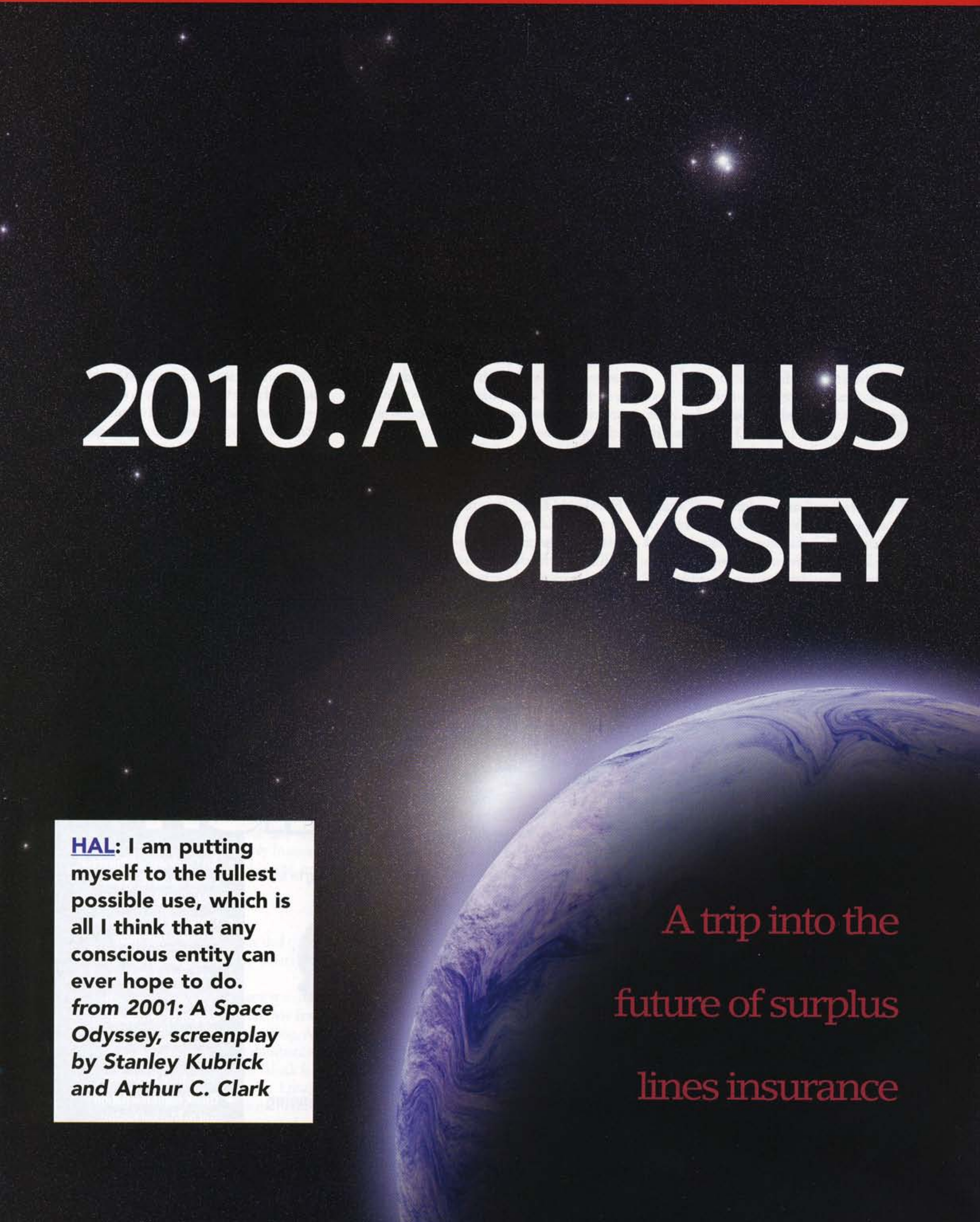
# 2010: A SURPLUS ODYSSEY



**<u>HAL</u>: I am putting myself to the fullest possible use, which is all I think that any conscious entity can ever hope to do.**
***from 2001: A Space Odyssey, screenplay by Stanley Kubrick and Arthur C. Clark***

A trip into the future of surplus lines insurance business. We will continue to see a lot of start-ups," Bouhan added.

