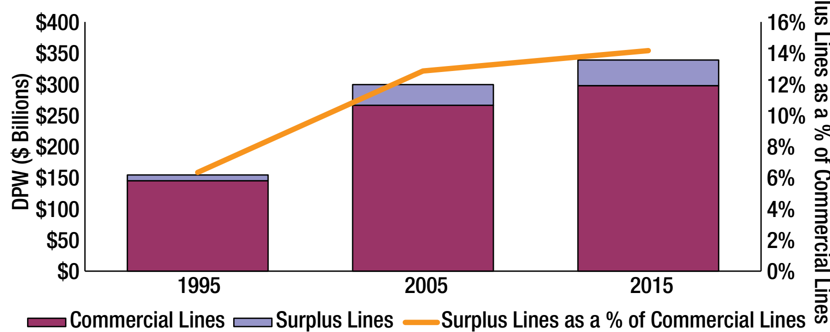
While DPW is a key metric, we have seen premium ebb and flow for the sector over the last ten years, encompassing market conditions, price sensitivity, loss experience, and economic factors. Expanding direct premium captures both rate actions and new business.

The path of surplus lines premiums over the past 20+ years shows how steadily it has increased as a percentage of commercial lines insurance industry premiums (**Exhibit 4**). This percentage trended upward again in 2015 to its highest level since A.M. Best began measuring this metric.

Consolidated financial results for the surplus lines sector hit a road bump for 2015. Despite suffering an underwriting loss, investment income helped ensure that overall profitability was achieved for the year. While results in 2015 were not up to the standard of prior years, underwriting integrity remains a core value and reserve management continues to be prudent.

One contributing factor that impacts the entire industry is weather-related catastrophe exposures. Surplus lines carriers maintain a fair amount of exposure to such events.

Exhibit 4
U.S. Surplus Lines – Direct Premiums Written vs. Commercial Lines (1995, 2005, 2015)



Source: A.M. Best data and research

Looking over the last five years, the losses in 2012 caused by Superstorm Sandy are no longer having an impact on operating results, although they contribute to ongoing discussions and evaluation of risk profiles. While 2015 did not see a significant increase in large-scale events, the frequency of smaller scale events did garner attention across the surplus lines participants.

Exhibit 5
Surplus Lines Specialists – Operating Performance (2015)
(%)

Group Name	Change in DPW	Loss/LAE Ratio	Combined Ratio	Pre-Tax ROR	Pre-Tax ROE
Alleghany Insurance Holdings	-1.4	53.9	89.4	21.5	12.6
Argo Group	8.1	60.8	91.6	16.4	9.9
Crum & Forster Insurance Group	8.1	64.1	97.5	2.3	2.7
Global Indemnity Group	-2.1	60.5	95.6	17.8	12.2
HIIG Group	7.3	67.8	100.6	1.6	1.9
Houston Casualty Group	0.5	59.2	88.2	29.0	16.9
IFG Companies	-6.6	42.4	93.4	16.2	5.7
James River Insurance Company	27.6	65.2	92.3	28.4	12.5
Kinsale Insurance Company	11.6	56.8	60.3	46.7	30.0
Markel Corporation Group	0.5	54.6	92.2	13.4	11.3
RLI Group	4.0	42.7	83.9	25.9	21.2
W. R. Berkley Group	6.0	56.5	89.2	18.8	18.1
Average - Surplus Lines Specialists	5.3	57.0	89.5	19.8	12.9
Total P/C Industry	**3.7**	**69.3**	**97.9**	**11.5**	**8.4**

Source: A.M. Best Co.'s *AMB Credit Report - Insurance Professional*

Strong Performance for Core Surplus Lines Specialists

Surplus lines specialists as identified in this report are insurance organizations that are particularly focused on surplus lines or specialty business, as opposed to organizations such as AIG, Nationwide, and Zurich, for example, that are global insurers that have affiliates which specialize in surplus lines business but whose overall business model is as much, if not more, focused on admitted business. These specialists provide wide-ranging product diversification to cover the varied exposures that require critical insurance solutions in the market. These specialists, as shown in **Exhibit 5** and **Exhibit 6**, generate strong underwriting and operating ratios, solid returns, and favorable loss reserve development. The surplus lines specialists highlighted in these exhibits are U.S.-domiciled insurers that primarily write surplus and/or specialty admitted business. These specialists largely exclude companies or groups that are part of a much larger, global multiline insurance operation, but include some specialty groups with Bermuda-based parents.

Leading Surplus Lines Companies

The participants in the surplus lines market, the companies on whose paper the policies are written, have evolved over the years. In comparison with individual insurance organizations, Lloyd's has produced the largest share of surplus lines DPW (**Exhibit 7**). Their portion of the direct premium written has been near 20% for multiple years. Their platform provides a unique opportunity to write surplus lines direct as well as in conjunction with participants in the surplus lines market. Lloyd's has shown no sign of a diminished appetite for surplus lines business and A.M. Best believes they will continue to have the primary spot in the DPW ranking.

The largest U.S. domestic surplus lines writer continues to be AIG, as has been the case since A.M. Best's first review of the surplus lines market in 1994 (**Exhibit 8**). While their percentage share of business has diminished slightly over the last few years, this has, in part, reflected premiums and exposures being ceded to overseas affiliates. Still, there is no question that the Lexington Insurance Company brand retains considerable strength in the market.

In 2015, the combination of Lloyd's and AIG totaled approximately 32% of the direct premium total for the entire surplus lines market. As of year-end 2015, roughly $8.6 billion of direct premium written from the U.S. surplus lines market had been placed with Lloyd's, approximately 21% of the U.S. surplus lines market. These exposures ensure that the U.S. remains Lloyd's largest market. The ongoing growth of Lloyd's surplus lines business reflects their appetite for these exposures and A.M. Best expects this trend to continue.

Exhibit 6

Top Surplus Lines Specialists – Loss Reserve Development (2015 Calendar Year)

($ Thousands)

Group Name	One-Year Loss Reserve Development Through 2015	One-Year Development to Original 2014 Reserves (%)
Alleghany Insurance Holdings	-202,853	-2.1%
Argo Group	12,365	1.2%
Crum & Forster Insurance Group	-9,187	-0.4%
Global Indemnity Group	-18,333	-6.4%
HIIG Group	21,937	8.1%
Houston Casualty Group	-27,591	-1.6%
IFG Companies	-24,312	-6.5%
James River Insurance Company	-8,297	-9.8%
Kinsale Insurance Company	-9,496	-11.7%
Markel Corporation Group	-216,340	-6.9%
RLI Group	-60,926	-8.2%
W. R. Berkley Group	-97,466	-1.1%
Average - Surplus Lines Specialists	-53,375	-3.8%
Total P/C Industry	**-9,456,000**	**-1.6%**

Source: A.M. Best data and research

The balance of the top twenty-five companies writing U.S. surplus lines business in 2015 are familiar names. Berkshire Hathaway, Markel, Nationwide, W.R. Berkley, and Zurich all remain among the leaders. Ironshore Group also continues its recent trend, advancing further as a major writer of surplus lines business. Through M&A activity, two other entities have increased their market share as well. The consolidation of XL Group and Catlin Group has created a top ten surplus lines insurer ranked in terms of DPW. In addition, the consolidation of the Tokio Marine U.S. subsidiaries, noted as Philadelphia Insurance/Tokio Marine Group, now includes Houston Casualty Company (HCC), leading to it also becoming a top 25 group. A similar shift will be seen when full year 2016 DPW is tallied by group, when Chubb Limited, the combination of ACE & Chubb that was finalized during the first quarter of 2016, reports their consolidated results. As has been generally the case over the past two decades that A.M. Best has reported on the surplus lines segment, roughly 75% of the total U.S. surplus lines market is captured by the top 25 carriers.

The top 25 rankings have experienced variability due not only to consolidations, but also as teams of experienced surplus lines professionals have moved from one insurer to another, bringing expertise and controlled books of business with them to their new employers. For comparison, **Exhibit 9** shows the composition of the top 25 surplus lines groups from a decade ago. ACE, Chubb, and HCC were all distinct, top 25 groups a decade ago, while QBE Americas, the aforementioned Ironshore, Allied World Assurance and Aspen US Insurance Group had not grown into the more prominent surplus lines writers that they have become through the end of 2015. With interest in the surplus lines market continuing to be strong, especially with more complex emerging liabilities and exposures requiring tailored coverage solutions as technologies advance, other organizations may strive to increase their market share over the near-to-medium term, further re-shaping the top 25 group list.

A portion of the market will always be dominated by organizations focused solely on surplus lines business, including multi-faceted organizations with multiple internal affiliates and/

Exhibit 7
U.S. Surplus Lines – Top 25 Groups (2015) by Direct Premiums Written (DPW)
($ Thousands)

Rank	AMB No.	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	85202	Lloyd's	8,645,000	21.0
2	18540	American International Group*	4,656,353	11.3
3	05987	Nationwide Group	1,787,725	4.3
4	18252	W.R. Berkley Group	1,547,181	3.7
5	18549	Zurich Financial Svcs NA Group	1,229,918	3.0
6	18468	Markel Corporation Group	1,175,820	2.8
7	18874	XL Catlin America Group	1,154,629	2.8
8	18498	Chubb INA Group	1,037,187	2.5
9	00811	Berkshire Hathaway	1,000,701	2.4
10	18728	Ironshore Insurance Group	871,249	2.1
11	18640	Alleghany Insurance Holdings	780,416	1.9
12	03116	Fairfax Financial (USA) Group	744,372	1.8
13	18313	CNA Insurance Companies	675,663	1.6
14	18603	AXIS Insurance Group	603,112	0.1
15	18733	Philadelphia Insurance/Tokio Marine Group	590,614	1.4
16	04019	Argo Group	578,360	1.4
17	00012	Chubb Group	571,890	1.4
18	18713	QBE Americas Group	544,813	1.3
19	04835	Great American P&C Group	543,620	1.3
20	18604	State National Group	534,027	1.3
21	18591	Allied World Assurance Group	529,782	1.3
22	18484	Arch Insurance Group	527,384	1.3
23	18783	Aspen US Insurance Group	500,436	1.2
24	18756	Starr International Group	448,580	1.1
25	18674	Travelers Group	385,775	0.9
		Subtotal of Top 25	**$31,664,607**	**76.7**
		Total U.S. Surplus Lines Market	**$41,259,164**	**100.0**

* The group's DPW total does not include approximately $370 million in direct surplus lines premium moved to offshore affiliate AIG Europe, Ltd.
Source: A.M. Best data and research

or reinsurance participants. A significant part of the market consists of subsidiaries and affiliates of national or global organizations viewed more as insurance conglomerates. These organizations show similarities of balance sheet strength remaining supportive of the risks, operating performance based on underwriting integrity, challenged investment income, and expanding Enterprise Risk Management.

Metrics can only capture so much, and the similarities do fade. Structurally, the surplus line carrier in an organization participating in a pool or having 100% quota share reinsurance is appearing more common. Besides providing balance sheet support for the direct writer, this helps the usually larger parent company smooth out underwriting results, and provides a greater invested asset base for improved investment returns. The line between standard market carriers and surplus lines carriers continues to blur. The desire of insurance organizations to add top line premium with favorable loss experience leads some standard market carriers to consider "borderline" or "gray area" surplus lines business depending on the full nature of their risk appetite and whether it is changing or evolving in a material way.

Current Market Challenges

Surplus lines companies are facing an environment where underwriting profitability is compacting. This was captured in the 2015 net consolidated results as the combined ratio rose compared to prior years. Though having rate freedom, price sensitivity has limited the capability to elevate rates to anticipatory levels, where new rates can capture exposures for a forward-looking period. The expansion of the population of companies capable of writing non-standard business places pressures on the established carriers to differentiate on price, terms, distribution, service, and risk management. In many cases, surplus lines carriers have focused resources on enhanced underwriting capability, improved technology, and developing deeper relationships with fewer intermediaries to be more efficient and enhance productivity. Within the surplus lines market, reinsurers, standard market carriers, and start-ups have, at times, sought a bigger

Exhibit 8

U.S. Surplus Lines – Top 25 Companies (2015) by Direct Premiums Written (DPW)

($ Thousands)

Rank	AMB No.	Company Name	Group Name	Surplus Lines DPW	Total Surplus Lines Share (%)
1	02350	Lexington Insurance Company	American International Group	$3,725,063	9.0%
2	03292	Scottsdale Insurance Company	Nationwide Group	1,581,300	3.8%
3	03557	Steadfast Insurance Company	Zurich Financial Svcs NA Group	1,096,088	2.7%
4	03535	AIG Specialty Insurance Co	American International Group	931,010	2.3%
5	13866	Ironshore Specialty Ins Co	Ironshore Insurance Group	857,000	2.1%
6	03538	Indian Harbor Insurance Co	XL America Group	790,539	1.9%
7	11340	National Fire and Marine	Berkshire Hathaway Group	720,554	1.7%
8	12515	Evanston Insurance Company	Markel Corporation Group	684,305	1.7%
9	04433	Columbia Casualty Company	CNA Insurance Companies	675,663	1.6%
10	12523	AXIS Surplus Insurance Company	AXIS Insurance Group	603,112	1.5%
11	02428	Westchester Surplus Lines Ins	ACE INA Group	552,760	1.3%
12	12619	Colony Insurance Company	Argo Group	549,845	1.3%
13	02713	QBE Specialty Insurance Co	QBE Americas Group	544,813	1.3%
14	12562	United Specialty Insurance Co	State National Group	534,027	1.3%
15	03283	Arch Specialty Insurance Co	Arch Insurance Group	527,384	1.3%
16	01990	Nautilus Insurance Company	W. R. Berkley Insurance Group	523,570	1.3%
17	03759	Chubb Custom Insurance Co	Chubb Group of Insurance Cos	520,687	1.3%
18	02732	Aspen Specialty Insurance Co	Aspen US Insurance Group	500,436	1.2%
19	12118	Essex Insurance Company	Markel Corporation Group	489,230	1.2%
20	03510	Landmark American Ins Co	Alleghany Insurance Holdings	487,482	1.2%
21	10092	Illinois Union Insurance Co	ACE INA Group	484,428	1.2%
22	03026	Admiral Insurance Company	W. R. Berkley Insurance Group	471,470	1.1%
23	13105	Gemini Insurance Company	W. R. Berkley Insurance Group	468,919	1.1%
24	12630	Starr Surplus Lines Company	Starr International Group	448,580	1.1%
25	13977	Endurance American Spec Ins Co	Endurance Specialty Group	371,317	0.9%
		Subtotal		**$19,139,582**	**46.4%**
		Total U.S. Surplus Lines Market		**$41,259,164**	**100.0%**

Source: A.M. Best data and research

piece of the pie. As a niche where it has been proven that significant underwriting profits can be generated, the surplus lines market will maintain a level of attractiveness for investment from parties both inside and outside the industry (like private equity firms).

The challenged investment environment remains prominent, with depressed yields on fixed income investments, volatility in the equity markets, private placements falling short of expectations, and hedge funds recording lower returns. Almost all U.S.-based carriers with a domestic focus on investments have some insulation from negative interest rates and the ultimate impact of Brexit, the forthcoming withdrawal of the United Kingdom (UK) from the European Union (EU). Conversely, surplus lines carriers composed of subsidiaries of international organizations and companies having off-shore affiliated reinsurers may be among those exposed to these investment market issues.

Surplus lines carriers continue to be the first to market, providing coverage for developing exposures, including ride-sharing, drones, technology companies in the “gig-economy”, and

Exhibit 9

U.S. Surplus Lines – Top 25 Groups (2006) by Direct Premiums Written (DPW)

($ Thousands)

Rank	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share
1	American International Group	$8,164,885	21.1%
2	Lloyd's	5,989,000	15.5%
3	Zurich Financial Svcs. Group	1,638,125	4.2%
4	Nationwide Group	1,508,253	3.9%
5	ACE INA Group	1,507,966	3.9%
6	W.R. Berkley Group	1,288,056	3.3%
7	Markel Corporation Group	1,269,918	3.3%
8	Berkshire Hathaway Ins. Group	1,128,902	2.9%
9	Alleghany Insurance Holdings	1,004,112	2.6%
10	CNA Insurance Companies	837,557	2.2%
11	Arch Insurance Group	765,116	2.0%
12	Argonaut Insurance Group	669,443	1.7%
13	AXIS Insurance Group	660,613	1.7%
14	Travelers Insurance Companies	608,585	1.6%
15	XL America Group	555,303	1.4%
16	United America Indemnity Group	461,396	1.2%
17	Chubb Group of Insurance Companies	440,544	1.1%
18	RLI Group	437,611	1.1%
19	Fairfax Financial (USA) Group	382,214	1.0%
20	IFG Companies	360,523	0.9%
21	Great American P&C Insurance Group	344,096	0.9%
22	HDI U.S. Group	337,194	0.9%
23	Swiss Reinsurance Group	320,206	0.8%
24	Hartford Insurance Group	309,267	0.8%
25	HCC Insurance Holdings	307,703	0.8%
Subtotal		**$31,296,588**	**80.9%**
Total U.S. Surplus Lines Market		**$38,698,065**	**100.0%**

Source: A.M. Best data and research

cyber-insurance. When solutions for new exposures are needed, the core competencies of surplus lines companies – freedom of rate and form, underwriting expertise, and financial strength–allow for those solutions to be created. Underwriting and pricing acumen have been the bedrock of the surplus lines niche. As risks develop at an accelerated pace, insurance providers will be forced to develop at the same pace. In this view, there is always the unknown – can the surplus lines market be capable of designing and implementing coverage for the next new product? The answer to that question over many market cycles has been affirmative.

