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20 YEARS

U.S. Surplus Lines

20 Year Retrospective

September 2014

A.M. BEST

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Segment Review
September 15, 2014

Surplus Lines Profits Rebound as Catastrophes Ease, But Rates Go Flat

Balance sheets have endured many challenges.

Surplus lines insurers enjoyed some relief in 2013, with relatively light catastrophe losses after the devastation inflicted by Superstorm Sandy in 2012. The aftermath of the storm raised distant prospects of solidifying surplus lines insurers' place in covering flood risk, but that issue aside, the surplus lines market continues to grow through unique and creative products designed in close cooperation with brokers and insureds.

This well-established formula has led surplus lines companies to great success over the years when compared with the overall property/casualty (P/C) industry. The domestic professional surplus lines (DPSL) peer composite experienced a sharp rebound in profitability during 2013, as both pretax and net income more than doubled on the strength of a return to profitable underwriting and robust growth in investment gains.

A.M. Best views the surplus lines insurance market as stable but believes profit margins may shrink in the near term as average rate increases diminish on various lines of coverage. The balance sheets of professional surplus lines carriers have endured many challenges in recent years and maintained considerable strength to support future operating plans. Accident-year reserve development for surplus lines companies has been slightly more favorable than that of the overall P/C industry, but the gap has been shrinking as the markets wrestle with excess capacity, low interest rates and capital outlays to enhance operational efficiencies. A.M. Best expects surplus lines insurers' underwriting to remain disciplined.

The legal and regulatory environment surrounding surplus lines remains active. Several pieces of legislation that could impact the industry were introduced in the 113th Congress. One is the still-pending Terrorism Risk Insurance Program Reauthorization Act of 2014. Another bill, the National Association of Registered Agents and Brokers Reform Act (NARAB II), which had been introduced in previous congressional sessions, is advancing in the current Congress by being attached to other legislative proposals. Also, recently introduced legislation, the Flood Insurance Market Parity and Modernization Act of 2014, would ensure that surplus lines insurers are eligible to offer private market solutions to consumers needing specialized flood coverage.

These insurers' partners in the business – the wholesale and retail distribution channels – are being transformed through consolidation and specialization, as intermediaries maneuver to hold their positions or establish new ones in a competitive marketplace. Generally flat rates across most lines of business make scale or unique skills increasingly important for distributors to stand out. Meanwhile, ever-changing technology demands constant attention to maintain competitive levels of efficiency and ease of doing business with customers.

Analytical Contact
Kenneth Monahan, Oldwick
+1 (908) 439-2200 Ext. 5342
Kenneth.Monahan@ambest.com

Editorial Management
Brendan Noonan

Contents

A 20-Year Story of Growth Continues to Unfold

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 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.

Over the ensuing 20 years, A.M. Best has published annually a special report on the surplus lines market, commissioned by the Foundation. Since 1997, these reports also have documented:

• The market's role in covering hard-to-place, higher risk and unique classes of business, mainly commercial, that do not fit standard commercial lines underwriting guidelines.

• Surplus lines insurers' freedom of rate and form, which has allowed for creative solutions while sparing insureds from any risks associated with self-insurance or offshore sources of coverage.

• 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 rise, the surplus lines market has faced significant obstacles and intense competition. This includes aggressive pricing and liberal coverage from standard market carriers seeking organic growth, and the alternative risk transfer market's appeal as another means of covering potential surplus lines risk. Meanwhile, surplus lines industry representatives have been active in Washington and elsewhere on critical regulatory issues affecting the industry, advancing key pieces of legislation. Among these were the National Association of Registered Agents and Brokers provision in 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 tax-related provisions of the Nonadmitted and Reinsurance Reform Act and the progress of NARAB II (see Section III of this report).

Despite the challenges, the surplus lines market more than doubled from 3.3% of total P/C direct premiums written (DPW) in 1993, to approximately 6.9% by the end of 2013. As a percentage of commercial lines DPW, surplus lines insurers went from a 6.1% share to 13.7%, hence further demonstrating the undeniable interest in the sector.