Maher observed that the people who depart established wholesale units to start their own operations tend to be well known and have their own accounts that are big enough to anchor a good-sized enterprise. He noted that by 2010, relationships between retailers and wholesalers, whether new or established, will have matured.

Bouhan, Maher and others said they would not be surprised to see more entrepreneurs break loose as firms such as Stewart Smith and Swett & Crawford are sold or rumored to be sold by their big broker owners, Willis and Aon.

The anticipated sales by giant brokers of their wholesale units should lead to more competition among brokers not only for top surplus lines talent but also for their surplus lines accounts, according to industry leaders.

"Each one pretty much had a captive production source," said Don Urbanciz, CEO of Insurance Vianet Inc., which is the holding company for electronic wholesale broker Insurance Noodle. He believes they could lose some accounts to competitors. "Those large wholesalers will have to work harder now that they are independent and they are working in a softening market."

### Change in composition

While the population of surplus brokers might be about the same in five years, its composition could be altered as small local brokers as well as MGAs face several challenges, industry leaders suggest. On the one hand, they will find it increasingly difficult to get carriers to write their business or grant them underwriting authority; on the other, they will find online brokers gaining more of their small premium accounts.

Rick Lindsey, president and CEO of Utah-based Prime Insurance, said the challenges for local brokers are not new but are likely to get tougher in the years ahead. "Back 20 years ago the big insurance companies didn't want to talk about small stuff, so you had to go to smaller companies or Lloyd's to get an underwriter. For brokers, this has gotten worse. The number of companies and Lloyd's syndicates have gone down. They are bigger, but it's harder to get to them," Lindsay said, suggesting this spells opportunity for smaller carriers like Prime to serve wholesalers as this continues.

ELANY's Maher agrees the squeeze will be on smaller brokers, especially those without a market niche. "I wouldn't want to be a smaller wholesaler with a broad range of coverages. Having an expertise in one area would be better."

### Quality the key

The quality of a broker—and of a carrier, too—will be more important than its size by 2010, according to one visionary. Marshall Kath, CEO of Dallas-headquartered Colemont Insurance Brokers, believes brokers will be judged less on size than on their quality, including their financial performance. "I don't see any minimum critical mass but brokers will have to have adequate capital to be able to grow the business," Kath explained. "It won't be as possible to bootstrap an operation as maybe it was in the past."

Quality will also be evident in the companies with which brokers place business, Kath maintained. By 2010, "There will be a further and increased reliance on insurers with strong rating and underwriting. The flight to quality becomes the flight to only quality."

While quality may indeed be the defining force for the future, technology will also play a bigger role in wholesale transactions. By 2010, most observers agreed that retail agents will find more small premium surplus and specialty products have been standardized for electronic handling, although larger surplus accounts will still be handled individually.

Aggregators such as Urbanciz's InsuranceNoodle and Dallas-based online broker Market Scout expect to become bigger players in smaller accounts by continuing to bring together retail agents and insurers via the Web.

By 2010, Urbanciz sees Insurance Noodle aligning with carriers that have a "different vision" of distribution. These will be insurers that may now be tied into MGAs but realize they can save money and reach agencies more effectively nationwide by switching to an online system for their products that

## 2010: A SURPLUS ODYSSEY:
### Carriers, Cycles and Performance Five Years Down the Road

**By Andrew G. Simpson**

Looking ahead to 2010, the easiest prediction is that the fortunes of the surplus lines industry will, as usual, be linked to the behavior of standard lines carriers. The second easiest is that the hard and soft market cycle will still be a defining force, although each leg may not be as extreme or as long as in the recent past.

"This industry is still subject to the same forces and will still suffer the same cycles," noted Daniel Maher, executive director, Excess Lines Association of New York, noting that price competition is now heating up after a few years of strong results.

Most observers do not expect the current softening of the market to be deep or prolonged and by 2010 they see the industry back on solid pricing ground, which should be good news for surplus lines. That's when surplus lines writers regain business lost to standard markets.

"The market is competitive but I don't see us headed the way of the soft market of the late '90s," said David Blades, a property casualty analyst with A.M. Best.

"The industry should be back at the center or in a firm, predictable center," affirmed Marshall Kath, chief executive officer for Colemont Insurance Brokers, based in Dallas, Texas.