Considering the aforementioned elevated interest in the surplus lines market and the wealth of capital available to insurers and those outside the market looking for an opportunity to get in, some industry observers would consider the greatest challenge to be retaining market share while preserving profitability. The surplus lines market is traditionally a wholesale broker-driven business and will always have an element of price-sensitivity. Expanding the population of participating carriers increases the opportunity for clients shopping for the lowest rate or price for their insurance program. Existing carriers emphasizing services provided and past claim settlement to prove that they stand behind their insurance product expand the decision-making consideration of insureds past simple price comparisons. Carriers focusing on their risk appetite will either draw business away from competitors or place into the market insured risks that are likely to lead to unprofitable results, possibly falling victim to some degree of adverse selection. Historically though, on a whole, surplus lines insurers have been loath to be drawn into such a level of unhealthy competition and have, instead, allowed top line premium volume to diminish if the market dictates that present levels cannot be maintained at acceptable profit margins.

Mergers and Acquisitions

When it comes to insurance industry mergers and acquisitions, the opportunities for both the company side and insurance intermediaries still appear plentiful. In terms of motivation, the usual assortment of drivers for M&A deals includes accretive earnings, talent and technology acquisition, and the classic "bolt-on transaction". While a fair portion of the insurance consolidation activity is outside the surplus lines arena, surplus lines carriers and intermediaries have been and continue to be primary targets as they fulfill many of the desires of acquiring organizations – favorable loss experience, market expertise, and diversification.

Completed in January, 2016, the acquisition by ACE Ltd. of Chubb Corporation brought together significant participants in the surplus lines market. Both organizations were among the top 25 writers in this space. It is possible that going forward the new Chubb Limited could move as high as one of the top five producers of surplus lines business.

The ongoing story of American Financial Group, Inc. (the parent of Great American P&C Insurance Group) and their attempts to complete the acquisition of National Interstate Corporation reached a key turning point on July 25, 2016. The announcement of the acceptance of the most recent purchase offer was combined with the expectation of the transaction closing in the fourth quarter of 2016.

Occurring in a similar timeframe, Ironshore Inc., which is owned by Shanghai-based Fosun International Ltd., disclosed its intention to launch an initial public offering. It was noted that Fosun would remain majority owner. While this transaction is clearly the opposite of the M&A definition, it does speak to the strength of the surplus lines business Ironshore has built and Fosun's ability to capture a financial benefit from the IPO.

The most recent finalized transaction is Hartford completing its acquisition of Maxum Specialty. This deal closed on August 1, 2016. This acquisition allowed Hartford to diversify its business lines and advance its market reach. Hartford has gone on record saying they would retain Maxum's employees. This reflects that general feeling in the industry of this transaction reflecting a talent acquisition.

No observer of the insurance industry can predict with certainty the details concerning "who" or "when" regarding future M&A activity. A.M. Best anticipates that surplus lines carriers will continue to be involved in M&A activity over the near term. As noted in the 2015 Surplus Lines Segment Review, capital needs to be allocated where it will create favorable returns for appropriate risks. Addressing this through participating in the surplus lines market via acquisition is a strategic option we believe many companies may seek. These actions could be accelerated by economic conditions, including continued depressed investment income returns.

Conclusion

The surplus lines market conditions so far in 2016 remain consistent with the last handful of years – competitive, underwriting-results-driven, and eluding (for now) the exposure to natural catastrophe events. This framework allows for the current market participants to continue recording overall profitability, retain balance sheet strength, maintain service levels for insureds, and provide capacity for a growing market.

Over the years that A.M. Best has composed this report, the strength of surplus lines carriers has remained evident. Designing customized coverage for specialized risks within disciplined underwriting and pricing structures while providing expert service, risk management, and financial strength has been the foundation of this segment. The unrelenting focus on consistent bottom line performance drives the long-term stability of the market. A.M. Best believes that surplus lines insurers that continue their laser-sharp focus on the market fundamentals are the ones that will retain their leadership positions in this market.

Stamping Offices Report 2015 Growth in Surplus Lines Premium, 2016 Premium Level Remains Steady

According to information compiled by the Surplus Lines Stamping Office of Texas, the 14 states maintaining stamping offices reported a 3.6% increase in premium volume during 2015, compared with a 7.6% increase in premium volume in 2014. The total $25.0 billion in premium processed by stamping offices in 2015 is the highest level ever recorded for a single year.

In conjunction, the stamping offices also reported a 6.4% increase in the number of documents filed, 3.6 million in 2015, compared with 3.4 million and 3.2 million in 2014 and 2013, respectively. The document count indicates the number of policies and endorsements handled by the various stamping offices. A change in document count provides a rough estimate of the flow of business into and out of the surplus lines market.

While the stamping offices only report on 14 states, the results continue to be influenced heavily by four specific states — California, Florida, New York, and Texas. California again generated the highest premium volume of these states, its third consecutive year with top ranking. Many smaller states recorded strong percentage changes in premium. This included Oregon – 16.6%, Illinois – 14.6%, and Idaho – 13.5%. By document count, the leading states continue to be Florida and Texas.

Through the first six months of 2016, overall, the reported document count remained steady with a minimal 0.3% decrease, which is counter to increases of 5.3% in 2015, and 9.5% in 2014, over the same period. Likewise, premium levels also remained on par with those through mid-year 2015 with a 0.2% increase during the first half of 2016. This was again counter to the trend experienced during the first six months of each of the past two years, with premium increasing in 2015 by 9.5%, and by 4.8% in 2014. The results across the four leading markets were mixed. California and New York experienced increased premium volume, with California's modest 1.9% increase outpacing the nominal 0.7% premium increase reported for New York. Both of those states, along with Texas reported an increase in documents filed during the first half. Texas reported a 3.1% rise in document count despite a slight 1.6% decline in premium. Among these four states, New York had the most significant increase in filings of 6.5%, while Florida's document count dropped by 9.8%, although its premium level held more firm, declining by only 2.2%.

Looking at the full-year 2015 results, the larger increase in the number of items processed compared to premium generated is probably indicative of the competitiveness in the current marketplace. In recent years, premium increases had outpaced the increase in the number of items processed, indicating adherence to underwriting discipline and pricing integrity across the surplus lines market. Times of heightened competition will test the resolve of surplus lines underwriters to remain disciplined and remain focused on bottom line profitability. Historically, surplus lines insurers have risen to the challenge, and generated profitable results, with 2015 being no exception. The activity so far in 2016, with slight declines in both premium and filings being reported, could reflect some stability in the market. Nonetheless, with inconsistency in some regional results, it is also likely that there is an element of price-sensitivity in certain pockets of the market as well.

Section II – Financial Condition and Ratings Distribution

This section provides a statistical analysis of A.M. Best's Domestic Professional Surplus Lines (DPSL) composite. We believe that this composite of leading companies in the Surplus Lines sector provides an accurate representation of the overall sector's financial condition. This section also discusses the distribution of A.M. Best ratings among the DPSL composite companies, with comparison to the overall P/C industry.

A.M. Best's DPSL Peer Composite Defined

The analysis in this section is based on the statutory financial data of the 72 U.S.-based domestic professional surplus lines (DPSL) companies. The DPSL composite produced approximately $17.0 billion in direct premium written (DPW) in calendar year 2015, representing approximately 41.2% of the total surplus lines market and 58% of the DPSL market.

DPSL companies are identified as those that write at least half of their business on a nonadmitted basis. These organizations historically have accounted for approximately two-thirds to three-quarters of the total surplus lines market.

To determine the population of true DPSL companies for purposes of this section and the comparisons herein, A.M. Best excludes surplus lines companies that are members of intercompany pools that predominantly write admitted business as opposed to surplus lines business, those companies that reinsure all of their business with an affiliate, and companies that write a relatively small amount of premium. The DPSL composite, however, does include companies that may be part of an intercompany pool, but still write surplus lines business predominantly on a direct basis and retain a substantial portion of this business.

Key Lines of Business

General liability business (coded as Other Liability for NAIC statutory reporting), which includes professional liability coverage, makes up the greatest percentage of both direct and net premium written by DPSL companies (**Exhibit 10**). The only other line of business accounting for a double-digit percentage of the total DPSL portfolio is property or fire business. In terms of the spread of premium among lines of business, the DPSL composite is very top-heavy, with more than 80% of its direct premium attributable to its five leading lines of business.

Composite Growth Slows, But Continues

For 2015, the DPSL composite generated growth in DPW of 2.2% (the smallest DPW growth rate of the last five years), compared to 3.4% for the composite in 2014. The limited growth can be attributed to noted competitive market conditions and sluggish growth in some industry sectors that impacted overall exposure bases. Net premium written levels grew by 4.2% in 2015, a more normalized result than in 2014.

In a turnaround from 2014, less favorable underwriting results captured within the DPSL composite moved close to those seen across the overall P/C industry at a combined ratio of 101.0% in 2015. By contrast, for 2014,

Exhibit 10

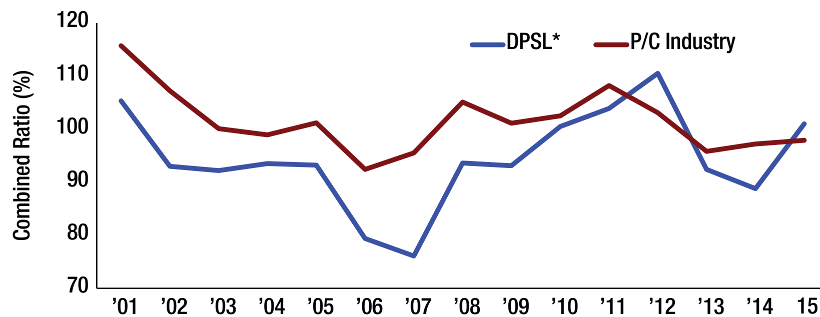
DPSL Peer Composite – Top 5 Product Lines (2015) by Direct Premiums Written (DPW)

($ Thousands)

Rank	Product Line	Surplus Lines DPW	DPSL Peer Composite Market Share (%)
1	Other Liability	8,028,443	47.2
2	Fire	1,827,512	10.7
3	Allied Lines	1,599,289	9.4
4	Inland Marine	1,149,899	6.8
5	Commercial Multi-Peril	1,100,241	8.0
Subtotal of Top 5		**13,705,384**	**82.1**
Total DPSL Peer Composite		**17,027,310**	**100.0**

Note: "Other Liability" consists primarily of commercial occurrence and claims made general liability policies.
Source: A.M. Best data and research

Exhibit 11
U.S. DPSL – Combined Ratios vs. U.S. P/C Industry (2015)



Source: A.M. Best data and research

the composite produced a combined ratio that was nearly ten points below the total U.S. P/C industry (**Exhibit 11**). This was consistent with the performance of the overall Surplus Lines industry, which we measured at a 101.5 % combined ratio. While out of alignment with the 2013 and 2014 results, ratios at or near this level have been reported for the surplus lines market in the past. Even though these carriers recorded elevated loss ratios in 2015 and suffered a net underwriting loss, net investment income remained stable and supported the overall generation of pretax and net income.

Operating Performance

On average, the DPSL composite over a five-year and, in particular, over a ten-year average has outpaced the U.S. P/C results in terms of underwriting and operating profitability. This is demonstrated by the composite's 99.3 and 93.9 five- and ten-year combined ratios compared to the P/C industry's 100.3 and 99.8 averages over that same time period. While the five-year averages here are relatively close, in many years, the DPSL has recorded combined ratios well below those produced by the broader P/C industry.

The main contributing factor to the elevated loss ratio was an increase in the DPSL's pure loss ratio, up to 54.9 on a net basis, partially related to the composite's lead general liability line (encompassing both occurrence and claims-made policies). The general liability line accounts for more than one-third of the composite's earned premium base. The composite's workers' compensation, inland marine, and commercial automobile liability lines of business also experienced higher pure net loss ratios in 2015. The total underwriting expense component of the combined ratio remained relatively stable, near the DPSL's long-term historical average.

Despite the effects of weather-related losses incurred in 2015, balance sheet strength of the DPSL composite carriers remained strong. The possibility for significant impact from weather-related losses on this market remains moderated by the line of business distribution, which remains significantly weighted toward liability exposures. The increase in the pure loss ratio in 2015 was partially attributed to increases in severity from a combination of larger losses and inflationary factors. On a net basis, the pure loss ratio for the DPSL in 2015 was in line with historical five- and ten-year averages, and continued to outperform the industry's 57.5 mark.

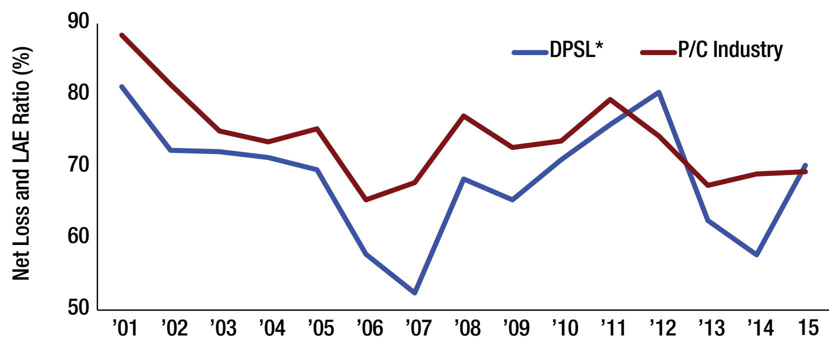
The loss-adjustment expense ratio for the DPSL composite was slightly elevated in 2015 as well, contributing to an overall net loss and loss adjustment expense (LAE) ratio of 70.2, up from 57.7 in 2014. Despite this sizable increase, the composite's result was in line with the total P/C industry's 69.3 net loss and LAE ratio (**Exhibit 12**). In terms of bottom line profitability, the DPSL composite continued to produce net income, although the amount of the net income decreased by half in 2015, after a moderate, 14.6%, drop in 2014. In addition to underwriting losses, net income was also negatively impacted by a large drop in realized capital gains in 2015.

A.M. Best is taking a closer look at direct loss ratios for the DPSL composite. With the expanding impact of pooling and reinsurance agreements on the surplus lines carriers,

net results have started to reflect performance that is not solely driven by traditional surplus lines business. For 2015, negating the impact of assumed business and focusing just on that business the DPSL companies compete for and write on their own accord, the direct loss ratio for the DPSL composite was 45.2, roughly ten points below its pure net loss ratio. Applying this loss ratio across the combined ratio calculation it would imply a combined ratio more directly tied to surplus lines business of around 91.0.

Exhibit 12

U.S. DPSL – Net Loss & Loss Adjustment Expense Ratios vs. U.S. P/C Industry (2015)



Source: A.M. Best data and research

Considerations When Analyzing Operating Profitability and Balance Sheet Strength

Some of the organizations competing in the surplus lines arena have deployed measures to achieve operational flexibility and balance sheet capacity. These measures include administration of policies through admitted and non-admitted carriers within the same organization, the use of risk-sharing tools such as internal reinsurance programs and pools, and the distribution of risks across U.S.-based and foreign-domiciled affiliates. The establishment of multiple carriers within an organization and the consolidation of their statutory reporting across the entire organization reflect their operational success. Nonetheless, the blurred statutory reporting lines between the carriers make it more difficult to examine results specific to the individual carriers.

Continuing in this manner, A.M. Best also considered the differences by line of business between direct premium written and net premium written. By this measurement, it can be seen how surplus lines carriers in certain organizations that pool or share risks via reinsurance cessions are carrying an increased risk load. For example, within the DPSL composite, workers' compensation direct premium is well below 1% of the composite's total direct premium, but on a net basis, it makes up 7% of net premium written.

Comparing the key financial indicators for both the DPSL and the total P/C industry, it becomes clearer that the increase in losses incurred for the DPSL composite was the key operating performance differentiator in comparing results with the total industry (**Exhibit 13**). While the P/C industry experienced a sizable drop in underwriting income, it did not suffer an underwriting loss as was the case for the DPSL composite. For both the composite and the P/C industry, growth in premium written and earned were modest, including the 7.0% increase in earned premium for DPSL companies and both experienced an equally modest increase in underwriting expenses. Overall, both experienced a drop in net income, year-over-year, although the decline was much greater, percentage-wise, for the DPSL composite.