Surplus lines companies in 1994 held a higher median A.M. Best financial strength rating (FSR) than the total P/C industry; 85.4% of surplus lines companies had secure ratings (defined as an A.M. Best rating from B+ to A++), compared with 74.2% for the industry. Through midyear 2014, 100% of surplus lines companies maintained secure ratings versus 94.8% for the P/C industry. Most noteworthy is that almost 97% of surplus lines insurers have A.M. Best ratings of A- or higher, compared with 77% for the total P/C industry – further corroborating the health of the surplus lines sector today.

Unlike the P/C industry, the landscape among surplus lines insurers continues to change. In fact, only seven of the top 25 surplus lines companies today were in the top 25 ranking in 1993 (based on DPW).

The surplus lines market clearly is a safety valve for the insurance industry, especially in hard markets. As emerging issues and exposures drive more demand for creative insurance solutions, A.M. Best believes the surplus lines market will only gain in prominence. We are most appreciative of the Derek Hughes/NAPSLO Educational Foundation for allowing A.M. Best to be part of this long and fruitful journey and look forward to working with the Foundation for many years to come.

Section I – State of the Market

Surplus lines insurers, as well as those in the standard market, benefited in 2013 from a relatively benign catastrophe year. This was welcome relief, given the devastating impact that Superstorm Sandy had on this segment and indeed the entire insurance industry just one year earlier. Sandy now ranks among the largest single loss events in the industry's history – and would have been far worse if not for the National Flood Insurance Program (NFIP), which absorbed the lion's share of the damage sustained. While discussions to privatize this program could offer surplus lines insurers an enormous opportunity to write some of this business, the near-term prospects are dim in light of issues with affordability and subsidized rates that do not reflect the risk insured.

Potential flood business aside, surplus lines insurers continue to grow through innovative and customized products and by working closely with brokers and insureds to provide needed coverage. Over the years, surplus lines companies also have been extremely successful when compared with the overall property/casualty (P/C) industry. This is exemplified by data covering the most recent five- and 10-year periods. A.M. Best believes this disparity is due, in part, to surplus lines insurers' freedom of rate and form, customization of policy wording, innovation in product development and ability to adapt quickly to insureds' needs as they arise. Since surplus lines companies cover unusual risks that are difficult to place in the standard admitted market, there typically is a greater focus on underwriting for a complete understanding of the nature of the risks insured; risk mitigation strategies; loss avoidance; and claim control. The focus on these fundamentals is paramount for these non-commoditized and higher hazard classes of business.

In this 2014 update on the state of the market, A.M. Best will highlight, among other things:

• Growing market share among surplus lines insurers, including some changes in the top 10 and 25

• Some key drivers of premium growth

• Merger and acquisition activity among surplus lines and specialty lines insurers

• Overall performance among the leading surplus lines groups

• A.M. Best's views on the near-term market cycle

Many of the large, standard market insurers historically have dominated commercial lines and continue to do so. However, A.M. Best finds that surplus lines insurers have made inroads, now accounting for approximately 13.7% of all commercial lines direct premiums written, up from 6.1% in 1993. A.M. Best believes this trend is likely to continue, as more borderline ("fringe") business will be shifted into the surplus lines sector amid improving market conditions and declining appetites for risk among standard market insurers.

Although it is very difficult to predict insurers' behavior, A.M. Best believes standard market insurers remain steadfast in their desire to retain business. However, considering the prevailing low interest rate environment and tighter profit margins, standard market insurers may relent and be less aggressive in retaining accounts they may consider more difficult to price and service. As a result, some of this business may find its way back into the surplus lines market. In addition, there likely will be more mergers and acquisitions as insurers seek opportunities to deploy capital. This is already occurring among surplus lines companies.

Nonetheless, commercial lines pricing is flattening, and the overall markets remain competitive, which carries over to surplus lines. For commercial property risks, the degree of competitive pricing is compounded by less expensive property catastrophe reinsurance as alternative sources of capital flow into property reinsurance. Some industry observers feel it is only a matter of time before these same capital providers target longer tail commercial casualty lines, a sweet spot for surplus lines insurers. Interestingly, in early 2014, Arch Capital Group Ltd. and hedge fund investment manager Highbridge Capital collaborated on a new, Bermuda-based reinsurer, Watford Re Ltd., in what appears to be the first casualty-oriented, hedge-fund-backed reinsurer ever formed. If successful, Watford Re could stimulate further interest from other reinsurers and alternative capital providers.