### Investment prospects

"We're very bullish on the surplus lines business," said Don Urbanciz, chief executive at Insurance Noodle, the online wholesaler, who captured the attitude of other surplus lines executives. But precisely what shape the industry will be in and where in the hard cycle it will be parked in 2010 will depend on what happens on the investment side for insurers, they agreed.

Colemont's Kath is one who believes that insurers will not be able to make up losses on investments and this will keep them disciplined over the next few years. "We will continue in a lower interest rate environment for the foreseeable future. The effect on carriers will force them to continue to be disciplined in their underwriting," predicted Kath.

Blades of A.M. Best agreed that the investment scene will be key to the financial picture of the industry over the next five years. But Blades, who helps produce the annual surplus lines industry report for the National Association of Surplus Lines Offices, also thinks a "catalytic event" could push the cycle. If there is a major event similar to the 9/11 terrorist attacks, the Northridge earthquake or a hurricane season like 2004, prices could harden faster than

*NARRATOR:* The year is 2010 and Dr. Lois Kwoat, Dr. Heywood Jawrithis and their know-it-all computer companion, Pal 2010, have returned to planet Earth from Recover Space Station a million miles away. They are on a new mission.

*Kwoat:* We all agree that we are no longer interested in wearing funny suits or putting our lives on the line. We need to find a career where we can have fun, dress is normal business attire and make money without getting killed.

*Jawrithis:* I'm all for that. I like being around high-risk adventures as much as the next space cadet but I no longer feel the need to be at the center of the danger. From now on, I'm happy to operate from the outside looking in, or inside looking out, whichever is safer.

*Pal:* Well, Lois and Heywood, given those parameters, our best option is to investigate the surplus lines insurance industry. The best surplus lines professionals go where others fear to tread without actually placing themselves in jeopardy. They can pull profit out of a black hole. Plus they throw the best parties.

*NARRATOR:* Then the surplus lines industry is the way to go, the trio agreed. From the safety of their Hyundai Hummer all-terrain vehicle, they set out to interview industry experts and uncover the ways of the surplus lines insurance industry in the year 2010. First touching down in Kansas City, Mo., home of the National Association of Professional Surplus Lines Offices, they toured East, West, South and North. Here's a summary of their report in the year 2010.

### 2010: SURPLUS LINES EXECUTIVE SUMMARY

*CARRIERS*
The carrier population remains stable. Over the past five years there have been a few mergers, a few new entries and a few failures. But there has been no dramatic change in the number of carriers. A few new entries have sprouted, similar to four and five years ago when now-entrenched James River, Aspen and Wellington were started.

*PRICING*
A hard market challenges surplus lines. Annual rate of surplus lines premium growth is in the single digits. Observers think standard prices could start softening in the year ahead.

*FINANCIALS*
Continued low interest rates and inflation along with intensified rating agency scrutiny have kept all insurers, including surplus lines writers, focused on profitability. The surplus lines industry continues to produce an underwriting profit and a respectable combined ratio of around 93.

*MARKET SHARE*
The flight to size and quality evident in the last decade has kept up with premium growth. The top 25 insurer groups still control 75 to 80 percent of the surplus market. Foreign insurers maintain a healthy U.S. surplus lines market share, although domestic carriers have gained slightly.

*DISTRIBUTION*
The effects of the wholesaler spin-offs by the big brokerage houses five years ago continue to be felt. Broker mergers have slowed but growth of national and regional wholesalers continues. Smaller local wholesalers and MGAs report being squeezed by the carriers, regionals and online brokers.

# 2010: A SURPLUS ODYSSEY

***The Road Ahead for Surplus Lines Wholesalers***

**By Andrew G. Simpson**

The model surplus lines insurance whole of 2010 should be faster, bigger, better, leaner, able to cross state lines and come in colors other than white.

Industry leaders predict that while there might be slightly fewer surplus lines brokers five years from now, new start-ups will offset whatever toll consolidation takes on the numbers. More surplus brokers will be licensed in every state and handle business regionally and nationally. Also, more firms will have female and minority executives.

Brokers who act as managing general agencies will be under the most pressure to survive, along with small, localized excess and surplus lines brokers, according to those close to the business.

Over the last decade, mergers have led to the creation of more national and larger regionalized wholesalers, noted Dick Bouhan, executive director, National Association of Professionl Surplus Lines Offices. AMWINS, CRC and BISYS are just a few of the acronyms the industry has come to know.