Net Investment Income

One element of operating performance not impacted by any of the recently implemented risk-sharing programs is investment income. Returns on a company's asset base are not subject to allocation of insurance risk. A sizable and diverse invested asset base allows carriers in this segment of the industry to maintain and, in some cases, improve return metrics. Net investment income on a dollar basis increased to $1.9 billion, rising by about 5% from the prior

Exhibit 13
U.S. DPSL Composite – 12-month Financial Indicators (2014-2015)
($ Billions)

	DPSL Composite			Total U.S. P/C Industry		
	12 Months 2014	12 Months 2015	Year/Year % Change	12 Months 2014	12 Months 2015	Year/Year % Change
Net Premiums Written	12.1	12.6	4.1	507.9	524.6	3.3
Net Premiums Earned	11.5	12.3	7.0	499.2	516.4	3.4
Pure Losses Incurred	5.1	6.7	31.4	285.9	297.0	3.9
Loss Adjustment Expenses (LAE)	1.5	1.9	26.7	59.0	60.8	3.1
Losses & LAE	6.6	8.6	30.3	344.8	357.8	3.8
Underwriting Expenses	3.7	3.9	5.4	139.6	146.7	5.1
Policyholder Dividends	0.1	0.1	0.0	3.4	3.4	0.0
Underwriting Income (Loss)	1.2	-0.2	-119.5	11.4	8.5	-25.4
Net Investment Income	1.8	1.9	5.2	55.2	49.3	-10.7
Other Income/(Loss)	-0.1	-0.1	-44.4	-2.7	1.4	-151.9
Pretax Operating Income	2.9	1.6	-44.8	63.9	59.2	-7.4
Realized Capital Gains/(Losses)	0.9	0.2	-78.7	12.1	9.9	-18.3
Federal Income Taxes	-0.7	-0.3	-60.3	-10.3	-10.1	-1.9
Net Income	3.1	1.5	-51.6	65.7	58.9	-10.4

Note: Figures may not add due to rounding
Source: A.M. Best data and research

year (**Exhibit 14**). Looking at net investment income as a percentage of net premiums earned, the net investment ratio of 15.5 for 2015 was down modestly from the composite's five-year average of 19.5. Nonetheless, comparing both 2015 and the most recent five-year period, the composite's net investment ratio exceeded the total P/C industry averages by wide margins.

The composition of the invested asset allocations shifted slightly, which is believed to be nothing more than changes in values of equity investments. Similar to the rest of the industry, surplus lines companies are facing real challenges with investment returns. Interest rates remain stagnant, equity allocations have reached risk tolerance levels, and the appetite for alternative investments remains modest. Sizable unrealized losses during 2015 impacted total return measures. This factor was not specific to the DPSL or Surplus Lines companies in general, as large losses were experienced throughout the industry. The bottom line for our DPSL composite is that by total return measures, the 2015 results (ROR 6.6 and ROE 3.3) were well below long-term averages, as was the case for pretax return measures.

Exhibit 14
U.S. DPSL Composite – Investment Performance vs. P/C Industry
($ Millions)

	DPSL* 2014	DPSL* 2015	Year/Year Change (%)	Total P/C Industry 2014	Total P/C Industry 2015	Year/Year Change (%)
Net Investment Income	1,813	1,907	5.2	55,210	49,323	-10.7
Realized Capital Gains or (Losses)	873	186	-78.7	12,088	9,873	-18.3
Net Investment Gain	2,686	2,093	-22.1	67,298	59,196	-12.0
Unrealized Capital Gains or (Losses)	563	-716	-227.2	4,221	-21,208	-602.4
Total Investment Return	3,249	1,377	-57.6	71,519	37,988	-46.9

Source: A.M. Best data and research

Loss Reserve Development Trends

Favorable loss reserve development has been assisting the financial results of many insurance companies, although this varies by industry. There remains a level of concern throughout the industry that certain

lines of business, such as workers' compensation, may not have the level of redundancy that companies project. As A.M. Best has noted many times over the years in our impairment studies, inadequate reserves have been a leading cause of insurance company impairments. Companies and rating agencies must continually review and assess reserve levels and reserve development trends to ensure that adequate levels are maintained.

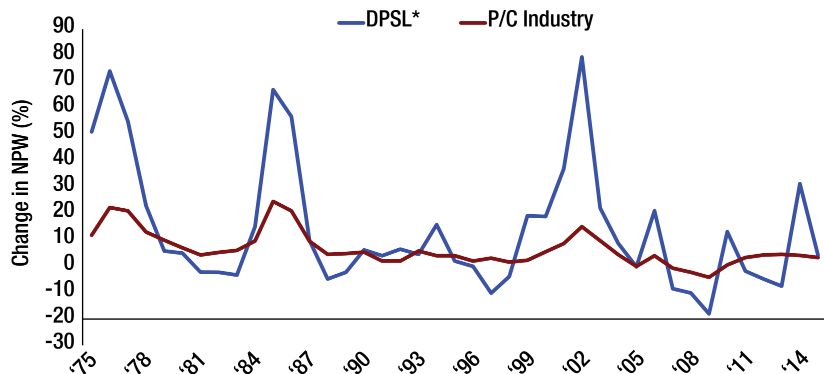
When reviewing the reserving trends for the DPSL composite, we continue to see a dissipating cushion with respect to where reserves were initially set and how they are developing. For both calendar year and accident year measures, the amount of favorable development has contracted and, in some years, already appears adverse. Overall, for calendar year 2015, A.M. Best estimates that reserve development accounted for 4.3 percentage points of the composite's aforementioned 101.0% combined ratio. Conversely, the total P/C industry recognized a 1.6 point benefit (lowering) of its overall 97.9% combined ratio stemming from favorable loss reserve development.

DPSL's Premium Growth Again Trailed That of the P/C Industry

While the net premium growth experienced in the DPSL composite over the last couple of years has been skewed by new pooling agreements between affiliates, direct premium was not affected by such arrangements and thus may serve as a better metric to determine the level of growth throughout the surplus lines sector. In 2015, the DPSL composite produced 2.2% growth in direct premium, which trailed the 3.7% growth for the total P/C industry. For both the composite and the P/C industry, direct premium has grown in each of the last five years, with the compound annual growth rates over those five years being very close: 4.4% for the DPSL composite, and 4.1% for the P/C industry. Growth in 2015 net premium written for the DPSL composite of 4.2% slightly outpaced the 3.3% growth for the P/C industry (**Exhibit 15**).

Exhibit 15

U.S. DPSL Composite vs. P/C Industry – NPW Growth (1978-2015)



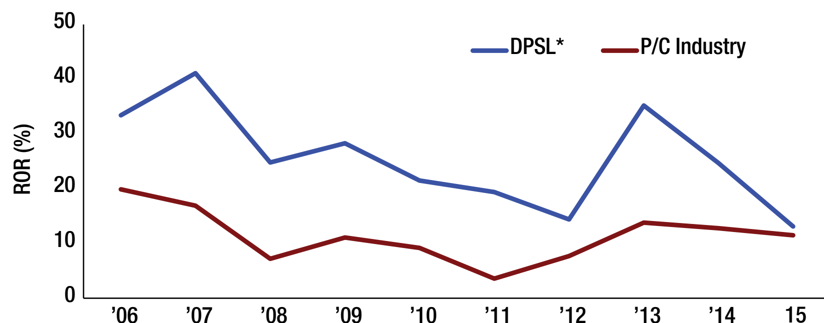
Source: A.M. Best data and research

Balance Sheet Strength

Strong balance sheet positions remain prominent for the Surplus Lines market. Despite underwriting losses and reduced levels of investment income, the DPSL composite's policyholders' surplus position was effectively unchanged from 2014 to 2015, remaining at $24.0 billion. Although earnings were down in 2015, the composite still generated a pretax return on revenue that exceeded the total P/C industry return, which has consistently been the case for the past decade (**Exhibit 16**). Over the same time frame, total

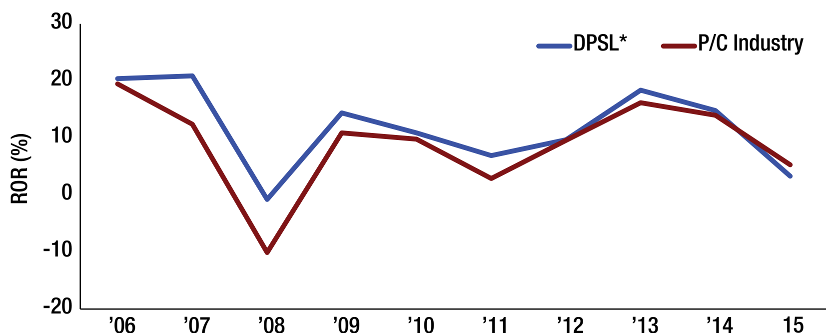
Exhibit 16

U.S. DPSL – Pretax Returns on Net Premiums Earned (NPE) vs. U.S. P/C Industry (2015)



Source: A.M. Best data and research

Exhibit 17
U.S. DPSL – Total Returns on Surplus vs. P/C Industry



Source: A.M. Best data and research

return on equity (surplus) has been lower in magnitude and dropped below the overall industry in 2015 (**Exhibit 17**).

While the composite continues to maintain supportive policyholders' surplus levels, stockholder dividends have been significant, totaling approximately $12.9 billion over the past five years. The composite actively manages dividends and adjusts payments based on overall profitability (**Exhibit 18**). For example, in 2015, the composite's approximately $1.9 billion in stockholder dividends were almost half the total dividends paid in 2014, which was in line with net income of about $1.5 billion being half of the 2014 total of $3.1 billion.

Underwriting leverage ratios continue to remain generally lower for the DPSL composite than the total P/C industry. Ceded leverage remains the exception, running higher for the DPSL composite at 0.8 times policyholders' surplus compared to the P/C industry at 0.5. The difference appears to remain within a range of tolerance in the surplus lines industry, as gross leverage at 2.9 remains comparable to the P/C industry. Judicious use of reinsurance to mitigate exposures is a sign of prudent capital management. Disciplined expansion of reinsurance coverage can be expected, taking into account the current reinsurance market conditions, where extended coverage provisions are being offered and rates appear soft.

The health of a consolidated DPSL balance sheet can also be assessed through the quality of the invested asset base. Bonds at the highest rating levels – U.S. government and NAIC class 1 and 2 – comprised just over 95% of the total bond holdings, in line with the quality of holdings for the total P/C industry.

Exhibit 18
U.S. DPSL Composite – 12-month Change in Policyholders' Surplus (2014-2015)
($ Billions)

	DPSL Composite			Total U.S. P/C Industry		
	12 Months 2014	12 Months 2015	Year/Year % Change	12 Months 2014	12 Months 2015	Year/Year % Change
Beginning Policyholders' Surplus (PHS) at Prior Year End	24.4	24.0	-1.6	682.4	705.7	3.4
Net Income	3.1	1.5	-51.6	65.7	58.9	-10.4
Unrealized Capital Gains/(Losses)	0.6	-0.7	-227.2	4.2	-21.2	-604.8
Contributed Capital	-0.2	1.1	-766.3	-3.0	10.7	-456.7
Stockholder Dividends	-3.4	-1.9	-44.1	-33.7	-38.6	14.5
Other Changes	-0.4	0.0	-94.6	-9.9	-9.3	-6.1
Ending Policyholders' Surplus	24.0	24.0	0.0	705.7	706.0	0.0
Change in PHS from Prior Year End ($)	-0.4	0.0	-100.0	23.3	0.3	-98.5
After Tax Return on Surplus (ROE) (%)	12.8	6.3	-50.8	9.5	8.3	-12.6

Note: Figures may not add due to rounding.
Source: A.M. Best data and research

Ratings Distribution

As shown in **Exhibit 19**, DPSL insurers continue to maintain a higher proportion of issuer credit ratings in the "Exceptional," "Superior," "Excellent," and "Good" categories than the overall P/C industry. As of August 15, 2016, 100% of the A.M. Best-rated DPSL rating units held ratings in these categories, compared to 92.1% for the total P/C industry.

The percentage of DPSL insurers in the top-tier rating categories, Excellent to Exceptional, relative to all rating opinions remained extremely high at almost 97% (86 out of 89 rating units in the top tier). The decline in the number of rating units over the past couple of years, from 98 in 2012 and 91 in 2014, is primarily due to intragroup consolidations and merger and acquisition activity in the surplus lines market space. In some cases, the utilization of new quota-share reinsurance or reinsurance pooling agreements has resulted in multiple rating units merging into single rating units. In the years before 2012, the number of rating units had grown through the influx of smaller, start-up companies and the impact of some companies becoming single, affiliated rating units and no longer maintaining their status as part of group rating units as defined by A.M. Best.

Exhibit 19

U.S. Domestic Professional Surplus Lines – Best's Rating Distribution by Rating Unit

vs P/C Industry

		DPSL		Total P/C Industry	
Category	**Rating Level**	**Rating Units**	**%**	**Rating Units**	**%**
Exceptional	aaa	1	1.1	3.0	0.4
Sub-Total		**1**	**1.1**	**3.0**	**0.4**
	aa+	8	9.0	14.0	1.8
Superior	aa	4	4.5	17.0	2.2
	aa-	16	18.0	44.0	5.7
Sub-Total		**28**	**31.5**	**75.0**	**9.7**
	a+	12	13.5	86.0	11.2
Excellent	a	28	31.5	174.0	22.6
	a-	17	19.1	245.0	31.8
Sub-Total		**57**	**64.0**	**505.0**	**65.5**
	bbb+	2	2.2	37.0	4.8
Good	bbb	1	1.1	43.0	5.6
	bbb-	0	0.0	47.0	6.1
Sub-Total		**3**	**3.4**	**127.0**	**16.5**
		89	100.0	710.0	92.1
Fair	bb+, bb, bb-	0	0.0	32	4.2
Marginal	b+, b, b-	0	0.0	5	0.6
Weak/Very Weak	ccc+, ccc, ccc-, cc	0	0.0	2	0.3
Poor	c	0	0.0	1	0.1
Reg. Supervision/ Liquidation	e/f	0	0.0	21	2.7
		0	0.0	61	7.9
Total Issuer Credit Ratings		**89**	**100.0**	**771**	**100.0**

Domestic Professional Surplus Lines ratings are as of August 15, 2016
Total industry ratings distribution data is as of June 30, 2016
Source: A.M. Best data and research

For the total P/C industry, the number of rating units in the Excellent to Exceptional rating categories has remained fairly stable over the past year, with 75.6% of the ratings in the top tier, compared with 74.3% through the middle of 2015. In concert with these statistics, DPSL companies continue to enjoy a higher rating median of "a", compared with "a-" for the overall P/C industry.

Section III: Regulation and Legislation

As we move into autumn, current and recent events serve as a reminder of the important role surplus lines insurers can play in developing solutions for new risks and improving coverage for known risks. The race for the Presidency, which will culminate on Election Day, November 8th, has featured widely contrasting views on domestic terrorism threats, the economy, and a host of other areas. The devastating August 2016 flooding in Louisiana also serves as a reminder of the important role surplus lines insurers play in solving flood insurance challenges. These events influence the work of state insurance regulators and Congress, which has direct impact on the surplus lines industry.

The End of NIMA

The Nonadmitted and Reinsurance Reform Act (NRRA) was enacted in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The surplus lines reform provisions took effect in July 2011. The goal of the NRRA was to simplify regulation and taxation of the surplus lines industry. To achieve this, the "home state" of the insured would be the one and only jurisdiction with authority to regulate and tax surplus lines transactions.

On May 2, 2016, the Nonadmitted Insurance Multistate Agreement (NIMA) was dissolved after its two largest members, Florida and Louisiana, withdrew from the tax-sharing system. NIMA's wind down plan anticipates conclusion of the agreement by December 2017. The dissolution is effective October 1, 2016 and includes a 12 month run-off period, ending September 30, 2017 to allow endorsements on policies effective prior to October 1, 2016 to be filed through the Surplus Lines Clearinghouse (SLC). No new multistate renewal or reinstatement transactions effective on or after October 1, 2016 will be accepted through the SLC multistate reporting platform. On or after October 1, transactions for South Dakota and Wyoming insureds will continue to be reported through the SLC single state reporting platform in the Surplus Lines Information Portal (SLIP), while transactions for Puerto Rico and Utah will be reported directly to Puerto Rico's Commissioner of Insurance and Utah's Surplus Lines Association, respectively. Further guidance can be found in the Clearinghouse's June 30, 2016 bulletin.

As a result of the dissolution of NIMA, 45 states plus the District of Columbia now calculate surplus lines taxes on 100% of the premium at the home state's tax rate, in accordance with the NRRA. Multistate allocations of risk still take place in Florida, Hawaii, Massachusetts, New Hampshire, and Vermont.

Congressional Action on Private Flood Insurance

In 2005, as a result of Hurricane Katrina and, to a lesser extent, Hurricanes Rita and Wilma, a record nearly $18 billion in loss dollars were paid through the National Flood Insurance Program (NFIP). Seven years later, Hurricane/Superstorm Sandy pummeled the Mid-Atlantic States, resulting in over $9 billion in loss dollars paid. These events were significant contributors to the NFIP's approximate debt of $23.0 billion as of mid-year 2016 and facilitated Congressional action on legislation to promote and develop private market solutions for flood insurance.

The Louisiana flooding that started in August 2016, even as emergency personnel in the western United States were battling wildfires caused by dry conditions, serves as a stark reminder of Katrina and how devastating excessive rainfall can be, particularly in low-lying areas. Anywhere from 1-foot to 2 ½-feet of rain fell in parts of Louisiana in less than a week in mid-August. Even as water receded in some parts of the state, it was still rising in other parts that flowed downstream toward the Gulf of Mexico. Initial estimates reported at least 11 people were killed; 30,000 people were rescued; and 40,000 homes were affected. This

serves as another reminder of the NFIP's growing debt and U.S. taxpayers' exposure to the significant financial impact of devastating flood events.

On April 28, 2016, the U.S. House of Representatives unanimously passed the Flood Insurance Market Parity and Modernization Act, HR 2901, by a vote of 419-0. An identical bill was previously introduced in the Senate (S. 1679) on June 25, 2015. The House-passed bill was received by the Senate and referred to the Senate's Committee on Banking, Housing, and Urban Affairs on May 9, 2016. The Senate's Committee on Small Business and Entrepreneurship conducted a hearing on private flood insurance and the NFIP on June 30, 2016.