For the most part, the U.S. P/C insurance marketplace has many insurers constantly competing for a finite volume of business. This is particularly true in a sluggish economic environment that stymies new business growth and hinders existing businesses from expanding. While this applies to the surplus lines sector, this sector is somewhat different in that the volume of business often varies with the expansion and contraction of standard market insurers' appetites for risk. In 2013, 22 of the top 25 surplus lines groups produced year-over-year growth in premium (as measured by direct premiums written) – a testament to what is likely a contraction in the standard market's appetite for risk and a broad flow of business back into surplus lines.

Year-over-year growth is also due to increasing rates in certain lines and the gradual improvement in the overall economy, which creates new insurable exposure that often requires surplus lines capacity. In addition, as a consistent indicator of the strong financial condition of surplus lines writers overall, their aggregate performance continues to outpace that of the total P/C industry (see **Exhibit 1)**, as discussed further in **Section II: Financial Condition and Rating Distribution**.

Groups that focus primarily on surplus lines/specialty business, particularly market leaders, once again generated considerable operating profits and returns on both revenue and, to a smaller degree, surplus during 2013 (see **Exhibit 2**). Furthermore, reserves of the specified surplus lines specialists developed favorably by 4.2%, compared with 2.8% of favorable development for the total P/C industry (see **Exhibit 3**), although the volume of the redundancies is decreasing. Reserve adequacy is a material component of A.M. Best's assessment of overall capital adequacy. It is important to note, however, that reserve development and reserve adequacy for some insurers are not necessarily equal.

A.M. Best believes favorable development will continue to decline and may reach an inflection point at which the segment will not, in total, be able to release much more in prior-year loss reserves. However, for 2014, A.M. Best expects commercial insurers likely will continue releasing reserves, despite A.M. Best's position that reserves are deficient.

As A.M. Best has advised, the competitive operating environment, coupled with lower levels of redundancies on older accident years, has led on average to lower levels of favorable reserve development. Although few and far between, insurers that maintain conservative reserve levels will have a competitive advantage over those that have strayed from these practices. For some, adverse development, low investment returns and competitive pricing may be too overwhelming and too steep. For the most part, surplus lines specialists have a proven history of conservative reserving and effective cycle management that has led to considerable balance sheet strength over the long term. These entities' ability to continue benefiting from reserve redundancies could last longer than is predicted for commercial lines insurers overall.

Exhibit 1

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

(USD 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

* Estimates

Source: A.M. Best data & research and BESTLINK

Sandy was directly responsible for the unusual situation in which surplus lines insurers posted higher than anticipated loss and combined ratios in 2012 and, as a result, ended the year with worse results than the P/C industry. With property and allied lines accounting for a large portion of net writings, Sandy affected surplus lines carriers more severely than the total P/C industry. While by most key measures of operating performance, the margin between the surplus lines and P/C industries has narrowed in recent years, surplus lines insurers continue to maintain a comfortable lead over the rest of the industry (these measures of operating performance will be further explored in **Section II**). Again, this is due to the non-commoditized nature of the business, these insurers' ability to underwrite each risk, freedom from rate and form regulation, and the benefit from being a market of last resort.

Exhibit 2

U.S. Surplus Lines Specialists – Operating Performance, 2013

(%)

Group Name	Change in DPW	Loss/ LAE Ratio	Combined Ratio	Pretax ROR (%)	Pretax ROE (%)
W. R. Berkley Group	14.2	61.6	94.6	13.6	12.5
Markel Corporation Group	23.1	52.4	91.4	13.4	10.9
Alleghany Insurance Holdings	17.9	55.5	89.4	23.5	15.1
Argo Group	6.8	60.9	95.1	20.3	11.2
RLI Group	8.6	41.2	82.2	25.4	20.8
Global Indemnity Group	15.2	72.2	110.6	8.4	2.4
HCC Insurance Group	1.3	43.4	76.5	51.0	22.1
IFG Companies	-1.7	47.9	86.5	24.9	12.0
James River Insurance Company	19.8	36.7	79.6	61.7	11.8
Western World Insurance Group	22.4	68.9	101.8	7.3	4.5
AXIS Insurance Group	6.9	65.2	100.1	4.7	2.6
Arch Insurance Group	3.0	65.0	97.9	7.5	6.7
Catlin U.S. Pool	28.1	62.0	82.7	18.4	10.9
Average - Surplus Lines Specialsts	**12.7**	**56.4**	**91.4**	**21.5**	**11.0**
Total P/C Industry	**4.3**	**67.2**	**95.8**	**13.8**	**10.2**

