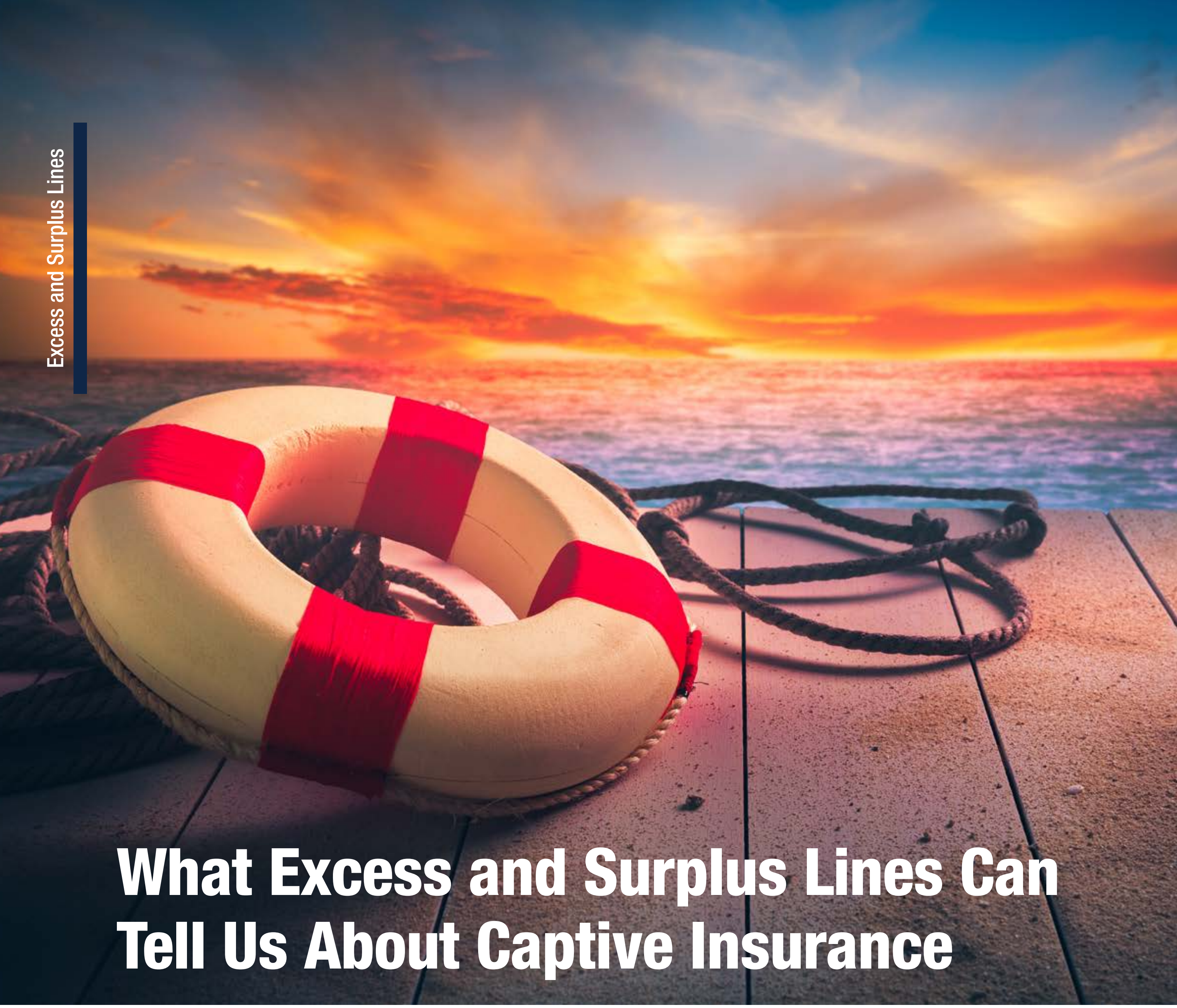


# What Excess and Surplus Lines Can Tell Us About Captive Insurance

Both have provided financial lifelines for organizations needing coverage that otherwise would have been unavailable or unaffordable.