While it appears that there is widespread support for the legislation, the election season is in full swing and time for action by the 114th Congress is running out. If no action is taken before the 115th Congress convenes on January 3, 2017, then the legislation would have to be reintroduced. If passage of the bill were to take place, it is likely that it would be during the "lame duck" period stretching from November 9th (the day after Election Day) to the end of the year.

One of the principal aims of HR 2901 is to clarify to lenders that private market flood insurance solutions, such as those found in surplus lines policies, would be considered acceptable for satisfying mandatory purchase requirements for both personal and commercial mortgages, while providing consumers with choices. This uncertainty was created when the Biggert-Walters Reform Act became law in 2012.

The Federal Emergency Management Agency (FEMA), which administers the NFIP, received significant negative publicity for its handling of claims after Katrina and Sandy. Many members of Congress, lenders, and the insurance industry believe that opening the flood insurance marketplace to private insurance options will better protect those in flood-prone areas, will reduce the burden on taxpayers not in those locations, and will satisfy requirements of mortgage lenders.

The NFIP was created in 1968 to make flood insurance more readily available to property owners in flood-prone areas and to reduce the costs associated with taxpayer-funded relief efforts. Since that time, it has served as the primary market for flood insurance coverage. HR 2901 would eliminate any uncertainty regarding the acceptance of the flood solutions currently offered by surplus lines insurers, and may create a unique opportunity for the industry to develop innovative flood insurance coverages should the flood insurance market become more open to the private market. For 2017, reauthorization of the NFIP looms on the legislative horizon.

TRIPRA Background

On January 12, 2015, President Obama signed the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) into law. The program had expired on December 31, 2014. Enactment not only reinstated the expired program, but extended it until December 31, 2020. Before September 11, 2001, losses incurred as a result of terrorist attacks typically were covered by general insurance policies. As the cost became prohibitive in the aftermath of the attacks, the passage of the Terrorism Risk Insurance Act of 2002 created a government reinsurance backstop to encourage commercial insurers to offer terrorism coverage.

2016 Reporting Requirement Under TRIPRA

The Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA) requires the Secretary of the Treasury to submit a report to Congress on the effectiveness of the program. In response to this requirement, the Federal Insurance Office (FIO) issued a voluntary call in

March 2016 asking participating insurers to submit the following information starting with calendar year 2016:

- Lines of insurance with exposure to terrorism-related losses,
- Premiums earned on such coverage,
- Locations of exposures,
- Pricing of coverage,
- Take-up rate of coverage,
- Amount of private reinsurance for acts of terrorism purchased, and
- Any other matters the Treasury Secretary considers appropriate.

Starting in 2017, responses to this terrorism data call will be mandatory. In July 2016, the National Association of Insurance Commissioners (NAIC) also issued a call for terrorism-related data through the New York Department of Financial Services as the lead state, joined by all remaining states and the District of Columbia.

In June 2016, the FIO issued its initial Report on the Overall Effectiveness of the Terrorism Risk Insurance Program (TRIP). While the data that was collected was limited due to both time constraints and the voluntary nature of the data collection, the FIO opined that TRIP ensures that affordable comprehensive terrorism risk coverage is available, noting that there is no indication that coverage would be more available in the absence of TRIP.

While there has not been another attack on the scale of September 11, 2001, in which nearly 3,000 individuals lost their lives and thousands more suffered injuries to varying degrees, terrorist attacks the last few years in Boston, San Bernardino, Paris, Nice, and Brussels remind us that there still is significant and uncertain risk to manage.

NARAB II Update

While the main focus of TRIPRA is terrorism, the law's passage also created the National Association of Registered Agents and Brokers (NARAB II). The insurance industry had been lobbying for many years for the creation of NARAB in an effort to streamline the licensing process for agents and brokers throughout the U.S, with an eye toward eliminating burdensome multistate requirements but still preserving state regulatory authority and consumer protection with respect to nonresident licensing.

NARAB in effect is a new federal agency that is set to become operational once its Board of Directors is in place. The 13-member Board is nominated by the President and subject to confirmation by the Senate. The Board will be comprised of eight state regulators plus five industry members, of which three will represent the property and casualty segment. To date, President Obama has nominated the following 10 individuals to serve as inaugural members of NARAB's Board:

- Susan Castaneda, AVP and Compliance Officer, The Hartford
- Raymond Farmer, Commissioner, South Carolina Insurance Department
- John Huff, Director, Missouri Department of Insurance
- Thomas McLeary, President, Endow Insurance Brokerage
- Marguerite Salazar, Commissioner, Colorado Division of Insurance
- Robert Suglia, Senior Vice President & General Counsel, Amica
- Angela Ripley, President, V.W. Brown Insurance Services
- Michael Rothman, Commissioner, Minnesota Department of Commerce
- Heather Steinmiller, Senior Vice President, Conner Strong &Buckelew
- Lori Wing-Heier, Director, Alaska Division of Insurance

The three remaining board members to be nominated will be Commissioners, or possibly former Commissioners. Once approved, these ten nominees would constitute a quorum, thereby enabling NARAB to start fulfilling its mission. NARAB will be based in Washington, DC as a nonprofit corporation and regulatory agency with authority to issue multistate licenses to agents and brokers. After becoming licensed in one's home state, agents and brokers can obtain a nationwide license by becoming "members" of NARAB.

One key reason that some have advocated so strongly for passage of the NARAB legislation is that it aims to strike the right balance between simplifying multistate licensing and preserving state regulatory authority and consumer protection. This will in turn allow surplus lines insurers to focus more time on meeting the needs of their clients than on burdensome, non-standard regulatory requirements.

Selected State Legislative & Regulatory Highlights

- **Alaska** – HB 372 eliminates fees required for being included on the state's eligible surplus lines insurer list; previously only applicable to alien insurers, it awaits the governor's signature.

- **Arizona** – HB 2149 took effect on August 6, 2016, with Arizona becoming the tenth state to allow domestic surplus lines insurers.

- **Arkansas** – The Arkansas Insurance Department issued Bulletin #14-2015 in October 2015, which clarified that "inspection fees" may be included as an "expense of underwriting" and, in relation, are not subject to the 20% aggregate fee limit associated with solicitation, negotiation, or servicing expenses. However, the Department further ruled that fees customarily associated with the solicitation, negotiation, or servicing of a surplus line policy are subject to the 20% aggregate limit contained in Ark. Code Ann. 23-66-310(c)(2).

- **Delaware** – Effective September 2015, the Delaware requirement that evidence of diligent effort must be provided on a notarized affidavit has been amended such that evidence will now be provided on a written statement to be retained by the producer or surplus lines broker. This change was made by 2015 Delaware House Bill 40, the details of which are outlined in Delaware Department of Insurance Surplus Lines Bulletin NO. 18.

- **Florida** – HB 651 eliminated effective July 1, 2016, the requirement that surplus lines brokers submit an affidavit to the Florida Surplus Lines Service Office even in quarters in which they did not transact business.

- **Kentucky** – SB 58, which took effect July 15, 2016, authorizes the use of an automobile guaranty "reimbursement insurance policy" that may be exported to a nonadmitted insurer by a licensed surplus lines broker. In April 2016, the Kentucky Department of Insurance issued Bulletin 2016-01, which outlines special instructions for local premium tax payments for surplus lines business. The bulletin states that surplus lines brokers are not required to submit Forms LGT-141 and LGT-140 to each local government for each insurance company through which insurance business was exported.

- **Louisiana** – HB 935, which takes effect January 1, 2017, requires all insurers, including surplus lines insurers, to provide notice to policyholders of changes that reduce coverages at renewal. HB 1133 took effect on August 1, 2016, granting new authority for the state fire marshal pertaining to enforcement and rulemaking authority related to amusement rides. The bill stipulates that after a hearing to determine availability in the admitted market, the fire marshal may determine that required insurance may be provided by surplus lines insurers.

- **Maryland** – HB 60, which becomes effective January 1, 2017, will amend the surplus line agent licensing process to allow for electronic renewal of a license. Certificates of qualification for brokers will expire on the last day of the birth month of the licensee rather than on June 30 of the second year.

- **Michigan** – The state's Department of Insurance and Financial Services released a bulletin clarifying the role of retail agents in surplus lines transactions. In short, while a surplus lines license is required for surplus lines transactions, the retail agent doesn't have to be the one holding the license.

- **Nebraska** – LB 837 eliminatesthe requirement to tax multistate risks at other states' rates. Effective January 1, 2017, all surplus lines premium where Nebraska is the home state of the insured shall be taxed 100% at Nebraska's rate of 3%. Although Nebraska did not participate in NIMA when it became operational, because it ultimately withdrew shortly after joining, it was one of five states that continued to tax multistate risks at multiple states' rates, even though they retained 100% of the tax. This legislation also clarifies that taxes are only due on risks located within the U.S., and it revises the tax filing and payment dates to the first day of March, June, September, and December.

- **North Carolina** – On November 18, 2015, the North Carolina Surplus Lines Association formally announced that North Carolina House Bill 262 authorized the creation of a North Carolina Stamping Office, making it the fifteenth stamping office in the nation. The announcement included a timeline for Stamping Office Implementation, but clarified that current licensing and filing requirements will remain in effect, utilizing the existing Department of Insurance system until the Stamping Office System is available for use.

- **Ohio** – 2015 HB 64, which took effect September 30, 2015, revises the Ohio affidavit requirement to only require a signed statement and explicitly states that notarization is not required.

- **Rhode Island** – HB 7842 permits surplus lines insurers to write private flood insurance without a due diligence affidavit, effective July 1, 2016. SB 2864 regulates transportation network companies (TNCs), effective November 3, 2016.

- **South Carolina** – HB 4660 became effective March 2, 2016, and allows surplus lines brokers to act as a limited lines or special producer without being required to be appointed by the surplus lines insurer.

- **Update on Transportation Network Companies (TNC) Legislation** – To date, no states have adopted legislation that would prohibit a surplus lines insurer from insuring TNCs, such as Uber and Lyft. Only 10 states have yet to pass legislation related to TNCs, including Connecticut, Florida, Hawaii, Pennsylvania, Michigan, New Jersey, New York, Oregon, Vermont, and Wyoming. All of these ten states, except for Oregon and Wyoming, have either considered legislation that failed or have pending legislation at the time of this report.

Section IV – Current Distribution Trends

Surplus lines coverage solutions emerge when the standard market cannot provide needed coverage. For these higher hazard exposures, and for new exposures that arise, the surplus lines market often provides the best, or sometimes the only, option for retail producers and insureds seeking coverage. The surplus lines sector has developed specialized coverages to address exposures associated with emerging technologies, such as cyber-liability, robotics, and unmanned aerial systems. Sharing services such as Uber and driverless cars are among the list of newly emerging risks as well. Only a few years ago, many of these exposures were not on anyone's radar screen; however, in 2016, they are prominent in the minds of insurance professionals. In fact, retail agents are turning to the surplus lines market for coverage solutions they cannot get in the standard market. This shift has helped the market transition from solely being considered as a market for distressed risks to one on the cutting edge.

Opportunities

With new technologies come new risks, which present an opportunity for surplus lines intermediaries and insurers to develop coverage solutions for those who are looking to protect themselves against these risks. An example of a unique exposure of technology presenting new liability risks is the increasing usage of small unmanned aerial vehicles, or drones. Drone manufacturers, programmers, and operators all require insurance protection for their distinct exposures that could lead to litigation. The number of usages for drones is extremely high and still growing, and includes, but is not limited to: insurers along with engineering and/or surveying firms using unmanned aircraft for property inspections; government entities using drones to aid search and rescue missions, and in catastrophe response efforts; a rising number of delivery companies finding ways to utilize drones to make the delivery of their products more efficient; and law enforcement organizations using drones to obtain detailed photographs of terrain, homes, and people.

The major concerns and risks posed by the use of commercial drones include population safety, property damage, and both security and privacy concerns. Legal challenges and potential claims are expected to rise from burgeoning usages of unmanned aircrafts, especially since U.S. airspace is already considered crowded. Drones that record personal information also present their operators with potential exposure to new litigation stemming from privacy concerns. Surplus lines insurers can further contribute to the resolution of issues related to drones by working with intermediaries to evaluate the risks and offering specialized coverage solutions for insureds that have implemented or are considering employing drone technology in their businesses. This market has room for significant expansion.

Cyber-threats are a growing loss exposure as well and cyber-crime has grown rapidly. Data security breaches and related litigation garnered a substantial number of headlines in 2015 with this trend continuing in 2016. Through the utilization of mobile devices, increasing amounts of information are available every minute of every day. This includes personal information, medical data, store purchases, bank account information, and other confidential material, all of which are enticing targets for cyber-criminals. Increased instances of personal data being compromised provide evidence that the Internet is less safe and drives up the cost of doing business. Many companies that previously chose not to purchase cyber-risk insurance are having second thoughts and are now weighing its importance. Through the end of 2015, estimates received from several intermediaries suggested that roughly only half of large enterprises carried cyber-risk coverage, despite the growing frequency and scale of cyber-attacks.

With the end of 2016 on the horizon, cybersecurity threats show no signs of abating; if anything, the opposite is true and, as a result globally, governments are instituting more

regulation. Companies are being required to provide greater protection for online assets in addition to facing requirements for storage of data on local servers. The need for enhanced protection against cyber-threats continues to be an area of focus for companies and governments, resulting in significant opportunities that likely can best be met by the tailored coverages developed by surplus lines insurers. Considering the rapidly changing nature and scope of cyber-exposures juxtaposed with the state form filing process that admitted insurers are encumbered with, surplus lines insurers can step up and serve the market by meeting the needs of insureds where standard coverage is insufficient or nonexistent.

The service and manufacturing industries have benefited from increased automation provided by robotics for more than forty years. As industries become more deeply interconnected because of the demands and realities of the global marketplace, the nature of robotics utilization continues to evolve. However, the increased proliferation of robotics brings as many new risks as benefits, which heightens the need for control over robotic creations. There are presently many different types of robots in commercial and private use.

Industrial robots are programmed to carry out a series of repetitive tasks and thus are designed to have limited mobility or autonomy. Other than careless operation or accidental obstruction, property damage or injury to persons caused by these robots is quite rare. Domestic or service robots used to carry out household tasks such as vacuuming or mowing the lawn are not plentiful in use, but over the near-to-medium term such devices could move from luxury gadget to affordable amenity.

Applications for robot usage in the health care, hospitality, security, and defense fields are expected to grow over the next couple of decades, with significant enough growth expected over the near term that necessitates more attention from the insurance industry. From an insurance perspective, human or operator error is a high risk associated with robotics usage. Identifying the root of liability in the event of accidents involving robots as private, household usage increases will be very complex. Considering the unique, higher hazard nature of these burgeoning exposures, developing a better understanding of the risks at hand by insurance intermediaries will likely be integral in working with surplus lines insurers to develop effective, tailored coverage solutions that standard market carriers cannot provide.

Current Challenges

Feedback that A.M. Best received from surplus lines intermediaries revealed that primary concerns in 2016 are many and varied. Among the chief concerns noted with the greatest frequency were:

- The ability to enhance operations through effective diversification;
- Leveraging improved automation in partnerships with insurers;
- Addressing the aging workforce;
- Consolidation; and
- Competitive market pricing.

Diversifying product offerings and operating territories in the current, competitive marketplace has become more of a critical issue for both surplus lines insurers and wholesale intermediaries. Insurance market cyclicality appears to be changing in terms of the nature and length of traditional ebbs and flows reflecting hard and soft market conditions compared to what has been experienced historically. Providing a broad array of products, and being able to reach the territories and states where those products are in demand, can be critical components for companies to have the fluidity to thrive in the current competitive environment. This is especially important for companies to be able to capitalize on growth opportunities as the market continues to look to surplus lines insurers for innovative solutions.

Growth in the Importance of Data Analytics

Data analytics continues to have a deep impact on the insurance industry, including the surplus lines market. By nature, the P/C industry has been heavily data-driven and dependent on solid data to shape underwriting and pricing decisions. The enhancement of data analytics capabilities has provided greater insight for decision-makers to determine target markets and products, develop more efficient underwriting processes, and analyze overall performance. Insurers and intermediaries have invested tremendously in this area in recent years to better serve both broker/agency partners and insured clients. This trend is only expected to continue since the overall belief appears to be that such investments are creating tremendous value for surplus lines organizations and will be necessary for them to thrive in the future.

Technology

The importance of effectively using technology includes not only utilizing “big data” to augment operations, but for the most successful surplus lines insurers, it also includes understanding the technology needs of their brokers and agents to see where gaps can be filled. This allows for better strategies to be built incorporating technological enhancements to improve underwriting tools, claim reporting and processing, and risk management efforts. Another major benefit of effective technology is that when well-implemented, it makes it easier for producers to focus on their main goals. Ideally, small businesses benefit from new technology by simplifying tasks while larger companies benefit from greater efficiency. Technology also allows for greater mining of data.

For the future success of surplus lines insurers, it cannot be overstated that as technology changes, they need to be able to keep pace. Insured clients will undoubtedly be using even more advanced technologies in the years ahead. Brokers, agents, and other intermediaries, along with insurers, need to be knowledgeable enough to understand client needs before helping develop risk management or coverage solutions. Employees will have to be trained on how to use the new tools that become available. Depending on the priorities of the insurer, there could be a significant learning curve involved in becoming expert at using new tools and technologies effectively. Such strategies can be difference makers for insurance companies and their broker/agency partners in building long-term relationships as company product inventories expand to address emerging markets and product needs.