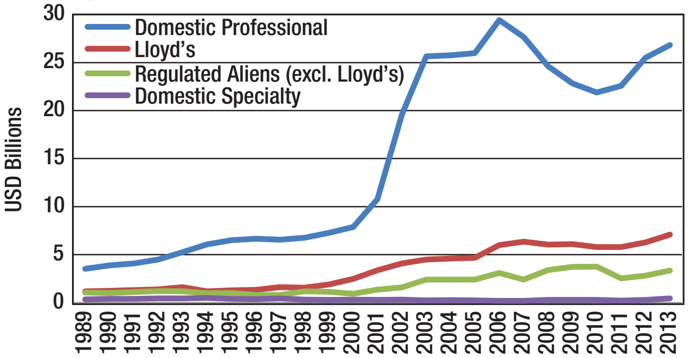
Source: BESTLINK – *AMB Credit Report - Insurance Professional*

Exhibit 3
U.S. Surplus Lines Specialists – Loss Reserve Development, 2013
Calendar year.
(USD Thousands)

Group Name	1-Year Loss-Reserve Development Through 2013	1-Year Development to Original 2012 Reserves (%)
W. R. Berkley Group	-$92,066	-1.1%
Markel Corporation Group	-$234,403	-8.2%
Alleghany Insurance Holdings	-$238,174	-2.3%
Argo Group	-$19,654	-1.8%
RLI Group	-$73,133	-9.8%
Global Indemnity Group	$1,819	0.7%
HCC Insurance Holdings	-$101,531	-5.6%
IFG Companies	-$35,799	-9.1%
James River Insurance Co	-$14,398	-6.7%
Western World Insurance Group	-$15,893	-2.7%
AXIS Insurance Group	-$64,817	-3.9%
Arch Insurance Group	-$13,736	1.0%
Catlin U.S. Pool	-$6,510	-5.7%
Average - Surplus Lines Specialsts	**-$69,869**	**-4.2%**
Total P/C Industry	**-$17,022,000**	**-2.8%**

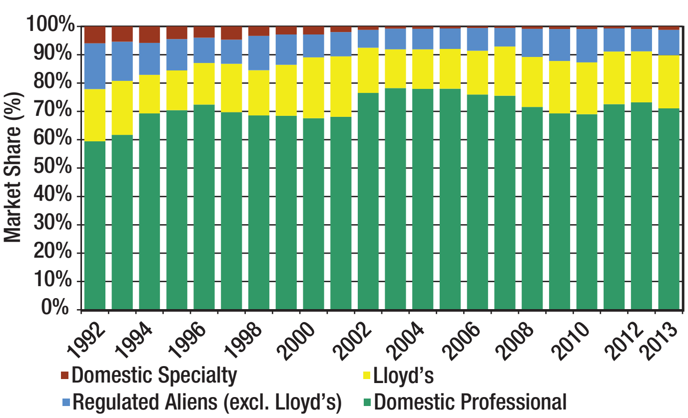
Source: A.M. Best data & research.

Exhibit 4
U.S. Surplus Lines – Direct Premiums Written by Segment



Source: A.M. Best data & research

Exhibit 5
U.S. Surplus Lines – Market Share by Segment



Source: A.M. Best data & research.

Also noteworthy is the year-over-year disparity in top-line growth for surplus lines compared with the P/C industry. In 2013, direct premiums written (DPW) for surplus lines increased 8.4%. This compares with an annualized growth rate of 4.3% in DPW for the total P/C industry (see **Exhibit 1**). The ability to grow reflects increasing rates, macroeconomic improvements and the movement of certain lines of business back into the nonadmitted market, as discussed previously.

