The Infringement of Standard Markets on the Excess & Surplus Market: Industry Concerns and the Impact on the Wholesaler

By

Hannah G. Lanier

Senior

Appalachian State University

Dr. David Wood, CPCU, CRM

BRANTLEY RISK & INSURANCE CENTER

APPALACHIAN STATE UNIVERSITY

The Infringement of Standard Markets on the Excess and Surplus Market

I. Introduction

To many insurance industry professionals, the functions of standard markets and excess and surplus markets can easily be differentiated. Whereas the standard market is licensed by the state and must abide by rate and form regulations, the excess and surplus industry has freedom of rate and form. Not being licensed, the E&S market can insure policies that consist of high and unique risks that the standard market would typically reject (Johnson). However, historically standard line companies will occasionally place high risk policies that would not usually be written in the standard market, taking business away from the E&S market. With the development of new and emerging risks and more insurers entering the market, this infringement continues to expand. The excess and surplus lines industry was developed to supply coverage for policyholders who had unique or high risks. With the growing phenomenon of standard markets insuring these types of risk, there is curiosity within the industry about the variety of possible positive or negative impacts that the E&S market could face.

II. Standard Markets Insuring High Risks --- Why?

Market cycles play a substantial role in the operation of property and casualty insurance markets and can heavily impact business results. Currently, the industry is working in a soft market, which comes with challenges. With market prices currently being low, insurance carriers are forced to lower rates to meet customer demand (Shroyer). There is also greater market competition, decreasing costs of reinsurance, and deteriorating underwriting results. Typically during a soft market, the insurance industry will make necessary alterations to drive business; whether that is to lower rates, offer different products, or to change the appetite of the company. With the market being soft, standard line carriers are also willing to relax their underwriting styles and take on higher risks to increase profit (Hunt). Standard markets are able to offer these high risk policies at a lower price than E&S carriers, making the standard company the obvious choice for a consumer (Behymer).

Chris Behymer, Director of Business Development at Markel Corporation, discusses the reasoning behind the infringement of standard line companies on the E&S market, and makes a direct correlation between the market cycle and the infringement. Behymer has been working in the industry for over 39 years and states that throughout his career the standard market has always infringed on the E&S market. He blatantly suggests that when standard line companies have the opportunity and capital to increase revenue by taking on higher risks, they do so. However, since they are required to abide by rate and form regulations, when high risk accounts begin to experience loss, underwriters are unable to make any adjustments to the policy. Consequently, the company ends up losing money on high risk accounts because rates were insufficient to cover the losses. Standard markets are then forced to backtrack and impose stricter underwriting guidelines to avoid similar losses, and the business eventually goes back to the E&S market. When discussing this cycle Behymer recalls, “I’ve had accounts come back two or three times because of this.” (Behymer).

Catastrophic events also have significant impacts on the behaviors of insurance companies. In property and casualty insurance, a catastrophe can be defined as “a natural or man-made disaster that is unusually severe" (Catastrophes). The last major catastrophe that affected the United States was Hurricane Katrina in 2005. There has not been an event with equal or greater devastation or financial loss in over ten years, which has allowed the insurance industry to relax underwriting guidelines (Catastrophes). Therefore, standard carriers are more willing to write coverage for high-risk coastal properties, due to the recent history of hurricane damage being so minimal. Accounts that would usually be classified as "high-risk" and rejected by standard line companies are now being insured with little hesitation.

III. Cyber Risk --- Example of Infringement

With technology being so prominent in our society, there is cyber risk all around us. However, individuals and organizations often do very little to protect important data, increasing the risk significantly more. Even when measures are taken to avoid cyber risk, there is always a chance of a breach in data that can cause massive harm (Olsen). Cyber risk is becoming more and more prevalent as each day goes on and with the threat of substantial losses it is surprising that standard line companies are willing to provide coverage. Being in a soft market, the standard line industry is using the increasing need for cyber coverage as an opportunity to build a new line of business, earning additional revenue.

Unlike most types of insurance within the standard market, there is no specific form in the industry which underwrites cyber coverage. Therefore, there is more freedom for consumer negotiation in terms of cyber policies than other insurance coverages. This can increase the risk of the policy for the insurer, but since cyber coverage is still fairly new, standard line companies do not mind writing the policies. Standard line companies are pricing cyber policies at low rates, making the coverage a popular buy for consumers. However, with so many policies issued and so much risk for cyber breaches and other types data hacks, the companies are bound to experience some heavy losses (Olsen).