Bridging the Talent Gap

Insurance executives have increasingly cited an aging workforce and a lack of new talent as one of their top concerns for the future of the industry. In coming years, the industry will face a major demographic challenge expected to cross disciplines, including critical underwriting, claim, and actuarial functions. Increasing demand and changing technology requirements is also making it difficult to recruit younger employees to fill information technology (IT) positions.

Another prevalent issue is centered on the belief that many of the experienced workers in the field today do not have the skills regarding data and technology to meet the changing needs that will become more prevalent in the coming years. The evolution of big data usage and analytics requires specific skills to capably interpret, analyze, and manipulate data. For insurance intermediaries and insurers to attract the best, brightest, and most technologically savvy young minds, concerted efforts need to be made to detail the opportunities that exist in the industry. Industry organizations such as NAPSLO and the American Association of Managing General Agents (AAMGA) have devoted resources to professionals under age forty to develop not only understanding of and interest in career opportunities in the surplus lines market but to also pave the way for the next generation of leaders.

Consolidation

The general feeling conveyed to A.M. Best by the intermediaries that shared their perspectives is that consolidation of both surplus lines carriers and brokerages will remain prevalent. However, the impact is still expected to be limited from an overall market perspective, although the impact could still be great in individual market segments or regions, depending on the merger and acquisition activity. From a carrier perspective, it is felt that further M&A activity will impact risk appetite and capacity, leading to greater competitiveness. Among surplus lines intermediaries, there is some concern that consolidation will adversely impact existing relationships and response time. There is also concern that fewer available alternatives could lead to quality giving way to price in the decision-making process. Finally, given the challenging rate environment shaped by ample market capacity, one of the only ways carriers may be able to grow and increase shareholder value is through greater risk-bearing. The trend toward higher retentions among primary insurers, including surplus lines companies, has been noted over the past couple of years.

Business Trends

Reports from surplus lines intermediaries provide some mixed signals in the surplus lines market concerning growth, especially with many market participants reporting modest reductions in per account premium due to competition-driven rate/price decreases, and lower exposures in some cases. Several reports indicate that some of the larger, national surplus lines writers are entering new spaces as their appetites expand, and growth they may experience is coming at the expense of other carriers. The carriers that are first to market with newer, innovative products to address emerging issues are among those reporting pockets of growth that are driving top-line premium expansion. Surplus lines intermediaries also report feeling the squeeze from standard lines insurers writing more business that was formerly written mainly in the surplus lines market. These market participants, and others, see flat growth prospects over the near-term that they expect will remain as such, absent a major catastrophe.

Investment in New Products

The development of new products and programs remains important to surplus lines intermediaries. One of the hallmarks of the surplus lines insurance market is the development of new insurance solutions to address new or emerging risks, or to provide improved coverage for known risks. Deploying capital to leverage unique growth opportunities leads to the proliferation of new products and programs being developed and launched. Many surplus lines intermediaries state the development of new products is a major component of their overall strategy for 2016 and beyond. Conversely, some surplus lines intermediaries place greater value on the importance of investing in core products while expanding into other areas in deliberate, circumspect fashion, as opportunities arise.

The reform of the National Flood Insurance Program could present opportunities for surplus lines insurers to fashion coverage solutions. The legislative reforms that are part of the Flood Insurance Market Parity and Modernization Act of 2015 are aimed in large part at making it more viable for private flood insurance solutions to be developed for those in need of coverage. The surplus lines market has provided a supplement to the coverage available via the National Flood Insurance Program for years; however, the Biggert-Waters Reform Act of 2012 unintentionally used terminology that caused a great deal of uncertainty among lenders regarding the ability to accept policies written by private insurers, including surplus lines insurers. While surplus lines insurers currently provide coverage for a small portion of this market, if the issues are cleared up concerning the acceptance of private flood insurance, there could be at least a short-term opportunity for the surplus lines market to be more involved in providing flood insurance. Considering the areas of the country that have been affected by floods this year, most recently in Louisiana where the flood damage is the worst the state has seen since Hurricane Katrina, the opportunity may be greater than initially anticipated.

Production Sources

During the second quarter of the year, A.M. Best contacted company representatives to gain insight into the production sources used most prevalently to generate surplus lines premium. While just over half of the companies responded to the survey, the premium that was accounted for was about 30% of the total surplus lines premium, due in large part to data not being received from many of the global or national insurance groups that write surplus lines business. The issue that officials of some of these groups communicated was that they do not track premium data or related production source data strictly in line with premiums produced by their subsidiary insurance companies solely for nonadmitted or surplus lines business. These groups reported that they collect premium data written by their various companies on an overall basis, or in some cases on a group basis, and not split between premiums written by company on a nonadmitted basis and on an admitted basis.

In any event, for the data that was collected, results for 2014 and 2015 were very similar (**Exhibit 20**). Wholesalers and agents **without** binding authority was clearly the primary distribution channel used by surplus line insurers, accounting for approximately 60% or more of total surplus lines premium in both years. In both years, wholesalers/agents **with** binding authority accounted for a little more than 24% of surplus lines premium produced in each year. Program managers, also a valuable source for niche surplus lines business, accounted for approximately 9% of premium generated in each year, while retail agents and brokers accounted for less than 5%. Without question, the wholesale brokerage distribution channel remains the engine that directs the majority of surplus lines clients to the companies that can provide the needed, tailored coverage solutions.

Exhibit 20
U.S. Surplus Lines: Leading Production Sources by Direct Premiums Written (DPW)

Production Source	2014 Percent (%) of Total	2015 Percent (%) of Total
Wholesale Agent/Broker Without Binding Authority	62.0	59.4
Wholesale Agent/Broker With Binding Authority	24.1	24.8
Program Manager - Retail or Wholesale Agent/Broker	8.5	9.2
Retail Agent/Broker	2.9	3.9
Direct Procurement	0.1	0.1
Other	2.4	2.6
Total	100.0	100.0

Source: 2015 A.M. Best Surplus Lines Distribution Survey

Section V – Impairment Trends

Continuing a recent trend that began in 2012, financial impairments in the U.S. admitted P/C industry declined in 2015, reaching the lowest levels since 2007, with 10 impairments recorded during the year. Since a total of 35 impairments were recorded in 2011, the impairment count in the succeeding years dropped from 25 to 15 to 12 to 10 in 2015. A significant highlight within the 2015 impairment activity was that for the 12th consecutive year, the surplus lines industry recorded no financial impairments. In July of 2016, however, Castlepoint National Insurance Company was placed into conservatorship, ending the favorable trend for surplus lines impairments.

First Surplus Lines Impairment in 12 Years

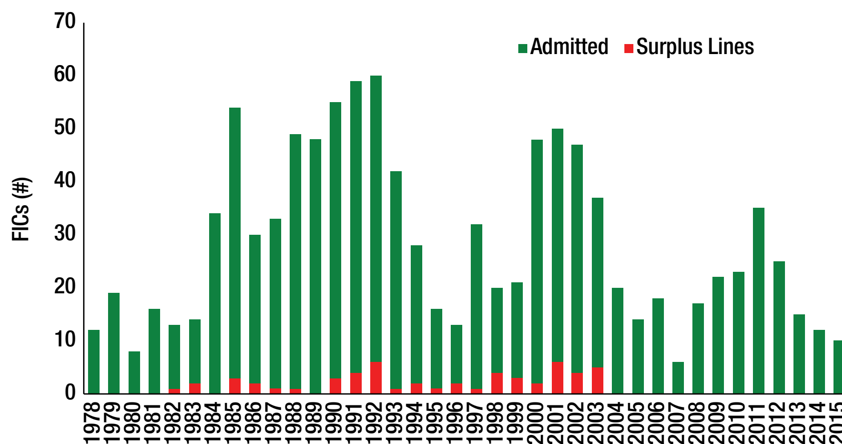
Following 12 consecutive years without a recorded impairment for a surplus lines company, on July 28, 2016, the California Insurance Commissioner was appointed by the San Francisco Superior Court as the statutory conservator of surplus lines insurer Castlepoint National Insurance Company (Castlepoint), the sole remaining member carrier of the Tower Group. Castlepoint consists of ten Tower Group companies that were merged prior to Conservation. The Conservation Order authorizes and empowers the Commissioner to conserve Castlepoint and its assets for the benefit of the company's claimants, creditors, and shareholders as provided in the California Insurance Code. Immediately following being appointed conservator, the Commissioner filed a motion seeking approval of a conservation and liquidation plan for Castlepoint to further protect its policyholders by deconsolidating Castlepoint from the Tower Group.

P/C Industry Impairment Experience

The declining number of impairments from 2013-2015 (**Exhibit 21**), compared with the higher levels in 2011 and 2012, have been more in line with figures seen consistently during the 1970's and early 1980's. For the companies that became impaired in 2015, A.M. Best assigned ratings to only one and reported on eight as opposed to having assigned ratings to four and reported on seven of the 12 impairments in 2014. Of the impaired companies that were rated in either 2015 or 2014, none carried a financial strength rating (FSR) of B+ or higher in the year of impairment.

Exhibit 21

U.S. Property/Casualty – Annual Impairment Count, Admitted Companies vs. Surplus Lines



Source: A.M. Best data and research.

It is possible that additional financial impairments could emerge. There could be a lag in the reporting of impairments due to the increasing use of confidential actions by insurance regulators, who are reluctant to publicly disclose impairments until all possible avenues to rehabilitate or find a buyer for troubled insurers have been exhausted. A.M. Best has found that, on average, there is a 1 ½-year lag between a confidential regulatory action and public disclosure of the impairment, usually the time between supervision and liquidation – if the confidential action ever becomes public at all.

Financially Impaired Companies Defined

A.M. Best designates an insurer as a Financially Impaired Company (FIC) if placed under court order into conservation, rehabilitation, or liquidation as of the date of the earliest court action.

Revisions

As a result of ongoing research efforts, A.M. Best's impairment database is updated continually to reflect the incorporation of new data or adjustments to existing data. In addition, in past years, A.M. Best utilized a broader definition of FIC in impairment reviews, which included companies under regulatory oversight short of court-ordered conservation, rehabilitation, or insolvency. Many of these situations, however, were resolved such that insolvency was avoided, and the definition has been refocused to more narrowly capture just those cases in which insolvency has occurred or is reasonably likely.

A.M. Best believes the financial impairment frequency (FIF) is a more accurate indicator of impairment trends than a simple count. The FIF is calculated using the number of companies that become impaired in a given year, divided by the number of companies operating in the insurance market in that year. The P/C industry's 2015 FIF was 0.33, far below the industry's historical average of 0.86. Reviewing the most recent ten-year-term, the 2011 FIF of 1.06 seems to have marked the peak for impairment frequency, after the 2007-2010 soft-market trough and the 2007-2009 recession.

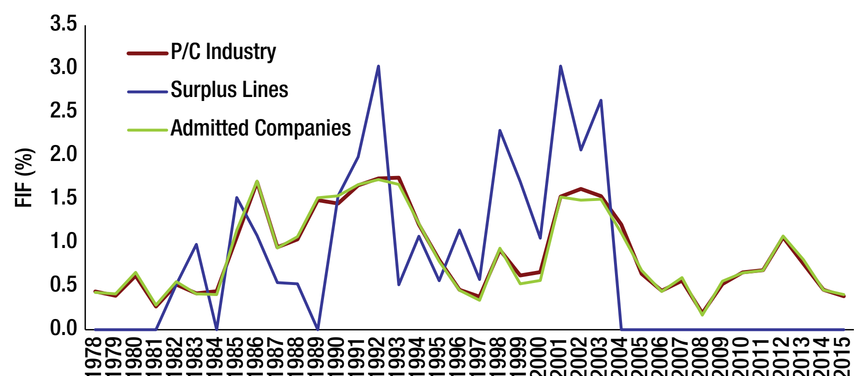
A.M. Best has found that, historically, increases in the insurance industry's FIF correlate strongly with preceding negative operating environments marked by events such as stock market declines; economic recessions; and extraordinarily large catastrophe losses that typically force the end of soft markets. Evidence of these trends resides in the increased FIF rates during the periods 1988 to 1993 and 2000 to 2003.

Surplus Lines Impairment Experience

Due to the absence of surplus lines financial impairments from 2004-2015, the surplus lines industry's FIF of 0.74 from 1977 to 2015 is modestly lower than the admitted company average of 0.86. The fact that it is still relatively close to the admitted company average reflects the surplus lines industry's significantly higher impairment frequencies during certain periods, in particular, 1992, 1998, 1999 and 2001-2003 (**Exhibits 22 and 23**). Since 2003, with each year that the surplus lines industry experienced no financial impairments, the historical impairment frequencies for admitted and surplus lines companies converged steadily. The absence of surplus lines insurer impairments in the mid-2000's is related primarily to the surplus lines industry's improved underwriting performance, driven by demonstrated underwriting discipline and adequate pricing, overall. Investments in advanced technologies, data analytics, and improved systems, along with better

Exhibit 22

U.S. Property/Casualty – Financial Impairment Frequency, Admitted vs. Surplus Lines



Source: A.M. Best data and research, BestLink *Best's Statement File – P/C, U.S.*

Exhibit 23

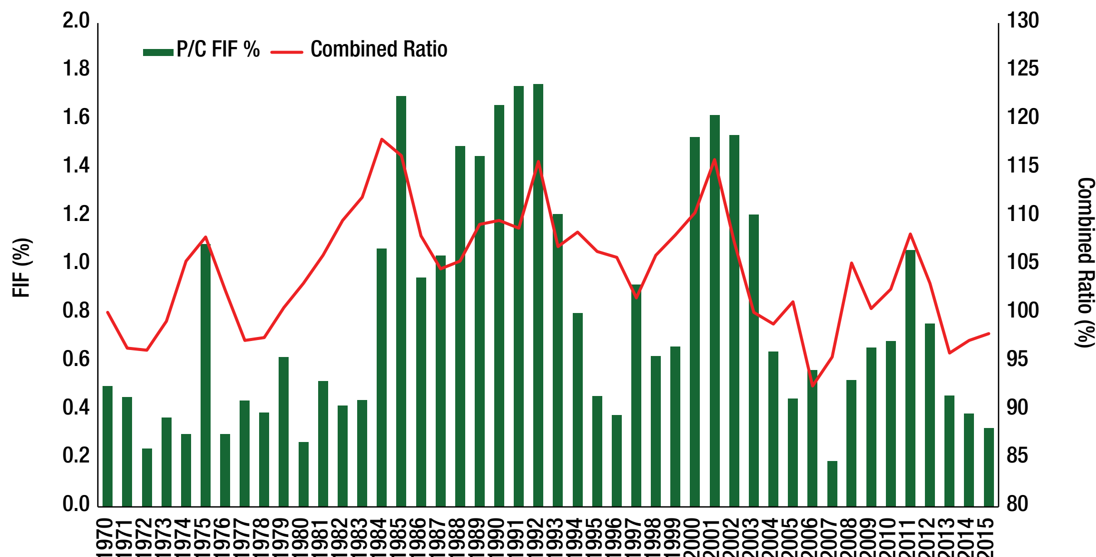
U.S. Property/Casualty – Financially Impaired Companies Count & Frequency

Industry vs. Surplus lines

	Financially Impaired Companies (FIC)			Financial Impairment Frequency (FIF)[2]		
Year	P/C Industry	Surplus Lines	Admitted Cos.[1]	P/C Industry	Surplus Lines	Admitted Cos.[1]
1977	13	1	12	0.44	0.62	0.43
1978	12	0	12	0.39	0.00	0.41
1979	19	0	19	0.62	0.00	0.66
1980	8	0	8	0.27	0.00	0.28
1981	16	0	16	0.49	0.00	0.55
1982	13	1	12	0.42	0.52	0.41
1983	14	2	12	0.44	0.98	0.40
1984	34	0	34	1.13	0.00	1.14
1985	54	3	51	1.54	1.52	1.54
1986	30	2	28	0.95	1.08	0.94
1987	33	1	32	1.04	0.54	1.07
1988	49	1	48	1.49	0.53	1.55
1989	48	0[3]	48	1.45	0.00	1.54
1990	55	3	52	1.66	1.54	1.67
1991	59	4	55	1.77	1.99	1.76
1992	60	6	54	1.72	3.03	1.64
1993	42	1	41	1.21	0.52	1.25
1994	28	2	26	0.80	1.08	0.79
1995	16	1	15	0.46	0.56	0.45
1996	13	2	11	0.38	1.15	0.34
1997	32	1	31	0.92	0.58	0.94
1998	20	4	16	0.62	2.29	0.53
1999	21	3	18	0.66	1.70	0.60
2000	48	2	46	1.53	1.05	1.56
2001	50	6	44	1.62	3.03	1.52
2002	47	4	43	1.54	2.07	1.50
2003	37	5	32	1.21	2.64	1.11
2004	20	0	20	0.64	0.00	0.68
2005	14	0	14	0.45	0.00	0.47
2006	18	0	18	0.56	0.00	0.60
2007	6	0	6	0.19	0.00	0.20
2008	17	0	17	0.53	0.00	0.56
2009	22	0	22	0.66	0.00	0.69
2010	23	0	23	0.68	0.00	0.71
2011	35	0	35	1.06	0.00	1.11
2012	25	0	25	0.76	0.00	0.81
2013	15	0	15	0.46	0.00	0.49
2014	12	0	12	0.39	0.00	0.40
2015	10	0	10	0.33	0.00	0.35
1977-2015	**1088**	**55**	**1033**	**0.86**	**0.74**	**0.86**

[1] Includes alternative markets.
[2] Failure frequencies are annualized rates.
[3] 1989 figures have been adjusted from previous reports to exclude 7 U.K.-domiciled companies.
Source: A.M. Best data and research, BestLink – Best's Statement File – P/C, US

Exhibit 24
U.S. Property/Casualty – Financial Impairment Frequency vs. Industry Combined Ratio*



*Combined ratios are after policyholders' dividends. A combined ratio below 100 indicates an underwriting profit; above 100, an underwriting loss.
Source: A.M. Best and research, BESTLINK – Best's Statement File – P/C, U.S.

management reporting and more robust oversight, have also helped impairments to trend positively for surplus lines insurers.