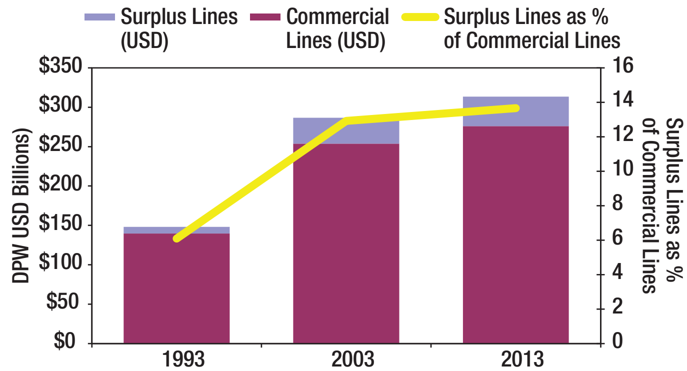
For the third consecutive year, the core domestic professional surplus lines (DPSL) insurers showed growth in DPW, recording a 5.2% increase in 2013. This follows growth of 12.9% in 2012 and 3.2% in 2011. The total increase in DPW for the surplus lines industry in 2013 was broad but largely attributable to the 13.2% increase for Lloyd's, and a 22.4% increase for non-Lloyd's alien (non-U.S.) companies whose premium is tracked by the National Association of Insurance Commissioners (NAIC).

Growth in 2013 also reflects a notable 46.2% increase for domestic specialty insurers, up from 30.3% in 2012, and marks the second year of premium growth for them in recent years. This confirms the rising interest in the surplus lines marketplace, which includes insurers that write some surplus lines business but may concentrate more on the specialty admitted or standard markets. The growth for domestic specialty companies has come from both new products and the buildup of existing, smaller books of business into larger portfolios. The recent spurt in surplus lines premium reversed five consecutive years of contraction from 2007 to 2011, which had been unprecedented over the past two decades (see **Exhibits 4, 5** and **6**).

Historically, commercial lines have accounted for 75%-80% of all surplus lines business written. However, the bulk of commercial lines business still is written on an admitted basis and in most cases never comes to surplus lines insurers. Nonetheless, over the past 20 years, surplus lines as a percentage of total commercial lines premium has increased steadily. In fact, during this period, direct premiums written by surplus lines insurers have expanded substantially, increasing more than four and one-half times (see **Exhibit 6**). Further analysis on how surplus lines insurers stack up on various profitability measures over the past five years will be explored in **Section II**.

Exhibit 6

U.S. Surplus Lines – Direct Premiums Written vs. Commercial Lines



Source: A.M. Best data & research

Growth Trends and the Cycle

Growth and contraction within the surplus lines industry largely tracks with the overall insurance market cycle. When market conditions harden, standard market carriers tend to turn away from more traditional surplus lines risks to refocus on their core business. Given the continued low yields on new investment opportunities, coupled with tenacious competition for borderline and traditional surplus lines accounts from well-capitalized insurers, surplus lines insurers continually are challenged to maintain their competitive edge and generate adequate shareholder returns. Despite the Federal Reserve's announcement that it will end its economic stimulus plan later in the year, A.M. Best believes interest rates are likely to increase marginally in late 2014 but likely will remain low in the intermediate future, which will continue to dampen investment returns. As a result, A.M. Best believes surplus lines insurers will continue to focus resources on improved pricing and sharpening their underwriting fundamentals, which could further accelerate the shift of business back into the surplus lines segment in 2015.

