

California Surplus Lines Are Now A Bigger Chunk of the Commercial Market

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The phrase “new normal” might be a cliché, but it was too hard for Ben McKay, executive director of the Surplus Lines Association of California, to avoid using when describing the state’s excess and surplus market in 2016 and going forward. Surplus lines has become a larger and larger part of the state’s commercial insurance market over the past eight years, and then last year it seemed to reach an equilibrium of sorts. “What I think we saw in 2016 was more of a normalization of the market,” McKay said. “We had several years where we were growing by leaps and bounds.” Since 2008 surplus lines in California has more than doubled its share of the commercial market. Surplus lines in 2007 accounted for around 7 percent of the commercial market in the state, and it’s now hovering around 15 percent, according to SLA figures. McKay credits that growth to the financial crisis and the zero-interest rate environment following the Great Recession, during which admitted carriers were forced to make their profits on underwriting instead of on investments. Because admitted insurers had to be so disciplined in underwriting, they couldn’t go after risks they didn’t typically write, thereby channeling more customers into the surplus market, he said. The graphic below, based on SLA data, shows the percentage of export list coverages in the California market. Top 10 Export Coverages by Premium 2016 Commercial

Coverage	Total Premium	Percentage
DIC/Standalone Earthquake	\$560.9 million	33.0%
Individual Insureds with Large Schedules	\$289.9 million	17.1%
Excess Liability Where All or Part of the Underlying is Non-admitted	\$261.7 million	15.4%
Environmental Impairment Remediation/Pollution Liability	\$162.2 million	9.5%
Employment Practices Liability	\$143.7 million	8.5%
Contractors Engaged in Building of New Tract Homes/Condos	\$58.2 million	3.4%
Products/Completed Operations	\$44.2 million	2.6%
Event Cancellation	\$40.3 million	2.4%
High Limits Disability	\$32.4 million	1.9%
Products Recall	\$31.4 million	1.8%
Other	\$73.7 million	4.3%

“We had this big period of growth largely on the interest rate,” McKay said. The growth in surplus lines hasn’t receded, but it has leveled off to be more in line with growth in the commercial lines market, he said. The surplus

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market grew from roughly \$6.18 billion in premiums a year earlier to about \$6.33 billion in 2016, according to the SLA. “It’s a more pedestrian growth rate and more in line with the admitted market,” he said. “This is the new normal for our industry.” The new normal may be a good place to be. The growth over the past eight years has left surplus lines in what seems to be a better spot. “It means that we’re a bigger player now in the commercial insurance marketplace,” McKay said. On the back of that growth, some of those who offer surplus lines products have started to express interest in getting some of these products on the state’s export list. During the annual California Department of Insurance administrative hearing in December, several surplus lines brokers expressed interest in testifying about what should and shouldn’t be on the list. The list exempts retail agents and brokers from having to first search for a coverage in the admitted market and then file a “Diligent Search Report” (SL2) to show they searched for an admitted carrier and they received three declinations before going into the surplus lines market. In fact, premium and transactions for export coverage are up in most categories since 2012. One big area of growth in surplus lines is cyber. “We’re starting to see cyber policies,” McKay said, adding that there were about 6,700 cyber policies in surplus lines introduced last year. “That’s a new product coming to market. My expectation is that will continue to grow.” McKay acknowledged there are myriad cyber policies available in the admitted market. “But there are so many different types of cyber (coverage) that customers want that we’re going to continue to see a rise in the coverage code,” he said. “That’s a reason that people continue to advocate for it to be added to the export list.” The list of cyber coverages needed in this developing market is extensive and may continue to expand: making the customer whole; regulatory requirements; hiring a public relations firm; modifying computer systems; forensics; and a whole lot more. “It means a lot of different things to a lot of different people and I think that’s been the challenge in getting it added to the list,” he said. “We’re doing everything we can to improve the odds of it being added.” The SLA and several wholesalers have been interested in getting a number of stand-alone cyber products added to the export list, but to do that they must first show the CDI there’s enough of a demand for such products. This is why the SLA is focusing its resources into compiling data to show the demand is there. “We’re going to start tracking the discrete types of cyber,” McKay said. He expects that in 2017 not only will there be a big focus on cyber, but we’ll see a big push for private flood in the surplus lines market. “There’s a lot of, I think, capacity in the surplus lines market to help depopulate the National Flood Insurance Program,” he said. “The capacity’s there if the federal government wants to lay off that risk. It’s my sense that our marketplace, we could handle that risk.” The NFIP has been a big hurdle for carriers interested in offering the private flood insurance, but the \$23 billion in debt amassed by the program is cause to believe that this year will see a revival of a version of the Flood Insurance Market Parity and Modernization Act (H.R. 2901), which failed to pass last year. “I think we’re going to

see that materialize this year,” McKay said. It’s not just McKay saying that. Brady Kelley, executive director of the National Association of Professional Surplus Lines Offices, talked about a new private flood insurance bill earlier this month during an annual conference held by the California Insurance Wholesalers Association. “We have another opportunity I think to get this bill reintroduced,” Kelley told the audience at the CIWA conference. McKay believes the bill would give a big boost to the private flood market as well as generate innovation and calls to put more private flood products on California’s export list. “If that bill passes, then I think you will see a real increase in surplus lines private flood business,” he said. “There’s no reason it shouldn’t.”