Industry executives expect that by 2010 there could be a few more national wholesalers and that regional brokers will have grown. These large national and regional wholesalers should carry a lot of clout in 2010, just as they do now.

"The market is defined by competition among and between major national and regional wholesalers," pointed out Daniel Maher, executive director, Excess Lines Association of New York.

A.M. Best analyst David Blades suggested that broker merger activity, which has been flattened by the soft market, could pick up again by 2010. But nobody envisions merger mania among wholesalers between now and 2010.

### Surplus entrepreneurs

NAPSLO's Bouhan thinks that a few large firms might close a branch office or two but that the brokerage population will remain healthy as individuals seize opportunities created by the consolidation that has already taken place. Despite the mergers of the last decade, NAPSLO's wholesaler membership has remained stable at around 400. Bouhan believes the number will be close to that in the future, thanks to the entrepreneurial spirit of surplus lines brokers.

"At the same time the national wholesalers were being created, people left them and set out on their own to start their own firms," Bouhan said.

"There's always room for someone who can provide the service. It's a very entrepreneurial can be written electronically. "Carriers are listening but saying, 'not quite yet,'" Urbanciz said. But by 2010 he hopes to have them online.

**Insurance exchanges**

MarketScout's Richard Kerr has his own potentially revolutionary vision of what distribution will look like by 2010 (see related story, "The Invasion of the Insurance Exchanges," page N27). Kerr's crystal ball pictures aggregators among a number of so-called insurance exchanges, or teams of individual insurers that provide retail agents with all the markets, including specialty and surplus lines, that they need.

The insurance exchange model could be mixed news for some wholesalers. Kerr thinks retail agents will come to the conclusion that on non-complicated specialty and umbrella products and renewals, the commissions or fees paid to wholesalers may be more than their service on those accounts is worth. The agents could insist that wholesalers charge flat fees for these accounts or give back some of the commission to their retail partners.

"Wholesalers have to really watch these exchanges," Kerr warned.

While the development of insurance exchanges could be a challenge for some wholesalers, by 2010 other advancements in technology should make it easier for them to conduct business with their retail agents and electronically file with various state stamping offices and insurance departments.

Since the enactment of Gramm Leach Bliley, most states have made non-resident surplus licenses available. This has enabled national brokers to become licensed in most states and even allowed smaller brokers to "spread their wings" beyond their immediate borders, Bouhan noted. As a result, the number of active licenses has skyrocketed. In New York alone, where in 2001 there were 350 active excess lines brokers, thanks to out-of-state applicants there were more than 500 by 2004 and the number continues to grow, reported Maher.

Electronic filings by brokers with stamping offices are in their infancy now, but by 2010 they should be routine, officials predict.

Bouhan, who notes that a number of women have held key positions at NAPSLO and in surplus brokerages over the years, claims more minorities are also getting involved in the distribution business as evidenced by their attendance at NAPSLO meetings.

Others agreed more minorities would be involved in the years ahead.

"I expect to see changes in insurance management," Urbanciz said. "The days of the white guy are numbered."

*See the Sept. 19 issue for coverage of: "Surplus Lines Products and Regulation in 2010."* IJ

they might if left simply to carriers looking at their profitability, he noted.

A.M. Best expects to see "continued strong financial underwriting profitability" in the coming years for surplus lines carriers. Since 2002, the surplus lines industry has reported loss ratios between 92 and 93, and Blades thinks loss ratios in the low to mid-90s can be expected in the years ahead as well.

Dick Bouhan, executive director for NAPSLO, along with the other leaders, anticipates that the report on 2004 will again show solid financial performance by surplus lines carriers and be a harbinger of 2010 as well. Why? "Because the factors that A.M. Best puts forth as important—better capitalized companies, individual underwriting, freedom of rating and forms—exist regardless of the market conditions," he explained.

One area where the 2004 and future reports might be down from the recent past is in premium growth. For 2003, premium growth was up about 28 percent over the prior year. For 2002, it jumped a whopping 62 percent. But for 2004, A.M. Best will report that premiums grew barely 1 percent, a slowdown that is consistent with a softer market in which standard lines seek out more business.

Going forward, surplus lines leaders do not anticipate a repeat of the past decade's dramatic double-digit growth in surplus

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