Leading Surplus Lines Companies and Groups

Lloyd's maintained the status it has held for the past four years as the market-share leader, generating year-over-year growth in surplus lines premium of 13.2% in 2013 after recording an 8.3% advance in 2012. During the year, Lloyd's also exceeded its record for business sourced in the United States, reaching nearly $7.1 billion of DPW. This comes only three years after Lloyd's surpassed the former domestic leader in surplus lines premium production, American International Group (AIG), in 2010. Key drivers of this shift in market share include Lloyd's ability to attract third-party investors' capital, difficulties faced by some key competitors, specifically AIG, after the 2008 financial crisis, and the benefit of standard market companies refocusing on core competencies and business moving back into the surplus lines market. Lloyd's also has pushed to establish an on-the-ground presence in recent years via managing general agents (MGAs) and through risk-bearing companies, both of which continue to gain traction. The managing general agents write directly into Lloyd's, while the risk-bearing companies often cede a large proportion of their business to their affiliated Lloyd's syndicates. The streamlining of its coverholder approval process, additional training to help brokers and MGAs conduct efficient coverholder audits, and ensuring that the audits are coordinated efficiently to help minimize disruption for any coverholder, all have been designed to help Lloyd's increase market penetration.

Through its primary surplus lines insurer, Lexington Insurance Co., AIG reported approximately $4.8 billion of DPW, down slightly from more than $5.0 billion in 2012. Combined, Lloyd's and AIG accounted for approximately 31.6% of the total surplus lines market (see **Exhibits 7** and **8**), down slightly from their 2012 combined total of 32%. In 2013, AIG produced more than two and one-half times the level of direct premiums generated by its closest U.S. competitor, Nationwide Group (Nationwide). Nationwide maintained its hold on the No. 3 spot among the top 25 in 2013, recording a 15.4% increase in DPW year over year.

Stamping Offices Report Growth In Surplus Lines Premium

According to information compiled by the Surplus Lines Stamping Office of Texas, the 14 states maintaining stamping offices reported an increase of approximately 16.0% in premium volume in 2013. However, the overall growth in premium is somewhat overstated because of the large amount of prior years' return premium transactions processed in New York in 2012, which constricted the state's reported premium to a disproportionate degree for that year.

Adjusted for this anomaly, the 13 other offices (excluding New York) reflected a $2.1 billion or 12.2% increase in premium. Interestingly, the stamping offices reported a 4.0% increase in the number of documents filed: approximately 3.17 million in 2013, compared with almost 3.05 million in 2012. 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. In this case, the increase in the document count likely reflects the increased level of business moving from standard market insurers to the surplus lines marketplace.

The stamping offices only report on 14 states, and the results are influenced heavily by four states – California, Florida, New York and Texas. New York generated the fourth-highest premium volume of these states, consistent with its ranking in 2012. The state's 2013 results clearly show the effect of the aforementioned prior year's return premium items on total production.

Through the first six months of 2014, the reported document count reveals an increase of 9.5%, compared with an increase of 4.1% in 2013. The 4.8% increase in the six-month reported premium figure between 2014 and 2013 reflects positive increases in the aforementioned four leading states, with Utah, Nevada, Oregon and Washington all recording increases in excess of 10.0%. The premium change represents a slight decline from the 21.2% jump in the six-month reported premium between 2013 and 2012.

The six-month premium for New York in 2014 was $1.62 billion, compared with $1.53 billion in 2013. Excluding the premium reported for New York, the premium reported by the stamping offices in 2014 is up by 4.5% over 2013. After increasing by 17.0% during the first half of 2013, premium in California only increased by 2.5% during the first six months of 2014.

Meanwhile, Texas experienced a 6.2% increase, due in part to various assessments/ enforcement actions by the Texas Department of Insurance for late filings. Florida showed a 21.0% increase in the number of items filed through the first half of 2014, but the increase in premiums was just 3.6%.

The fact that the increases in the number of items processed by state exceed the increase in premium through the first half of 2014 is consistent with the prevailing trend toward moderating rate increases in the surplus lines market, which A.M. Best believes will continue at least through the end of 2014.

Despite two years of overall contraction in premium, AIG remains a dominant participant in the U.S. surplus lines market and continues to be a breeding ground for surplus lines professionals who, over the years, have found new career opportunities outside of AIG. Two most notable examples were the formation of Ironshore by former AIG executives in 2005 and, most recently, the departure of several key executives, including the former president of Lexington Insurance Co., to spearhead Berkshire Hathaway's push further into the surplus lines market. Berkshire's year-over-year growth in this sector was 38% – the highest among leading surplus lines groups in 2013. Ranked 14th, Berkshire is likely to move up the rankings and eventually may become a dominant player in this segment.