Beginning in 2007, however, underwriting profitability and operating performance began a period of deterioration that lasted through 2012, as indicated by a rise in the reported combined ratio for both the surplus lines market and the P/C industry as a whole (**Exhibits 24 and 25**), before notable improvement was reported in 2013 and 2014. Specific to the surplus lines market, the 12-year absence of impairments was initially more related to the overall capital strength of surplus lines companies than to underwriting performance. The market's profitability dipped in 2015 as incurred losses increased by almost 25% while written and earned premium volume only increased modestly. Overall, however, the improved profitability from recent years heading into 2015 contributed to the impairment trend for surplus lines companies remaining favorable in 2015.

Characteristics of 2015 Financial Impairments

Historically, the causes and characteristics of financial impairments have generally remained consistent for both the surplus lines and admitted P/C industries during the period that A.M. Best has examined impairment data, most recently updated in the special report, U.S. Property/Casualty – Impairment Review (August 2015). Deficient loss reserves/inadequate pricing and rapid growth historically have accounted for the largest portion of total impairment among surplus lines and admitted companies.

Exhibit 25
U.S. DPSL* Composite – Financial Impairment Frequency & Combined Ratio

Year	FIF	Combined Ratio
1997	0.58	93.8
1998	1.72	98.5
1999	1.70	99.8
2000	1.05	105.0
2001	3.54	105.3
2002	2.07	93.0
2003	2.64	92.2
2004	0.00	93.5
2005	0.00	93.2
2006	0.00	79.4
2007	0.00	76.1
2008	0.00	93.6
2009	0.00	93.1
2010	0.00	100.5
2011	0.00	105.1
2012	0.00	110.5
2013	0.00	92.4
2014	0.00	88.8
2015	0.00	101.1

*Domestic Professional Surplus Lines
Source: A.M. Best data and research

Of the ten admitted companies that became impaired in 2015, five were wholly or largely automobile carriers, including two non-standard auto companies, and two private passenger auto companies. Two of those companies, one of the non-standard auto companies and one private passenger auto company, were single state writers, underscoring the potential challenges associated with a limited market scope that can lead to significant pressures when myriad market forces and/or onerous regulatory pressures create tough operating conditions. The operations of the other private passenger auto writer that became impaired in 2015 were concentrated in three Midwestern states. Three of the other impaired companies were reciprocals or risk retention groups (RRG) focused on providing focused coverage to members. The remaining two 2015 impaired companies were largely devoted to commercial multi-peril (CMP) business; one was a multi-state writer, while the other was a CMP and commercial auto writer in Texas.

A.M. Best believes that except for those impairments directly related to catastrophe losses, all impairments are related to some form of mismanagement. In many instances, companies that become impaired because of catastrophe losses tend to be those concentrated in a particular line of business or geographic area, and have been financially weakened by years of operating losses.

Conclusion

A.M. Best remains guardedly optimistic about the favorable trend of surplus lines impairments from 2004 to 2015, which drove down the market's FIF to below that of the admitted market. Absent any specific drivers of surplus lines impairments, persisting sluggish economic conditions and a prolonged soft market could contribute to pressure on company combined ratios. As shown with the impairment of Castlepoint National, substantial inadequacy in setting appropriate loss reserves can greatly imperil a company's financial strength. The continuing low interest rate environment limits the ability of surplus lines (and admitted) companies to potentially withstand or offset any deficiencies in pricing, reserving, or inadequate risk selection with investment returns and capital market gains, particularly considering the volatility experienced across U.S. and global financial markets over the recent term.

Section VI – Fundamentals of The Surplus Lines Market

The U.S. surplus lines market (also called the nonadmitted market) functions as a supplemental market for insuring risks that are not acceptable to the standard insurance market (also called the admitted market).

The insurers in the surplus lines market are P/C companies that distribute their products to consumers through surplus lines producers. Consumers that are unable to secure insurance coverage from standard (admitted) insurers also have the option of self-insuring or seeking solutions in the alternative risk transfer (ART) market.

The risks insured in the surplus lines market are usually classified as follows:

- **Distressed risks –** characterized by unfavorable attributes, such as a history of frequent losses or the potential for catastrophic losses that make them unacceptable to admitted insurers. Examples of distressed risks include a vacant building located in an area that experiences frequent crime losses, a shopping mall with frequent liability claims or a manufacturer of explosives.

- **Unique risks –** so specialized or unusual that admitted insurers are unwilling or unprepared to insure them. An example of a unique risk is a medical device manufacturer that needs product liability coverage while a new product is in clinical trials.

- **High-capacity risks –** requiring high insurance limits that may exceed the capacity of the standard market. An example of a high-capacity risk is a chemical plant that could become legally liable for hundreds of millions of dollars in damages if a toxic chemical were to escape in large quantities.

- **New or emerging risks –** requiring special underwriting expertise and flexibility that the surplus lines market can provide. Examples of new or emerging risks that are in need of property and/or liability coverage include the nonmilitary use of unmanned aircraft systems (drones) and marijuana businesses in states that have legalized the medical or recreational use of marijuana.

The surplus lines market has historically been an innovator of new kinds of insurance coverage designed to meet emerging market needs. Examples of policies that were originated by surplus lines carriers include cyber risk, environmental impairment liability, employment practices liability, directors and officers liability, and excess and umbrella liability. These types of policies can now be obtained in either the standard (admitted) insurance market or the surplus lines market, depending on the characteristics of the particular risk.

The majority of surplus lines business consists of commercial lines insurance, although some personal lines coverage, such as homeowners insurance in catastrophe-prone areas, is also written on a nonadmitted basis.

Surplus lines insurers are referred to as nonadmitted insurers because they are not licensed (admitted) in the state where the insured's principal place of business is located or where the insured resides. This state is known as "the insured's home state" and is the state that is responsible by federal law for oversight and regulation of the surplus lines transaction. Every U.S. jurisdiction has a surplus lines law that permits specially licensed intermediaries

(surplus lines brokers/licensees) to "export" risks that cannot be placed in the standard market to eligible surplus lines (nonadmitted) insurers.

Although not a licensed insurer in the "home state of the insured," each surplus lines insurer is licensed in its state or country of domicile and is regulated for solvency by that jurisdiction. This is the same approach used by the state-based insurance regulatory system in the United States to assure the financial stability of licensed or admitted insurers. As a nonadmitted carrier, a surplus lines insurer is not subject to the rate and form regulations of the insured's home state and is therefore free to use policy forms and rates that are appropriate for the risks it accepts. State regulation of licensed or admitted insurers, in contrast, includes the oversight of insurance policy rates and forms. The purpose of this special regulatory approach to surplus lines insurers is to ensure that the surplus lines market provides an open and flexible marketplace for insureds that are unable to fulfill their insurance requirements in the state's admitted or standard market.

When the insurance market or capacity becomes restricted and market conditions "harden," standard market carriers typically reduce their appetites for some risks or lines of insurance, and business flows into the surplus lines market. Even under normal market conditions or when the market is considered "soft," there are still many distressed, unique, high-capacity and new or emerging risks that require surplus lines treatment. In fulfilling the role of insuring risks that the admitted market cannot or will not insure, the surplus lines market operates as a "safety valve" for the insurance marketplace.

The minimum capitalization requirement for surplus lines insurers is generally higher in each state than it is for admitted insurers. This enhanced capital standard provides greater protection for policyholders insured by surplus lines companies, since state guaranty fund protection, provided to policyholders of admitted insurers that become insolvent, is not generally available to surplus lines insureds. (See Section II for current financial trends in the surplus lines market.)

Market Cycles

In general, the condition of the admitted insurance market affects the state of the surplus lines market. (See Section I for the latest surplus lines market trends.) This impact, on occasion, can be significant. When admitted market conditions harden or become more difficult, a sizable amount of business flows from the admitted market to the surplus lines market. During a hard market, underwriters tend to become more conservative and restrictive, examining loss exposures more carefully to determine how a particular risk under consideration can be written at a profit.

In these circumstances, standard market carriers only insure those risks that they are most comfortable in assuming and tend to avoid risks that are more complex or with which they have little or no experience.

As the market cycle progresses, competition heats up and market conditions in the admitted market "soften" as producers and insurers strive to maintain market share by reducing rates, expanding coverage and offering additional services at the expense of profit margins. During this soft market phase of the cycle, consumers' bargaining power increases significantly, causing rates to drop and coverage limitations or exclusions to be relaxed. When these circumstances occur, business begins to return to the admitted market.

Over time, competitive pricing pressures erode admitted market capacity as margins deteriorate to unprofitable levels. This again leads to a hardening of the market, and the cycle continues.

Industry Participants

For the purposes of this report, A.M. Best has categorized surplus lines insurers into three broad segments:

- **Domestic professional companies:** This largest segment is represented by U.S.-domiciled insurers that write 50% or more of their total premium on a nonadmitted basis.

- **Domestic specialty companies:** U.S.-domiciled insurers that operate to some extent on a nonadmitted basis but whose direct nonadmitted premium writings amount to less than 50% of their total direct premiums written.

- **Regulated aliens (including Lloyd's):** To qualify as a regulated alien, insurers must file financial statements, copies of auditors' reports, the names of their U.S. attorneys or other representatives and details of their U.S. trust accounts with the International Insurers Department (IID) of the National Association of Insurance Commissioners (NAIC). Additionally, regulated aliens must fulfill criteria established by the IID concerning capital and/or surplus, reputation of financial integrity, and underwriting and claims practices. On a quarterly basis, the NAIC publishes its Quarterly Listing of Alien Insurers, which lists alien insurers that meet its criteria.

As a result of the Nonadmitted and Reinsurance Reform Act (NRRA) of 2010, which was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a state may not prohibit a surplus lines broker from placing nonadmitted (surplus lines) insurance with or procuring such insurance from a nonadmitted insurer listed on the NAIC Quarterly Listing of Alien Insurers.

Distribution

Retail producers, surplus lines intermediaries and program managers are the primary distributors for surplus lines insurers. All of these entities play an important role in helping consumers find insurance coverage that is unavailable in the standard market. (See Section IV for a description of current surplus lines distribution issues).

For purposes of this special report, the types of organizations within the surplus lines distribution system are defined as follows:

- Retail producers can be either agents that represent the insurer or brokers that represent the insured.
- Surplus lines intermediaries can operate as wholesale brokers, managing general agents (MGAs), underwriting managers or Lloyd's coverholders or open market correspondents (OMCs).
- Program managers are managers of specialty or niche insurance products and market to retailers, wholesalers or both.

Surplus lines intermediaries are licensed in the states where the insured or risk is located and act as intermediaries between retail producers and surplus lines insurers. Typically, a surplus lines intermediary provides the retail producer and the insured with access to the surplus lines market when the admitted market cannot provide coverage or the risk otherwise qualifies for export.

The basic difference between wholesale brokers and MGAs is that MGAs are authorized to underwrite and bind coverage on behalf of the surplus lines insurer through binding authority agreements. Wholesale brokers only have the authority to submit business to surplus lines insurers. The insurers then underwrite, quote and, if the risk is considered to be acceptable,

bind the risk. In addition, some MGAs have claims-handling responsibilities and may be involved in the placement of reinsurance.

Lloyd's coverholders are authorized to bind coverage on behalf of underwriting syndicates at Lloyd's. OMCs are approved for placing coverage at Lloyd's either directly or through a Lloyd's broker.

Surplus lines laws generally require that a "diligent search" of the admitted market be performed before a risk can be exported to a surplus lines insurer. In general, the diligent-search requirement, which assures the admitted market the first opportunity to insure the risk, requires that three declinations from admitted insurers be obtained before the risk can be placed in the surplus lines market.

In certain states, specified types of risks can be placed in the surplus lines market without the diligent search requirement being fulfilled. Many states have created an "export list," which sets forth types of risks for which the insurance commissioner has determined there is little or no coverage available in the state's admitted market. A type of risk that appears on the export list can be exported, without a diligent search, to an eligible surplus lines insurer. Also, a few states have commercial lines deregulation laws that allow for "automatic export" waivers, giving qualifying commercial buyers and their brokers or intermediaries immediate access to the surplus lines market, as well as access to a deregulated admitted market, without a diligent search.

In a surplus lines transaction, the surplus lines intermediary is generally responsible for:

- Filing an affidavit affirming that a diligent search has been performed, when it is required;
- Maintaining the records relating to the transaction; and
- Collecting premium taxes and remitting them to the insured's home state.

In addition to facilitating the surplus lines placement, the surplus lines intermediary provides a number of services, which include:

- Technical expertise about the risk to be insured;
- Extensive insurance product and market knowledge;
- Ability to respond quickly to changing market conditions; and
- Access to eligible surplus lines insurers.

Licensing and Compliance

In a surplus lines transaction, the insured's home state exercises the greatest degree of regulatory oversight, and the onus of regulatory compliance is placed on the surplus lines broker or licensee, which is the regulated entity in the transaction.

In addition to being a licensed (resident or nonresident) agent or broker, a surplus lines broker or licensee must do the following:

- In many states, pass a written surplus lines licensing examination to secure a resident license;
- Collect the state's surplus lines premium taxes;
- Pay an annual licensing fee; and
- Determine whether the risk meets all the requirements for placement with a surplus lines insurer.

Further, the surplus lines broker or licensee is responsible for determining whether the nonadmitted insurer insuring the risk meets the insured's home state eligibility requirements. A broker or licensee may be held liable for payment of claims when a risk is placed with a

surplus lines insurer not authorized to receive the risk, or with one that is financially unsound when the risk is bound. However, depending on state law, there may be no cause of action against a broker who exercises due diligence or care in selecting the insurer, even if the insurer becomes insolvent years later.

Surplus lines policies must disclose that a nonadmitted insurer is providing coverage and that guaranty fund protection will not be available if the insurer becomes insolvent.

Conclusion

This section on "Fundamentals" is a primer for readers who are not already familiar with the surplus lines market, to assist them in understanding this unique insurance marketplace and to put the other sections of this report into context. The fundamentals of the surplus lines market include the participants and their roles, the types of risks insured, the regulatory structure and the responsibilities imposed on the surplus lines broker/licensee and the dynamic role of market cycles.