Data breach incidents continue to grow and other cyber risks are gaining more publicity as more individuals and companies suffer losses, some detrimental to the business. Masses of information are still unknown about cyber insurance, which makes it an even riskier coverage for standard markets to insure. Jake Kouns, Director of Cyber Security and Technology Risks Underwriting for Markel Corporation, declares "Everywhere you look there's some new issue [with cyber insurance]. That's an emerging risk" (Aschkenasy). Kouns discusses the difficulty of deciphering exactly what cyber policies cover, especially in relation with data breach coverage. He says that there is a long way to go in truly understanding all of the unique risks when dealing with cyber exposure (Aschkenasy). However, there is no confusion that cyber risk does impose an increasingly serious threat to organizations, as well as individuals. Along with the growth of data breaches, the demand for cyber coverage will surely increase. With cyber risk being so high, it would only make sense for the E&S market to be the only ones providing the coverage. However, standard markets will most likely continue to infringe on this coverage until experiencing a significant loss.

IV. The Concerns of E&S Industry Professionals

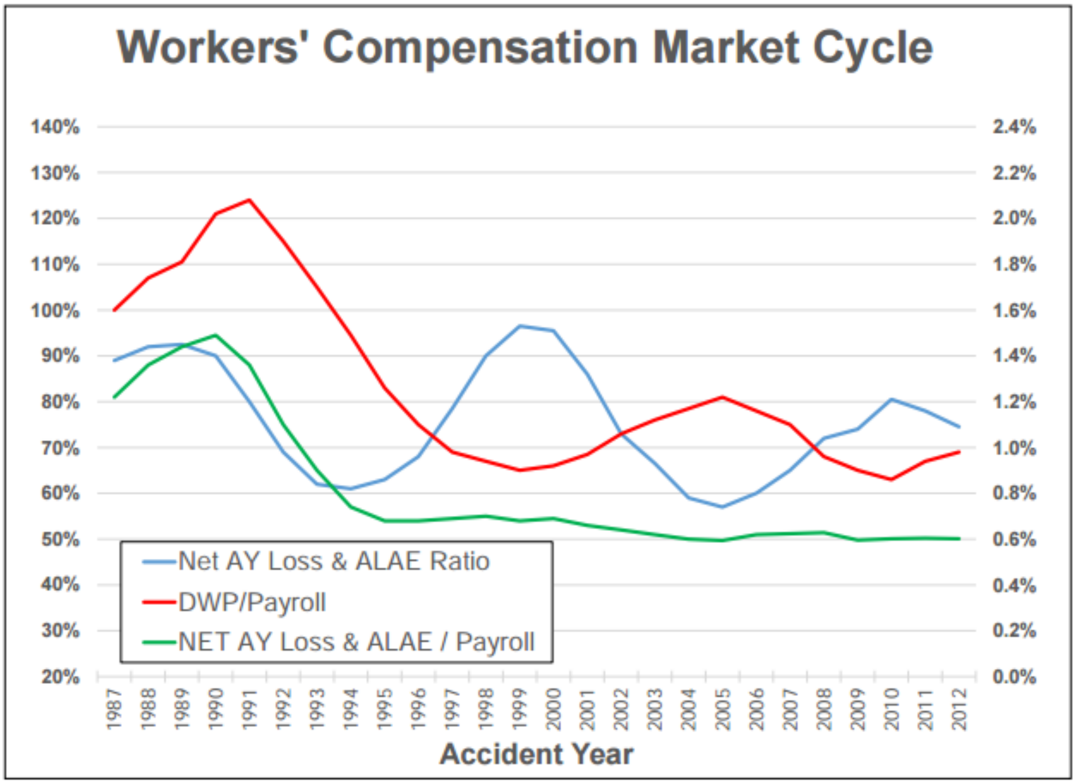
When the standard line markets take on high risk exposures, it does ultimately take business away from the E&S industry. However, financial reports indicate that nonadmitted marketplaces have been able to remain adequately solvent despite this infringement. When discussing this issue with E&S industry professionals, it was evident that the infringement of the standard market served as a nuisance, but has not been detrimental to business.

However, Chris Behymer indicated that Markel and every other E&S company have suffered losses due to the standard market infringing on the E&S market. In particular, Behymer stated that Markel's brokerage property department and larger property risks have been impacted most significantly by the infringement. Behymer discusses how standard line companies set rates so low, that when looked at on a profitability stand point for Markel it makes no sense to drive their own rates down so low to compete. Therefore, once they hit their walkaway price, they are forced to give the business up to the standard line company (Behymer).