During 2013, market share among the 25 leading surplus lines groups remained at approximately 74% of total surplus lines DPW, on par with 2012. By comparison, the top 10 groups accounted for approximately 56% of total premium. In 2013, Fairfax Financial (USA) Group cracked the top 10, leapfrogging from 12th place in 2012 to eighth in 2013. On the other hand, Ironshore slid from the No. 10 spot in 2012 to No. 12 in 2013. Despite Ironshore's decline in rank, total DPW increased nearly 11% year over year for the organization. In fact, of the top 10 groups, only AIG and QBE recorded overall declines in DPW during 2013 (4.2% and 23.9%, respectively). Excluding Lloyd's, Alleghany Insurance Holdings remained the 10th largest U.S.-domiciled group writing surplus lines business, which now has been the case for the past three years.

Exhibit 7
U.S. Surplus Lines – Top 25 Groups, 2013
Ranked by direct premiums written.
(USD Thousands)

Rank	AMB No.	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	85202	Lloyd's	7,099,000	18.8
2	18540	American International Group	4,832,158	12.8
3	05987	Nationwide Group	1,662,999	4.4
4	18252	W.R. Berkley Group	1,327,996	3.5
5	18549	Zurich Financial Svcs NA Group	1,232,050	3.3
6	18468	Markel Corporation Group	1,147,678	3.0
7	18498	ACE INA Group	976,441	2.6
8	03116	Fairfax Financial (USA) Group	837,129	2.2
9	18313	CNA Insurance Cos	808,262	2.1
10	18713	QBE Americas Group	776,999	2.1
11	18640	Alleghany Insurance Holdings	764,574	2.0
12	18728	Ironshore Insurance Group	745,382	2.0
13	18130	XL America Group	620,013	1.6
14	00811	Berkshire Hathaway	564,508	1.5
15	18603	AXIS Insurance Group	547,169	1.5
16	18484	Arch Insurance Group	513,786	1.4
17	04019	Argo Group	499,853	1.3
18	18591	Allied World Group	466,754	1.2
19	00060	Liberty Mutual Insurance Cos	434,647	1.2
20	00012	Chubb Group of Insurance Cos	421,934	1.1
21	04835	Great American P&C Group	393,864	1.0
22	18720	Catlin U.S. Pool	384,987	1.6
23	18723	HCC Insurance Group	353,052	1.5
24	18674	Travelers Group	330,889	0.9
25	03262	Swiss Reinsurance Group	329,798	0.9
		Subtotal of Top 25	**$28,071,922**	**74.4**
		Total U.S. Surplus Lines Market	**$37,719,000**	**100.0**

Source: A.M. Best data & research

Impacted to some extent by revisions to strategy and subsequent re-underwriting efforts, QBE America's ranking fell from No. 6 in 2012 to No. 10 in 2013. Before 2013, QBE's ranking among professional U.S. surplus lines groups had grown steadily as it acquired several specialty commercial insurers as a means to increase its presence in the United States. In 2012 alone, QBE Americas recorded an extraordinary 75.0% increase in DPW as a direct result of its most recent acquisitions, including NAU Country Insurance Co., the U.S. operations of RenaissanceRe and $1.2 billion of forced-placed insurance previously written by Balboa Insurance Group. QBE's lead surplus lines insurer, QBE Specialty Insurance Co., wrote renewal premiums garnered from these transactions. In 2013, however, QBE America's premium volume fell nearly 24% as certain commercial lines businesses were nonrenewed; rates on its forced-placed business came under pressure from state regulators; and a large number of loan sales, along with the loss of clients, lessened the amount of forced-placed business previously written by QBE Specialty.

Other changes in rankings among the top 10 surplus lines groups in 2013 were: W.R. Berkley, which surpassed Zurich and moved up from No. 5 in 2012 to No. 4, and Markel, which by its acquisition of Alterra moved up from No. 8 to No. 6.