Appendix A

U.S. Surplus Lines – Top 50 Groups, 2015

Ranked by direct premiums written

($ Thousands)

Rank	AMB #	Group/Company Name	Type	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating	Financial Strength Rating Outlook / Implications	Rating Effective Date
1	**85202**	**Lloyd's**		**8,645,000**	**6.0%**		**A**	**Stable**	**21-Jul-16**
2	18540	American International Group		4,656,353	-0.5%	6,671,038			
2	3535	AIG Specialty Insurance Co	PROF	931,010		40,130	A	Stable	2-Jun-16
2	2361	Illinois National Insurance Co	MISC	280		37,879	A	Stable	2-Jun-16
2	2350	Lexington Insurance Company	PROF	3,725,063		6,593,029	A	Stable	2-Jun-16
3	**5987**	**Nationwide Group**		**1,787,725**	**0.4%**	**960,631**			
3	1931	Scottsdale Indemnity Company	MISC	23,494		37,711	A+	Stable	7-Jul-16
3	3292	Scottsdale Insurance Company	PROF	1,581,300		766,143	A+	Stable	7-Jul-16
3	12121	Scottsdale Surplus Lines Ins	PROF	13,730		47,112	A+	Stable	7-Jul-16
3	601	Western Heritage Insurance Co	PROF	169,201		109,665	A+	Stable	7-Jul-16
4	**18252**	**W. R. Berkley Insurance Group**		**1,547,181**	**4.1%**	**1,023,172**			
4	3026	Admiral Insurance Company	PROF	471,470		633,979	A+	Stable	26-Feb-16
4	14158	Berkley Assurance Company	PROF	56,336		52,888	A+	Stable	26-Feb-16
4	11296	Berkley Regional Specialty Ins	PROF	23,940		54,063	A+	Stable	26-Feb-16
4	12118	Gemini Insurance Company	PROF	468,919		55,247	A+	Stable	26-Feb-16
4	11231	Great Divide Insurance Co	MISC	2,946		68,103	A+	Stable	26-Feb-16
4	1990	Nautilus Insurance Company	PROF	523,570		158,892	A+	Stable	26-Feb-16
5	**18549**	**Zurich Financial Svcs NA Group**		**1,229,918**	**2.1%**	**625,464**			
5	2147	Empire Fire & Marine Ins Co	MISC	1,194		40,601	A+	Negative	2-Oct-15
5	2148	Empire Indemnity Ins Co	PROF	130,595		50,795	A+	Negative	2-Oct-15
5	3557	Steadfast Insurance Company	PROF	1,096,088		499,590	A+	Negative	2-Oct-15
5	3565	Zurich American Ins Co of IL	MISC	2,042		34,477	A+	Negative	2-Oct-15
6	**18468**	**Markel Corporation Group**		**1,175,820**	**-1.3%**	**1,204,347**			
6	4898	Associated International Ins*	PROF	2,285		105,935	NR	N/A	15-May-15
6	2732	Essex Insurance Company**	PROF	489,230		378,952	**	**	1-Jul-16
6	3759	Evanston Insurance Company	PROF	684,305		719,460	A	Stable	1-Jul-16
7	**18874**	**XL Catlin America Group**		**1,154,629**	**58.8%**	**304,984**			
7	10092	Catlin Specialty Insurance Co	PROF	364,063		213,139	A	Stable	3-Aug-16
7	11340	Indian Harbor Insurance Co	PROF	790,539		45,260	A	Stable	3-Aug-16
7	2424	XL Select Insurance Company	PROF	27		46,585	A	Stable	3-Aug-16
8	**18498**	**Chubb INA Group**		**1,037,187**	**0.5%**	**339,397**			
8	3510	Illinois Union Insurance Co	PROF	484,428		161,193	A++	Stable	22-Jun-16
8	4433	Westchester Surplus Lines Ins	PROF	552,760		178,204	A++	Stable	22-Jun-16
9	**811**	**Berkshire Hathaway Ins Group**		**1,000,701**	**19.8%**	**7,698,701**			
9	3806	General Star Indemnity Co	PROF	144,143		543,272	A++	Stable	28-Oct-15
9	2540	Mount Vernon Fire Ins Co	PROF	97,590		399,665	A++	Stable	12-Jun-15
9	18657	Mount Vernon Specialty Ins Co	PROF	198		29,376	A-	Stable	4-May-15
9	2428	National Fire & Marine Ins Co	PROF	720,554		5,695,856	A++	Stable	1-Sep-15
9	4406	National Indem Co of Mid-Amer	MISC	1,993		168,061	A++	Stable	1-Sep-15
9	1824	National Indem Co of the South	MISC	1,889		179,061	A++	Stable	1-Sep-15
9	3736	U S Underwriters Insurance Co	PROF	27,160		124,189	A++	Stable	12-Jun-15
9	2541	United States Liability Ins Co	MISC	7,173		559,221	A++	Stable	12-Jun-15
10	**18728**	**Ironshore Insurance Group**		**871,249**	**-2.7%**	**487,920**			
10	13847	Ironshore Indemnity Inc.	MISC	14,249		153,969	A	Negative	24-Jun-16
10	13866	Ironshore Specialty Ins Co	PROF	857,000		333,950	A	Negative	24-Jun-16
11	**18640**	**Alleghany Ins Holdings Group**		**780,416**	**0.0%**	**379,814**			
11	1960	Capitol Specialty Ins Corp	PROF	119,539		53,817	A	Stable	19-Aug-16
11	13859	Covington Specialty Ins Co	PROF	163,295		49,977	A+	Stable	19-Aug-16
11	22013	Fair American Select Ins Co	PROF	10,100		47,312	A+	Stable	19-Aug-16
11	12619	Landmark American Ins Co	PROF	487,482		228,708	A+	Stable	19-Aug-16

Appendix A

U.S. Surplus Lines – Top 50 Groups, 2015

Ranked by direct premiums written

($ Thousands)

Rank	AMB #	Group/Company Name	Type	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating	Financial Strength Rating Outlook / Implications	Rating Effective Date
12	**3116**	**Fairfax Financial (USA) Group**		**744,372**	**-6.2%**	**492,807**			
12	12347	American Safety Indemnity Co***	PROF	971		89,246	NR	N/A	4-Jun-15
12	11123	Crum & Forster Specialty Ins	PROF	147,333		47,701	A	Stable	4-Jun-15
12	11883	First Mercury Insurance Co	PROF	290,854		50,490	A	Stable	4-Jun-15
12	14995	Hudson Excess Insurance Co	PROF	25,536		55,699	A	Stable	5-May-15
12	12631	Hudson Specialty Ins Co	PROF	168,579		201,151	A	Stable	5-May-15
12	12258	Seneca Specialty Ins Co	PROF	111,099		48,520	A	Stable	4-Jun-15
13	**18313**	**CNA Insurance Companies**		**675,663**	**-9.4%**	**247,258**			
13	3538	Columbia Casualty Company	PROF	675,663		247,258	A	Stable	23-Feb-16
14	**18603**	**AXIS Insurance Group**		**603,112**	**2.0%**	**192,029**			
14	12515	AXIS Surplus Insurance Company	PROF	603,112		192,029	A+	Stable	4-Aug-15
15	**18733**	**Philadelphia Ins/Tokio Mar Grp**		**590,614**	**265.8%**	**2,151,109**			
15	12531	HCC Specialty Ins Co	PROF	23,648		16,450	A+	Stable	22-Oct-15
15	3286	Houston Casualty Company	PROF	360,908		1,936,887	A+	Stable	22-Oct-15
15	763	Tokio Marine Specialty Ins Co	PROF	206,059		197,773	A++	Stable	4-Jun-15
16	**4019**	**Argo Group**		**578,360**	**9.9%**	**418,579**			
16	3283	Colony Insurance Company	PROF	549,845		349,595	A	Stable	22-Oct-15
16	2619	Colony Specialty Insurance Co	MISC	4,623		20,183	A	Stable	22-Oct-15
16	11035	Peleus Insurance Company	PROF	23,892		48,801	A	Stable	22-Oct-15
17	**12**	**Chubb Group of Insurance Cos**		**571,890**	**-0.4%**	**1,633,662**			
17	2713	Chubb Custom Insurance Co	PROF	520,867		200,786	A++	Stable	22-Jun-16
17	3761	Executive Risk Indemnity Inc	MISC	351		1,267,144	A++	Stable	22-Jun-16
17	11251	Executive Risk Specialty Ins	PROF	50,672		165,732	A++	Stable	22-Jun-16
18	**18713**	**QBE Americas Group**		**544,813**	**4.3%**	**184,075**			
18	12562	QBE Specialty Insurance Co	PROF	544,813		184,075	A	Stable	10-Mar-16
19	**4835**	**Great American P & C Ins Group**		**543,620**	**15.0%**	**259,210**			
19	3735	American Empire Surplus Lines	PROF	157,176		125,369	A+	Stable	12-May-16
19	10937	Great Amer Protection Ins Co	PROF	350		24,005	A+	Stable	12-May-16
19	3837	Great American E&S Ins Co	PROF	368,595		46,189	A+	Stable	12-May-16
19	3293	Great American Fidelity Ins Co	PROF	14,557		46,199	A+	Stable	12-May-16
19	14150	Mid-Continent E&S Ins Co	PROF	2,941		17,448	A+	Stable	12-May-16
20	**18604**	**State National Group**		**534,027**	**22.9%**	**79,836**			
20	13105	United Specialty Insurance Co	PROF	534,027		79,836	A	Stable	25-Aug-16
21	**18591**	**Allied World Assurance Group**		**529,782**	**2.4%**	**369,801**			
21	12525	Allied World Asr Co (US) Inc	PROF	226,998		138,854	A	Stable	11-Feb-16
21	12526	Allied World National Assur Co	MISC	73,609		134,220	A	Stable	11-Feb-16
21	11719	Allied World Surplus Lines Ins	PROF	229,175		96,727	A	Stable	11-Feb-16
22	**18484**	**Arch Insurance Group**		**527,384**	**-3.9%**	**305,928**			
22	12523	Arch Specialty Insurance Co	PROF	527,384		305,928	A+ u	Developing	17-Aug-16
23	**18783**	**Aspen US Insurance Group**		**500,436**	**17.7%**	**152,127**			
23	12630	Aspen Specialty Insurance Co	PROF	500,436		152,127	A	Stable	18-Nov-15
24	**18756**	**Starr International Group**		**448,580**	**13.0%**	**98,904**			
24	13977	Starr Surplus Lines Ins Co	PROF	448,580		98,904	A	Stable	20-Nov-15
25	**18674**	**Travelers Group**		**385,775**	**6.9%**	**971,567**			
25	4869	Northfield Insurance Co	PROF	117,821		127,726	A++	Stable	22-Jul-16
25	4025	Northland Casualty Company	MISC	758		37,040	A++	Stable	22-Jul-16
25	712	Northland Insurance Company	MISC	3,707		544,042	A++	Stable	22-Jul-16
25	3592	St. Paul Surplus Lines Ins Co	PROF	13,783		196,724	A++	Stable	22-Jul-16
25	241	Travelers Excess & Surp Lines	PROF	249,706		66,035	A++	Stable	22-Jul-16
26	**3262**	**Swiss Reinsurance Group**		**385,049**	**1.8%**	**115,703**			
26	10783	First Specialty Ins Corp	PROF	236,445		69,624	A+	Stable	11-Dec-15
26	11135	North American Capacity Ins Co	PROF	148,604		46,078	A+	Stable	11-Dec-15
27	**18620**	**Endurance Specialty Group**		**371,617**	**38.3%**	**97,902**			
27	13033	Endurance American Spec Ins Co	PROF	371,617		97,902	A	Stable	12-May-16

Appendix A

U.S. Surplus Lines – Top 50 Groups, 2015

Ranked by direct premiums written

($ Thousands)

Rank	AMB #	Group/Company Name	Type	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating	Financial Strength Rating Outlook / Implications	Rating Effective Date
28	**18081**	**Navigators Insurance Group**		**357,445**	**13.0%**	**1,086,302**			
28	1825	Navigators Insurance Company	MISC	102		950,266	A	Stable	21-Jul-16
28	10761	Navigators Specialty Ins Co	PROF	357,343		136,036	A	Stable	21-Jul-16
29	**60**	**Liberty Mutual Insurance Cos**		**340,198**	**-4.0%**	**103,495**			
29	12078	Liberty Surplus Ins Corp	PROF	340,198		103,495	A	Stable	8-Oct-15
30	**18626**	**James River Group**		**308,713**	**22.2%**	**136,072**			
30	13985	James River Casualty Company	PROF	3,873		16,368	A	Stable	29-Jul-16
30	12604	James River Insurance Co	PROF	304,841		119,705	A	Stable	29-Jul-16
31	**5696**	**Everest Re U.S. Group**		**264,797**	**17.2%**	**78,584**			
31	12096	Everest Indemnity Insurance Co	PROF	264,126		57,778	A+	Stable	9-Sep-15
31	11197	Everest Security Insurance Co	MISC	671		20,806	A+	Stable	9-Sep-15
32	**3883**	**RLI Group**		**254,431**	**-2.1%**	**447,836**			
32	2591	Mt Hawley Insurance Company	PROF	254,431		447,836	A+	Stable	4-Jun-15
33	**2946**	**Western World Insurance Group**		**246,755**	**-10.9%**	**601,114**			
33	2598	Tudor Insurance Company	PROF	53,352		180,066	A	Stable	1-Apr-16
33	3132	Western World Insurance Co	PROF	193,403		421,047	A	Stable	1-Apr-16
34	**856**	**State Auto Insurance Companies**		**244,382**	**9.8%**	**98,100**			
34	13023	Rockhill Insurance Company	PROF	244,382		98,100	A-	Stable	26-Apr-16
35	**3873**	**SCOR U S Group**		**235,468**	**34.7%**	**61,893**			
35	2837	General Security Indem Co AZ	PROF	235,468		61,893	A	Positive	11-Sep-15
36	**18753**	**Munich-American Hldng Corp Cos**		**234,227**	**-20.9%**	**270,000**			
36	13062	Amer Modern Surpl Lines Ins Co	PROF	828		30,461	A+	Stable	22-Oct-15
36	2666	American Modern Select Ins Co	MISC	879		52,731	A+	Stable	22-Oct-15
36	3763	American Western Home Ins Co	PROF	40,951		71,213	A+	Stable	22-Oct-15
36	14838	HSB Specialty Insurance Co	PROF	6,166		49,842	A++	Stable	5-Feb-16
36	12170	Princeton Excess & Surp Lines	PROF	185,403		65,752	A+	Stable	22-Oct-15
37	**18490**	**White Mountains Insurance Grp**		**214,433**	**-4.7%**	**163,766**			
37	10604	Homeland Ins Co of NY	PROF	192,359		112,431	A	Stable	30-Oct-15
37	14398	Homeland Insurance Company DE	PROF	22,074		51,335	A	Stable	30-Oct-15
38	**18717**	**HIIG Group**		**204,037**	**27.9%**	**286,997**			
38	13825	Houston Specialty Insurance Co	PROF	117,187		268,851	A-	Stable	10-Jun-16
38	14363	Oklahoma Specialty Ins Co	PROF	86,850		18,146	A-	Stable	10-Jun-16
39	**18523**	**Assurant P&C Group**		**196,999**	**-33.5%**	**199,739**			
39	2050	Standard Guaranty Ins Co	MISC	31,156		126,254	A	Stable	27-Jan-16
39	2861	Voyager Indemnity Ins Co	PROF	165,843		73,485	A	Stable	27-Jan-16
40	**4294**	**The Cincinnati Insurance Cos**		**183,392**	**12.9%**	**306,470**			
40	13843	Cincinnati Specialty Undrs Ins	PROF	183,392		306,470	A+	Stable	18-Dec-15
41	**897**	**IFG Companies**		**183,064**	**-3.8%**	**453,499**			
41	709	Burlington Insurance Company	PROF	180,823		178,332	A	Stable	14-Jul-16
41	12242	Guilford Insurance Company	PROF	2,241		275,168	A	Stable	14-Jul-16
42	**3926**	**Selective Insurance Group**		**179,383**	**22.0%**	**75,470**			
42	13842	Mesa Underwriters Spec Ins Co	PROF	179,383		75,470	A	Stable	16-Aug-16
43	**14027**	**Kinsale Insurance Company**		**175,981**	**11.4%**	**127,675**			
43	14027	Kinsale Insurance Company	PROF	175,981		127,675	A-	Stable	2-Jun-16
44	**18669**	**Global Indemnity Group**		**172,588**	**-2.7%**	**344,894**			
44	3674	Penn-America Insurance Company	PROF	58,975		83,144	A	Stable	12-Jun-15
44	11460	Penn-Patriot Insurance Company	PROF	55		21,047	A	Stable	12-Jun-15
44	12050	Penn-Star Insurance Company	PROF	41,964		47,585	A	Stable	12-Jun-15
44	3128	United National Insurance Co	PROF	65,506		173,147	A	Stable	12-Jun-15
44	447	United National Specialty Ins	PROF	6,087		19,971	A u	Developing	20-May-16
45	**18567**	**IAT Insurance Group**		**166,244**	**10.7%**	**266,132**			
45	11774	Acceptance Casualty Ins Co	PROF	12,662		50,294	A-	Stable	11-Jun-15
45	10611	Acceptance Indemnity Ins Co	PROF	101,186		123,769	A-	Stable	11-Jun-15
45	975	Wilshire Insurance Company	MISC	52,396		92,068	A-	Stable	11-Jun-15

Appendix A

U.S. Surplus Lines - Top 50 Groups, 2015

Ranked by direct premiums written

($ Thousands)

Rank	AMB #	Group/Company Name	Type	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Best's Financial Strength Rating	Financial Strength Rating Outlook / Implications	Rating Effective Date
46	**18653**	**Maxum Specialty Insurance Grp**		**155,299**	**2.6%**	**114,629**			
46	12563	Maxum Indemnity Company	PROF	155,299		114,629	A- u	Positive	18-Mar-16
47	**18429**	**Allianz of America Companies**		**135,707**	**27.8%**	**2,147,420**			
47	407	Allianz Global Risks US Ins Co	MISC	157		1,862,164	A+	Stable	11-Aug-16
47	2618	Allianz Underwriters Ins Co	PROF	33,334		68,346	A+	Stable	11-Aug-16
47	2843	Fireman's Fund Ins Co of OH	PROF	205		49,968	A+	Stable	11-Aug-16
47	2267	Interstate Fire & Casualty Co	PROF	102,011		166,942	A+	Stable	11-Aug-16
48	**25045**	**GeoVera U.S. Insurance Group**		**128,162**	**-9.1%**	**21,449**			
48	11678	GeoVera Specialty Insurance Co	PROF	128,162		21,449	A	Stable	5-Jun-15
49	**18587**	**Atain Insurance Companies**		**122,940**	**11.8%**	**213,747**			
49	12422	Atain Insurance Company	PROF	4,937		47,761	A	Stable	12-Jun-15
49	2842	Atain Specialty Insurance Co.	PROF	118,003		165,987	A	Stable	12-Jun-15
50	**18533**	**AmTrust Group**		**118,319**	**38.6%**	**218,965**			
50	11693	Associated Industries Ins Co	PROF	98,788		69,423	A	Stable	8-Jul-16
50	2522	Security National Ins Co	MISC	19,531		149,542	A	Stable	8-Jul-16

Ratings are as of September 12, 2016

* The rating on this company was withdrawn on May 15, 2015 per company request.

** The rating on this company was withdrawn following its merger into affiliate Evanston Insurance Company effective June 30, 2016.