Although business is being taken away from the E&S market by the standard market, Behymer makes it clear that this is not a new phenomenon. He states that this has been going on for years, and has not yet imposed a serious threat to the E&S industry as a whole. Behymer has no major concerns about the future stability of his company, or about his position (Behymer). Curtis Anderson, President of the MGA/Binding Division of Risk Placement Services Inc, also has little concern for future of RPS or for his position within the company. He states, "There will always be new, unique exposures and a changing environment for what makes a good or bad risk. The E&S industry is ever evolving and continuing to create new opportunities for people in the business" (Anderson).

V. What can the E&S market do to avoid the risk of standard market infringement?

In an article written by Bret Shroyer titled "What Really Drives Insurance Market Cycles?", Shroyer argues that the industry itself actually determines the market cycles, rather than the cycles determining the structure of the business. He says, "A common misconception about market cycles is they are caused by reactions to changes in loss ratio-- when losses start trending up, the market reacts with higher prices. So when the market overreacts and increases prices too much, it results in very low loss ratios, increased competition, and prices decreasing into a softening market" (Shroyer). However, he points out that a recent Willis Re research study proves the opposite. Rather, the market cycles are led by pricing inefficiency by insurance carriers. In Willis Re's study, a graph illustrates past workers' compensation cycles and the relationship it has between the accident year loss ratios and price. The graph displays that there has been no significant changes in historic loss rates per dollar of payroll in the past 20 years. However, price movement directly drives loss ratios.



Relating Shroyer's idea to the infringement of standard markets on the E&S market, Behymer explained his thoughts of how the E&S industry could avoid this problem. He says, "As an industry, we need to stick to our guns. At a certain point, we need to walk away and say 'alright, you can write that business [in the standard market]'" (Behymer). He is referring to the price wars that standard lines and E&S companies often get into. When standard markets choose to place higher-than-normal risks, they are ultimately going to have lower rates than most E&S carriers and brokers. To obtain or maintain that business, E&S companies will also drive their own prices down. However, Behymer explained that lowering rates too drastically only causes a loss in profitability. As discussed, Markel has a walk-away price limit, and Behymer suggests that all E&S companies should do the same. If E&S companies avoid decreasing their rates in order to match standard line companies, and instead patiently await the return of the business, the market cycle may begin to harden (Behymer).

Curtis Anderson pinpoints that there is extreme value in having open and frequent communication with retail producers about this issue. Educating the retail agents about the importance of writing tough or unique risks in the E&S market, rather than the standard market, can simply avoid the risk of the standard market infringement (Anderson). Anderson and Behymer both agree that the E&S industry has more expertise and knowledge in handling unusual risks than standard line companies. Retail producers and insureds will benefit by placing high or unique risks in the E&S market.

VI. Conclusion

The standard market has always infringed on the business of E&S markets, and will surely continue to do so. However, research and the opinions of industry professionals indicate that although it may create minor short term decreases in E&S revenue, the threat is minimal in the long term. However, the negative impacts of this infringement could be significantly lessened by the E&S market, simply by taking control of their price movements. The E&S market was created to insure high and unique risk exposures and is more equipped to drive innovative solutions for these types of risk than standard line companies. Due to constant emerging risks, the need for the nonadmitted market will continue to be demanded, even if the standard market occasionally does infringe upon E&S business.

Work Cited

Anderson, C. (2016, February 3). Infringement of Standard Markets on E&S Markets [Personal Interview].

Aschkenasy, J. (2014). You Can Go Home Again - Risk & Insurance. Retrieved January 31, 2016, from http://www.riskandinsurance.com/can-go-home/

Behymer, C. (2016, January 29). Infringement of Standard Markets on E&S Markets [Telephone interview].

Catastrophes: Insurance Issues. (2015, December). Retrieved January 31, 2016, from http://www.iii.org/issue-update/catastrophes-insurance-issues

Hunt, Brian. "Sailing in a Soft Market." From the Tower By Tower Hill Insurance. 8 Oct. 2015. Web. 20 Jan. 2016.

Johnson, Denise. "Understanding the Differences Between Standard and Excess/Surplus Lines." Claims Journal News. 31 July 2014. Web. 19 Jan. 2016.

Olsen, Bob. "Cyber Security Is a Lot More Intuitive Than You Think." North Star Group. 19 Jan. 2016. Web. 19 Jan. 2016.

Shroyer, Bret. "What REALLY Drives Insurance Market Cycles." LinkedIn. 6 Jan. 2016. Web. 19 Jan. 2016.