By Robert Walling

It's a hardening market for many coverages, including property, umbrella, medical professional liability, homeowners, cyber liability, directors and officers liability and many more.

In past markets with similar conditions, the insurance industry has responded with innovations, finding structural ways of meeting demand for unavailable or unaffordable coverage. Captives, risk pools, risk retention groups, and excess and surplus lines—or E&S—insurers are great examples of innovations that have acted as financial lifelines for organizations needing coverage in historically analogous markets.

Recent data shows that, increasingly, organizations are looking to captive insurance and E&S markets, indicated by increases in premiums written over the course of the past few years.

Closer examination of E&S premium growth and loss data offers insights into this market. Because E&S insurers are subject to the same financial reporting requirements as admitted markets, we can get a clear

*Best's Review* contributor **Robert Walling**, FCAS, MAAA, CERA, is principal and consulting actuary at Pinnacle Actuarial Resources. He can be reached at *rwalling@pinnacleactuaries.com.*

view into the operating results of E&S solutions. But E&S data also shows us very interesting and helpful information about cost, loss and availability trends in the captive insurance space—compelling conclusions worth a deeper dive.

One major regulatory requirement that admitted carriers and E&S insurers share is the completion of an annual financial statement that complies with the requirements of the National Association of Insurance Commissioners. The required format of the annual statement allows comparison of insurers on an apples-to-apples accounting basis. So, what can we learn by diving into the financial statements of the E&S market, and what is the relationship to trends in captive insurance?

E&S data highlights, amplifies and, in some sense, helps explain the market conditions captives face.

### Table 1 – Excess and Surplus Lines Annual Earned Premium Growth by Line of Business

| | | Annual Earned Premium Growth | |
|---|---|---|---|
| Line of Business or Group | 2021 Earned Premium | 3 Year Avg. | 10 Year Avg. |
| Tot All Lines | 55,408,776 | 19.1% | 8.8% |
| Other Liab (Occurrence) | 16,727,442 | 16.4% | 10.4% |
| Other Liab (Claims-made) | 10,756,309 | 21.5% | 10.0% |
| Fire & Allied Lines | 12,504,581 | 25.6% | 6.4% |
| Commercial Multiple Peril (Total) | 3,833,539 | 15.2% | 8.0% |
| Medical Professional Liability | 2,542,793 | 13.3% | 5.4% |
| Commercial Auto Liability | 2,413,133 | 23.9% | 17.6% |
| Earthquake | 1,944,178 | 47.4% | 4.7% |
| Products Liab | 1,880,497 | 11.7% | 6.4% |
| Inland Marine | 1,648,390 | 15.9% | 10.1% |
| Homeowners Mult Peril | 1,369,175 | 12.1% | 10.4% |
| Comm Auto Phys Damage | 594,016 | 25.1% | 14.5% |
| Private Flood | 320,399 | 59.8% | |
| Ocean Marine | 101,422 | 44.0% | 2.0% |
| Accident & Health Lines | 119,898 | 50.5% | 11.7% |
| Burglary & Theft | 69,526 | 36.6% | 13.9% |
| Fidelity and Surety Lines | 55,755 | 28.0% | 6.3% |
| Warranty | 13,155 | 62.3% | -0.2% |
| Farmowners Mult Peril | 12,124 | 50.4% | 12.1% |

Source: Pinnacle analysis of AM Best Statement data.

E&S carriers demonstrate many of the same characteristics of captive insurance companies. There are a number of strategic benefits and considerations that are not easy to dismiss. These include:

- Larger market share in coverages and industries with affordability and availability issues.
- Increased premium growth during hardening markets.
- Greater premium growth in smaller insurance companies.
- Some low frequency-high severity coverages with very low loss ratios in most years and periodic spikes due to catastrophic claims events.
- Lower loss ratios and increased loss ratio volatility in low frequency-high severity coverages.
- Even lower loss ratios and more loss ratio volatility exhibited by smaller insurers.