*** The rating on this company was withdrawn on June 4, 2015 per company request.

Source: A.M. Best data and research

Apendix B

Domestic Professional Surplus Lines Composite (2011-2015)

X denotes companies comprising the A.M. Best domestic professional surplus composite, defined as companies with direct premium from surplus lines business generating greater than 50% of total premium

Company Name	2011	2012	2013	2014	2015
Acceptance Casualty Insurance Co		X	X	X	X
Acceptance Indemnity Insurance Co	X	X	X	X	X
Admiral Insurance Co	X	X	X	X	X
Adriatic Insurance Co	X	X	X	X	X
AIG Specialty Insurance Co	X	X	X	X	X
AIX Specialty Insurance Co	X	X	X	X	X
Allianz Underwriters Insurance Co	X	X	X	X	X
Allied World Asr Co (US) Inc		X	X	X	X
Allied World Surplus Lines Ins	X	X	X	X	X
Alterra Excess & Surplus Ins	X	X	X	X	
American Empire Surplus Lines		X	X	X	X
American Modern Surpl Lines Ins Co	X	X	X	X	X
American Mutual Share Ins Corp	X	X	X	X	X
American Safety Indemnity Co	X	X	X	X	X
American Safety Insurance Co	X	X	X	X	X
American Western Home Ins Co	X	X	X	X	X
Appalachian Insurance Co	X	X	X	X	X
Arch Excess & Surplus Co	X				
Arch Specialty Insurance Co	X	X	X	X	X
Aspen Specialty Insurance Co	X	X	X	X	X
Associated Industries Insurance Co		X	X		X
Associated International Ins	X	X	X	X	X
Atain Insurance Co	X	X	X	X	X
Atain Specialty Insurance Co.	X	X	X	X	X
Atlantic Casualty Insurance Co	X	X	X	X	X
AXIS Specialty Insurance Co					X
AXIS Surplus Insurance Co	X	X	X	X	X
Berkley Assurance Co	X	X	X	X	X
Berkley Regional Specialty Ins	X	X	X	X	X
Burlington Insurance Co	X	X	X	X	X
Canal Indemnity Co	X	X	X	X	X
Canopius US Insurance, Inc.		X	X	X	X
Capitol Specialty Insurance Corp	X	X	X	X	X
Catlin Specialty Insurance Co	X	X	X	X	X
Century Surety Co	X	X	X	X	X
Chubb Custom Insurance Co	X	X	X		X
CIM Insurance Corporation	X	X	X		
Cincinnati Specialty Undrs Ins	X	X	X	X	X
Clarendon America Insurance Co	X				
Clear Blue Specialty Ins Co					X
Colony Insurance Co	X	X	X	X	X
Columbia Casualty Co	X	X	X	X	X
Companion Specialty Ins Co	X	X	X		
Conifer Insurance Co					X
Coverys Specialty Insurance Co					X
Covington Specialty Ins Co	X	X	X	X	X
Crum & Forster Specialty Ins	X	X	X	X	X
CUMIS Specialty Ins Co Inc	X	X	X	X	X
Discover Specialty Insurance Co	X	X	X		
Empire Indemnity Insurance Co	X	X	X	X	X
Endurance American Spec Ins Co	X	X	X	X	X
Essex Insurance Co	X	X	X	X	X
Evanston Insurance Co	X	X	X	X	X
Everest Indemnity Insurance Co	X	X	X	X	X
Executive Risk Specialty Insurance	X	X	X	X	X

Company Name	2011	2012	2013	2014	2015
Fair American Select Ins Co				X	X
Fireman's Fund Ins Co of OH	X	X	X	X	X
First Financial Insurance Co	X	X	X		
First Mercury Insurance Co	X	X	X	X	X
First Specialty Insurance Corp	X	X	X	X	X
Gemini Insurance Co	X	X	X	X	X
General Security Indem Co AZ	X	X	X	X	X
General Star Indemnity Co	X	X	X	X	X
Genesis Indemnity Insurance Co					
GeoVera Specialty Insurance Co	X	X	X	X	X
GNY Custom Insurance Co	X	X	X	X	X
Gotham Insurance Co	X	X	X	X	X
Great Amer Protection Insurance Co		X	X	X	X
Great American E&S Insurance Co	X	X	X	X	X
Great American Fidelity Insurance Co	X	X	X	X	X
GuideOne National Insurance Co			X	X	X
Guilford Insurance Co	X	X	X	X	X
Gulf Underwriters Insurance Co		X			
Hallmark Specialty Insurance Co	X	X	X	X	X
HCC Specialty Insurance Co	X	X	X	X	X
Hermitage Insurance Co		X			
Homeland Insurance Co of NY	X	X	X	X	X
Homeland Insurance Company DE			X	X	X
Housing Specialty Insurance Co. Inc.					X
Houston Casualty Co	X	X	X	X	X
Houston Specialty Insurance Co	X	X	X	X	X
HSB Specialty insurance Co			X	X	X
Hudson Excess Insurance Co			X	X	X
Hudson Specialty Insurance Co	X	X	X	X	X
Illinois Union Insurance Co	X	X	X	X	X
Indian Harbor Insurance Co	X	X	X	X	X
Interstate Fire & Casualty Co	X	X	X	X	X
Ironshore Specialty Insurance Co	X	X	X	X	X
James River Casualty Co	X	X	X	X	X
James River Insurance Co	X	X	X	X	X
Kinsale Insurance Co	X	X	X	X	X
Knight Specialty Insurance Co				X	X
Landmark American Ins Co	X	X	X	X	X
Landmark Insurance Co	X				
Lexington Insurance Co	X	X	X	X	X
Liberty Surplus Ins Corp	X	X	X	X	X
Maiden Specialty Insurance Co	X	X	X	X	
Maxum Indemnity Co	X	X	X	X	X
Medical Security Insurance Co			X	X	X
Merchants National Ins Co	X	X	X	X	X
Mesa Underwriters Spec Ins Co		X	X	X	X
Mid-Continent Excess & Surplus		X	X	X	X
Montpelier US Insurance Co					
MSA Insurance Co	X	X	X	X	X
MSI Preferred Insurance Co	X	X			
Mt Hawley Insurance Co	X	X	X	X	X
Mt Vernon Fire Insurance Co	X	X	X	X	X
Mt. Vernon Specialty Ins Co					X
NAMIC Insurance Co, Inc	X	X	X	X	X
National Fire & Marine Ins Co	X	X	X	X	X

Apendix B

Domestic Professional Surplus Lines Composite (2011-2015)

X denotes companies comprising the A.M. Best domestic professional surplus composite, defined as companies with direct premium from surplus lines business generating greater than 50% of total premium

Company Name	2011	2012	2013	2014	2015
National Guaranty Ins Co of Vermont	X	X	X	X	X
Nautilus Insurance Co	X	X	X	X	X
Navigators Specialty Ins Co	X	X	X	X	X
Nevada Capital Insurance Co			X		
Newport Insurance Co		X			
Noetic Specialty Insurance Co	X		X	X	X
North American Capacity Ins Co	X	X	X	X	X
North Light Specialty Insurance Co	X	X	X	X	X
Northfield Insurance co			X	X	X
Nutmeg Insurance Co	X			X	
Oklahoma Specialty Ins Co			X	X	X
Old Guard Insurance Co	X	X			
Old Republic Union Ins Co	X	X	X	X	X
Omega US Insurance Inc	X				
Pacific Insurance Co, Ltd	X	X	X	X	X
Peleus Insurance Company	X	X	X	X	X
Penn-America Insurance Co	X	X	X	X	X
Penn-Patriot Insurance Co	X	X	X	X	X
Penn-Star Insurance Co	X	X	X	X	X
Philadelphia Insurance Co	X				
Prime Insurance Co	X	X	X	X	X
Prime Insurance Syndicate Inc					
Princeton Excess & Surp Lines	X	X	X	X	X
ProAssurance Specialty Ins Co	X	X	X	X	X
Professional Security Ins Co			X	X	X
Professional Underwriters Liability	X	X			
Protective Specialty Ins Co	X	X	X	X	X
QBE Specialty Insurance Co	X	X	X	X	X
Rainier Insurance Co					
Republic-Vanguard Ins Co	X	X	X	X	X
Rockhill Insurance Co	X	X	X	X	X
SAFECO Surplus Lines Insurance Co	X				
Sagamore Insurance Co	X	X			

Company Name	2011	2012	2013	2014	2015
Savers Property & Casualty Ins Co		X			
Scottsdale Insurance Co	X	X	X	X	X
Scottsdale Surplus Lines Ins	X	X	X	X	X
Seneca Specialty Ins Co	X	X	X	X	X
Southwest Marine & General	X	X	X	X	X
SPARTA Specialty Insurance Co		X	X	X	
Specialty Surplus Insurance Co					
St. Paul Fire & Casualty Ins	X	X	X		
St. Paul Surplus Lines Ins Co	X	X	X	X	X
Standard Guaranty Ins Co	X	X			
Starr Surplus Lines Ins Co	X	X	X	X	X
Steadfast Insurance Co	X	X	X	X	X
TDC Specialty Insurance Co			X	X	X
TM Specialty Insurance Co	X	X			
Tokio Marine Specialty Ins Co		X	X	X	X
Torus Specialty Insurance Co	X	X	X	X	
Traders & General Ins Co	X	X			
Travelers Excess & Surp Lines	X	X	X	X	X
TrustStar Insurance Co		X			
Tudor Insurance Co	X	X	X	X	X
United National Insurance Co	X	X	X	X	X
United National Specialty Ins Co					X
United Specialty Insurance Co	X	X	X	X	X
US Underwriters Insurance Co	X	X	X	X	X
Utica Specialty Risk Ins Co	X	X	X		
Valiant Specialty Insurance Co	X	X			
Voyager Indemnity Ins Co	X	X	X	X	X
Westchester Surplus Lines Ins	X	X	X	X	X
Western Heritage Insurance Co	X	X	X	X	X
Western World Insurance Co	X	X	X	X	X
Wilshire Insurance Co		X			
XL Select Insurance Co	X	X	X	X	X

Source: A.M. Best data and research

Appendix C

State Survey: Capital & Surplus Requirements for Surplus Lines Companies

State	Domestic Company	Alien Company	Pending
Alabama	$5,000,000	$2,500,000 (1) &	No
		$15,000,000	
Alaska	$15,000,000	$15,000,000 &	No
		2,500,000 (1)	
Arizona	$15,000,000	$15,000,000(7)/	No
		$5,400,000 (1)	
Arkansas	$20,000,000	N/A	No
California	$45,000,000	(7)	No
Colorado	$15,000,000	(7)	No
Connecticut	$15,000,000	$15,000,000 (8)	No
Delaware^	$15,000,000	$15,000,000	No
District of Columbia	$300,000	$300,000	No
Florida	$15,000,000	$15,000,000 (2)	No
Georgia	$15,000,000	$4,500,000	No
		$10,000,000(1)	
Hawaii^	$15,000,000	$5,400,000 (1)	No
Idaho	$2,000,000	$15,000,000	No
Illinois	$15,000,000	$15,000,000	No
Indiana	$15,000,000	$15,000,000	No
Iowa^	$15,000,000	N/A	
Kansas	$4,500,000	$50,000,000	No
Kentucky	$15,000,000	$15,000,000	No
Louisiana	$15,000,000	$15,000,000 (7)	No
Maine	$4,500,000	Listed with NAIC	No
		International Insurers	
		Department (9)	
Maryland^	$15,000,000	N/A	No
Massachusetts	$20,000,000	$20,000,000	Yes
Michigan	$7,500,000	$15,000,000 (8)	Yes (4)
Minnesota^	$15,000,000	$15,000,000	No
Mississippi	$15,000,000	(7)	No
		5,400,000 (2)	
Missouri	$15,000,000	$15,000,000	Yes
Montana^	$15,000,000	$15,000,000	Yes

State	Domestic Company	Alien Company	Pending
Nebraska^	$15,000,000	(7)	No
Nevada	$15,000,000	$5,400,000 /	Yes
		100,000,000 (3)	
New Hampshire	$15,000,000	N/A	No
New Jersey	$15,000,000	$15,000,000 (5)	N/A
New Mexico	15,000,000 (4)	$15,000,000 (4)	N/A
New York	$46,000,000	(9)	No
North Carolina^	$15,000,000	$15,000,000 (10)	No
North Dakota	$15,000,000	$15,000,000	No
Ohio^	$5,000,000	$15,000,000	No
Oklahoma	$15,000,000	$15,000,000	No
Oregon	$5,000,000	15,000,000 /	No (5)
		$5,400,000 (2)	
Pennsylvania	$15,000,000/	(7)	No
	$4,500,000		
Puerto Rico^	$300,000 /	$300,000 /	No
	$1,000,000	$1,000,000	
Rhode Island	$15,000,000	$15,000,000	No
South Carolina	$15,000,000	(8)	No
South Dakota	$500,000	$500,000	No
Tennessee^	$15,000,000	Listed with NAIC	No
		International Insurers	
		Department	
Texas^	$15,000,000	(7)	No
Utah	$2,500,000 (1)	$15,000,000	No
Vermont	$15,000,000	$15,000,000	No
Virginia	$1,000,000/	Deemed Approval (6)	No
	$3,000,000		
Washington	$15,000,000	(8)	No
West Virginia	$15,000,000	(11)	No
Wisconsin^	N/A	N/A	No
Wyoming	$15,000,000	(7)	No

^ Indicates state's response is carried over from the August 2015 report. These states have not responded as of August 5, 2016.
(1) Trust Fund
(2) In addition, alien carriers required to maintain $5.4 million trust fund in the United States.
(3) Lloyd's
(4) Due to Dodd-Frank
(5) This law became effective January 1, 2012.
(6) Insurers appearing on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC deemed approved in Virginia.
(7) Alien company must be listed on the Quarterly Listing of Alien Insurers maintained by the International Insurance Department of the NAIC.
(8) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes.
(9) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes. As of January 1, 2013, new alien insurers require $45 million.
(10) For those alien surplus lines carries that have applied and been approved for registration in North Carolina. Additionally, those insurers listed on the NAIC Quarterly Listing of Alien Insurers are deemed eligible in North Carolina.
(11) Listed with NAIC WVA Code 33-12C-5(d)(3)
(12) Listed with NAIC GA Code O.G.C.A. 33-5-25(b)(1)
Source: A.M. Best data and research, as of August 5, 2016

Appendix D

State Survey: Stamping Office & Multi State Taxation

State	Stamping Office	Premium Tax	Stamping Fee
Alabama	No	6.00%	No
Alaska	No	2.70%	1.00%
Arizona	Yes	3.00%	0.20%
Arkansas	No	4.00%	No
California	Yes	3.00%	0.20%
Colorado	No	3.00%	No
Connecticut	No	4.00%	No
Delaware^	No	3.00%	No
District of Columbia	No	2.00%	No
Florida	Yes	5.00%	0.15%
Georgia	No	4.00%	No
Hawaii^	No	4.68%	No
Idaho	Yes	1.50%	0.50%
Illinois	Yes	3.50%	0.00%
Indiana	No	2.50%	No
Iowa^	No	1.00%	No
Kansas	No	6.00%	No
Kentucky	No	3.00%	No
Louisiana	No	4.85%	No
Maine	No	3.00%	No
Maryland^	No	3.00%	No
Massachusetts	No	4.00%	No
Michigan*	No	2.00%	No
Minnesota^	Yes	3.00%	0.06%
Mississippi	Yes	4.00%	0.25%
Missouri	No	5.00%	No
Montana	No	2.75%	0.00%
Nebraska^	No	3% (1)	No
Nevada	Yes	3.50%	0.40%
New Hampshire	No	3.00%	No
New Jersey	No	5.00%	No
New Mexico	No	3.00%	N/A
New York	Yes	3.60%	0.18%
North Carolina^	No	5.00%	No
North Dakota	No	1.75%	No
Ohio^	No	5.00%	No
Oklahoma	No	6.00%	No
Oregon	Yes	2.3% (2)	$15.00
Pennsylvania	Yes	3.00%	$25.00
Puerto Rico^	No	9.00%	No
Rhode Island	No	2.00%	No
South Carolina	No	4.00%	No
South Dakota	No	2.5% - 3.0%	No
Tennessee^	No	5.00%	No
Texas	Yes	4.85%	0.15%
Utah	Yes	4.25%	0.25%
Vermont	No	3.00%	No
Virginia	No	2.25%	No
Washington	Yes	2.00%	0.10%
West Virginia	No	4.55%	No
Wisconsin^	No	3.00%	No
Wyoming	No	3.00%	No

^ Indicates response is carried over from August 2015. These states have not responded as of August 5, 2016.
(1) Tax payable is the sum of 3% on portion of gross premiums allocated to Nebraska plus other state's applicable tax rates applicable on the portion of the premiums allocated to other states.
(2) This amount includes .3% collected for Oregon Fire Marshalls' office.
* In Michigan, a 0.5% regulatory fee applies in addition to the premium tax.

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SPECIAL REPORT

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2018 July 15–18
Indian Wells, California
Hyatt Regency Indian Wells Resort & Spa

2020 July 19–22
Orlando, Florida
Walt Disney World Swan Hotel

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The Publications Committee is looking for members to write articles for the quarterly Examiner magazine. Authors will receive six Continuing Regulatory Credits (CRE) for each technical article selected for publication.

Interested authors should contact the Publications Committee Chair, **Tian Xiao**, via **sofe@sofe.org**.

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