Ultimately, those dimensions are necessary for both the E&S and captive markets to help solve insurance challenges beyond the limitations of the admitted insurance market.

### What the Data Shows

E&S insurers, captives and risk retention groups are all mechanisms to address availability and affordability concerns in the admitted market. We would reasonably expect E&S premium growth would focus on lines dealing with these types of concerns. If we examine current direct earned premium and annual growth patterns for E&S insurers in Table 1, several results stand out:

- Premium growth in the E&S market overall has accelerated dramatically in the past three years, 2018-21, compared to the past decade.
- Numerous lines that typically face lower claim frequency and higher claim severity—such as liability using a claims-made form, fire and allied lines, earthquake, flood, ocean marine, warranty, farmowners—have experienced higher- than-average premium growth.
- Lines with extensive captive and/or risk retention group presence—for example, medical professional, workers' compensation—don't exhibit as large a percentage growth.
- Lines facing significant market distress—most

notably commercial auto liability, fire and allied lines in wind-prone and fire-prone areas—are showing significant premium growth.

In the captive and risk retention group markets, smaller insurance companies have seen substantial growth. The same is true of E&S carriers. AM Best assigns size groups based on capitalization. In Table 2, one can see the premiums for smaller E&S insurers are growing faster, often much more so than the overall E&S market.

For many captives providing insurance for low frequency and high severity coverages, loss ratios are often quite low but periodically experience high spikes in a given catastrophic year. Do E&S carriers writing these types of coverages experience the same phenomenon? Yes, absolutely.

Table 3 shows calendar year loss and defense and cost containment expense, or DCCE, ratios for the E&S insurance industry in total. Across all E&S insurers, loss ratios for these coverages are typically very low as a percentage of earned premium. There are even some cases in which case reserve reductions exceed paid losses and result in negative loss ratios in a year. The private flood and fidelity lines of coverage exhibit the loss ratio spikes one might periodically expect from a line of coverage with low frequency and high severity, while earthquake coverage has not had a year with significant loss activity in over a decade.

### E&S Versus Smaller Companies

Another phenomenon in the captive insurance industry that can be instructively compared to E&S loss experience is that smaller insurance companies often exhibit lower average loss ratios and more loss variability than larger ones.

Table 4 compares calendar year loss ratios for all E&S insurers to the subset of smaller insurers across all lines and for selected lines. For all lines combined, the loss ratios for 2012 through 2019 were significantly lower for E&S insurers in AM Best size groups VIII—$100 million to $250 million—and smaller. Smaller insurers also demonstrated more loss ratio variability across all lines and years.

The difference is even more pronounced for other liability claims-made coverage. The lower loss ratios and greater volatility in this line are notable as the claims-made form is often used for industries and coverages with claim severity or frequency that is too volatile for occurrence coverage.

E&S insurers writing homeowners and allied lines, that is, property coverage other than fire—such as wind and water—face relatively low frequency and very high severity as excess and surplus lines markets for these coverages

### Table 2 – Excess and Surplus Lines Premium Growth by 2021 Insurer Surplus Size

| AM Best Size Group (Current Surplus) | Earned Premium Growth 3 Year Avg. |
|---|---|
| XV ($2 Billion or greater) | 17.1% |
| XIV ($1.5 Billion to $2 Billion) | 25.8% |
| XIII ($1.25 Billion to $1.5 Billion) | 16.1% |
| XII ($1 Billion to $1.25 Billion) | 36.8% |
| XI ($750 Million to $1 Billion) | 44.1% |
| X ($500 Million to $750 Million) | 18.2% |
| IX ($250 Million to $500 Million) | 41.0% |
| VIII ($100 Million to $250 Million) | 34.6% |
| VII ($50 Million to $100 Million) | 38.6% |
| VI ($25 Million to $50 Million) | 21.4% |
| V ($10 Million to $25 Million) | 302.5% |
| **Total - All Sizes** | **19.1%** |

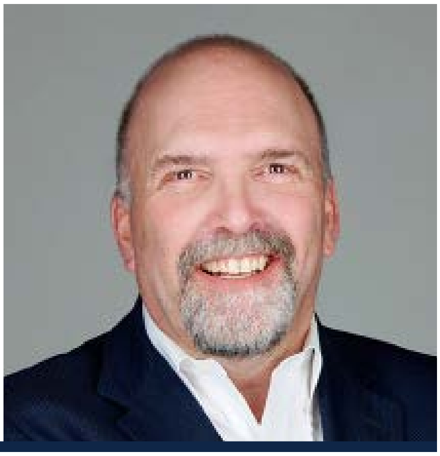
Source: Pinnacle analysis of AM Best Statement data.

### Table 3 – Excess and Surplus Lines Gross Loss and DCCE Ratios for Low Frequency-High Severity Lines of Business

| | Calendar Year Loss Ratio by Line | | | | |
|---|---|---|---|---|---|
| Calendar Year | Earthquake | Private Flood | Fidelity | Surety | Boiler & Machinery |
| 2021 | 0.8% | 38.8% | 46.4% | 87.1% | 25.0% |
| 2020 | 3.0% | 17.2% | 5.3% | 85.4% | 46.3% |
| 2019 | 2.9% | 19.4% | 21.2% | 41.9% | 32.1% |
| 2018 | 8.7% | 14.2% | 182.5% | -11.5% | 14.8% |
| 2017 | 3.0% | 204.3% | -63.6% | 2.8% | 26.4% |
| 2016 | -0.3% | 71.7% | 28.8% | 4.3% | 31.2% |
| 2015 | -1.2% | | 52.3% | 20.0% | 16.7% |
| 2014 | 0.6% | | 22.3% | 8.0% | 22.5% |
| 2013 | -8.6% | | 31.9% | 20.3% | 11.9% |
| 2012 | -3.6% | | 45.5% | 40.9% | 9.7% |
| **Total** | **0.6%** | **43.9%** | **40.7%** | **38.5%** | **23.0%** |

Source: Pinnacle analysis of AM Best Statement data.

> “E&S data highlights, amplifies and, in some sense, helps explain the market conditions captives face.”
>
> **Robert Walling**
> Pinnacle Actuarial Resources



are mainly needed in geographic areas with catastrophic loss exposures, such as wildfires and hurricanes. Consequently, the loss and DCCE ratios for both coverages demonstrate two common characteristics of low frequency-high severity lines by size of insurer.

First, smaller insurers have lower loss ratios from 2012-19 and more variability in their aggregate loss ratios. Second, when catastrophic claims do arise—for example, in 2020 and 2021—the small insurers experience even higher loss ratios than the market overall. In each of those lines and years, the loss ratios for the small insurers are between 105% and 193%. As much collective volatility as smaller E&S insurers seem to have, it is even more pronounced when broken down by individual insurance companies.

Table 5 indicates loss and DCCE ratio experience for individual E&S insurers in AM Best size group VII or smaller. As you can see, the loss

## Table 4 – Excess and Surplus Lines Gross Loss and DCCE Ratios by Line of Business and Surplus Size

Calendar Year Loss Ratio by Line and Surplus Size

| | All Lines | | Other Liability (Claims-Made) | | Allied Lines | | Homeowners | |
|---|---|---|---|---|---|---|---|---|
| Calendar Year | Total | <$250M | Total | <$250M | Total | <$250M | Total | <$250M |
| 2021 | 70.1% | 93.3% | 65.8% | 49.4% | 87.2% | 160.9% | 70.5% | 192.7% |
| 2020 | 76.5% | 79.6% | 74.1% | 45.4% | 107.0% | 105.2% | 91.4% | 138.9% |
| 2019 | 69.3% | 58.9% | 71.6% | 74.7% | 66.8% | 54.3% | 58.4% | 63.4% |
| 2018 | 75.9% | 63.3% | 65.0% | 43.9% | 92.5% | 46.8% | 130.8% | 55.5% |
| 2017 | 80.8% | 71.7% | 67.4% | 38.5% | 196.0% | 50.5% | 89.6% | 81.5% |
| 2016 | 64.2% | 49.0% | 65.8% | 43.7% | 64.8% | 38.6% | 39.5% | 36.4% |
| 2015 | 56.0% | 37.9% | 65.4% | 29.3% | 33.0% | 37.6% | 36.5% | 26.0% |
| 2014 | 54.6% | 37.0% | 68.8% | 43.4% | 36.5% | 23.7% | 29.2% | 22.5% |
| 2013 | 52.8% | 37.7% | 67.5% | 31.6% | 40.9% | 15.3% | 22.1% | 25.6% |
| 2012 | 69.6% | 40.1% | 83.7% | 42.0% | 124.8% | 14.9% | 54.0% | 32.5% |
| 2012-19 | 65.6% | 53.8% | 67.4% | 46.8% | 74.9% | 46.6% | 62.6% | 45.7% |
| **Total** | **68.0%** | **69.0%** | **69.1%** | **48.2%** | **84.8%** | **98.8%** | **67.1%** | **79.3%** |

Source: Pinnacle analysis of AM Best Statement data.

## Table 5 – Excess and Surplus Lines Gross Loss and DCCE Ratios by Line of Business for Selected Small Carriers

| Insurance Company | Line of Business | AM Best Size | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| NAMIC Ins. Co. | Other Liability (C-M) | VI ($25M to $50M) | 13.6% | 20.3% | 148.6% | 13.3% | 55.5% | -14.1% | 31.4% | 38.8% | 19.1% | 63.2% | 38.6% |
| Prime Ins. Co. | Other Liability (C-M) | VIII ($100M to $250M) | 38.6% | 29.5% | 28.1% | 20.9% | 27.5% | 0.3% | 28.3% | 46.6% | 41.9% | 22.3% | 29.3% |
| American Summit Ins. Co. | Fire & Allied Lines | VIII ($100M to $250M) | 46.0% | 318.8% | 26.7% | -1.4% | 18.7% | 2.8% | 34.8% | 21.9% | 17.6% | 88.1% | 48.7% |
| GeoVera Specialty Ins. Co. | Fire & Allied Lines | VIII ($100M to $250M) | 81.9% | 39.7% | 6.8% | 34.4% | 0.1% | 13.5% | 24.7% | 6.7% | -3.5% | 0.0% | 31.0% |
| Golden Bear Ins. Co. | Fire & Allied Lines | VIII ($100M to $250M) | 58.1% | 0.4% | 0.2% | 0.0% | 0.3% | -0.1% | 0.2% | 0.0% | 0.0% | 0.0% | 16.1% |
| Hallmark Specialty Ins. Co. | Fire & Allied Lines | VIII ($100M to $250M) | 61.7% | 93.0% | 42.6% | 1.6% | 79.7% | 0.3% | 45.3% | 88.3% | 77.8% | 53.7% | 60.5% |
| National Security Fire & Cas. | Fire & Allied Lines | VI ($25M to $50M) | 522.8% | 204.5% | 30.8% | -0.1% | -2.3% | -1.1% | 18.4% | 21.5% | 50.7% | 93.0% | 70.9% |
| Prime Ins. Co. | Fire & Allied Lines | VIII ($100M to $250M) | 4.9% | 25.4% | 1.4% | 1.2% | -3.1% | 58.7% | -27.7% | 57.8% | 52.6% | 179.6% | 26.8% |

Source: Pinnacle analysis of AM Best Statement data.

ratios are generally lower and more volatile than the group's overall results. For example, Golden Bear Insurance Co. has loss ratios of less than 1% in eight of the past 10 years.

E&S data tells a very insightful story, with a very instructive conclusion. Excess and surplus lines carriers are an important solution for insureds facing challenges with coverage affordability or availability. We may look to E&S as a very viable alternative, one that has seen and will likely continue to see growth—considering the conditions of the market. BR

# When Traditional Insurance Is Unavailable or Unaffordable, There Are Options

The traditional, or admitted, U.S. insurance market is largely a competitive environment in which admitted carriers develop rates, rating rules and forms and compete with other insurers to write business. In the U.S., an admitted insurance company has been "licensed to do business in the state … in which the insured exposure is located," according to the International Risk Management Institute Inc.

However, there are some risks for which the price the insured is willing to pay does not equal the premium the insurer will accept. That failure to agree on price results in coverage becoming unavailable or unaffordable. To address such situations, there are several solutions, including:

**Captive insurance:** In broad strokes, captives are insurance companies formed by one or more insureds, or related parties, for the primary purpose of meeting the unique risk management, coverage and financing needs of the insureds. But captives are not just an effective enterprise risk management tool; they also allow the captive owner to benefit in the insurance company's operating profits.

**Risk retention groups**: RRGs were created by the federal Risk Retention Act of 1981—revised in 1986—which authorized these vehicles to underwrite all types of liability other than workers' compensation. RRGs are better able to provide coverage in markets suffering from affordability or availability issues, partly because they are exempt from state insurance licensing and rate regulation. RRGs must be owned by their insureds, and most are formed as a special type of captive insurance company and regulated in a similar manner.

**Excess and surplus lines**: E&S insurance is defined as "[i]nsurance with an insurer that is not licensed to transact business within the state where the risk is located," according to Black's Law Dictionary. So E&S insurers also are known as nonadmitted. Although E&S insurers are not licensed to conduct business in a given state, many domiciles maintain "whitelists" of eligible excess and surplus lines companies; others keep "blacklists" of companies that are not eligible to do business. Another key element of E&S regulation is that domiciles closely regulate the brokers and agents authorized to conduct business in the market. Some domiciles also require evidence that prospective insureds attempted to obtain coverage in the admitted market before pursuing E&S coverage.

### Excess and Surplus Lines Insurer 2021 Written Premium by Line of Business

| Annual Statement Line of Business | Percentage of Total 2021 E&S Written Premium |
|---|---|
| Other Liab (Occurrence) | 30.7% |
| Other Liab (Claims-made) | 23.2% |
| Fire | 9.5% |
| Allied Lines | 8.2% |
| Comm Mult Peril(Non-Liability) | 4.7% |
| Other Comm Auto Liab | 4.2% |
| Medical Professional Liability | 4.0% |

Source: Pinnacle analysis of AM Best Statement data.

In 2020, E&S insurance premiums made up 9.1% of the total U.S. property and casualty market, according to the National Association of Insurance Commissioners. While E&S carriers can insure any P/C coverage that cannot be placed with an admitted insurer in that domicile, other liability coverages constitute the majority of E&S premium, shown in the table on E&S lines based on written premium by line of business.

Notable is the relatively lower share of medical professional liability and commercial auto liability E&S premium. This is very likely due to the role that RRGs and captive insurance companies play in providing coverage availability and affordability to those lines of insurance.

The E&S market has inherent advantages that enable them to serve industries, coverages and insureds that the admitted market was not willing or able to. The most notable differences are that E&S insurers are not as bound by rate and coverage form regulations as admitted carriers. Most E&S risks require more flexibility in coverage and/or premium determination than are commonly available in the admitted market. On the other hand, E&S insurers do not have access to state guaranty funds.