Movements in rank among the remaining top 25 groups include Berkshire, which leaped from No. 20 in 2012 to No. 14 in 2013, and AXIS, which fell from 14th place to 13th. After cracking the top 25 last year, Catlin U.S. Pool moved up to No. 22 (versus No. 25 in 2012). Catlin's acceleration in recent years has been driven mainly by its role as a growth engine for its ultimate parent, as well as the continued introduction of new products. In

Exhibit 8
U.S. Surplus Lines – Top 25 Companies, 2013
Ranked by direct premiums written.
(USD thousands)

Rank	AMB No.	Company Name	Group Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	02350	Lexington Insurance Co	American International Group	3,997,669	10.6
2	03292	Scottsdale Insurance Co	Nationwide Group	1,458,582	3.9
3	03557	Steadfast Insurance Co	Zurich Financial Svcs NA Group	1,072,358	2.8
4	03535	AIG Specialty Insurance Co	American International Group	1,088,634	2.9
5	03538	Columbia Casualty Company	CNA Insurance Cos	808,262	2.1
6	12562	QBE Specialty Insurance Co	QBE Americas Group	776,999	2.1
7	13866	Ironshore Specialty Ins Co	Ironshore Insurance Group	732,375	1.9
8	11340	Indian Harbor Insurance Co	XL America Group	619,332	1.6
9	12619	Landmark American Ins Co	Alleghany Insurance Holdings	573,554	1.5
10	12515	AXIS Surplus Insurance Co	AXIS Insurance Group	547,169	1.5
11	04433	Westchester Surplus Lines Ins	ACE INA Group	529,977	1.4
12	12523	Arch Specialty Insurance Co	Arch Insurance Group	513,786	1.4
13	03283	Colony Insurance Co	Argo Group	495,446	1.3
14	01990	Nautilus Insurance Co	W. R. Berkley Insurance Group	485,877	1.3
15	03510	Illinois Union Insurance Co	ACE INA Group	446,464	1.2
16	03759	Evanston Insurance Co	Markel Corporation Group	440,893	1.2
17	02732	Essex Insurance Co	Markel Corporation Group	434,754	1.2
18	12078	Liberty Surplus Ins Corp	Liberty Mutual Insurance Cos.	434,647	1.2
19	12118	Gemini Insurance Co	W. R. Berkley Insurance Group	401,368	1.1
20	10092	Catlin Specialty Insurance Co	Catlin U.S. Pool	384,987	1.0
21	03026	Admiral Insurance Co	W. R. Berkley Insurance Group	383,857	1.0
22	02713	Chubb Custom Insurance Co	Chubb Group of Insurance Cos	370,025	1.0
23	03026	First Mercury Insurance Co	Fairfax Financial (USA) Group	350,133	0.9
24	03286	Houston Casualty Co	HCC Insurance Group	334,802	0.9
25	12630	Aspen Specialty Insurance Co	Aspen US Insurance Group	311,023	0.8
		Subtotal		**$17,992,973**	**47.7**
		Total U.S. Surplus Lines Market		**$37,719,000**	**100.0**

Source: A.M. Best data & research

addition to the mainstays, 2013 marked the entrance of two new entities into to the top 25: Travelers Group (24th ranked) and Swiss Reinsurance Group (25th ranked). Great American P&C Insurance Group came in at No. 21 (up from No. 24 in 2012), propelled by organic growth.

As noted earlier, for the second year in a row, 22 of the top 25 surplus lines groups reported very healthy growth of premium. A.M. Best believes this continues to reinforce the notion that despite the high level of capacity in the marketplace, areas of opportunity remain for surplus lines carriers to grow, given new, emerging markets and product lines, as well as the flow of business from the admitted space.

Of the top 25 surplus lines groups (ranked by DPW), 18 grew by more than 10% in 2013: Lloyds (13.2%), Nationwide (15.3%), W.R. Berkley (19.0%), Markel (39.7%), ACE INA (11.6%), Fairfax Financial (30.3%), Alleghany Insurance Holdings (18.2%), Ironshore (10.6%), XL America Group (36.3%), Berkshire Hathaway (38.1%), AXIS Insurance Group (14.9%), Arch Insurance Group (14.6%), Argo Group (21.9%), Liberty Mutual (22.4%), Great American P&C (25.2%), Catlin U.S. Pool (25.9%), Travelers Group (16.0%) and Swiss Reinsurance Group (28.4%).

Eight of the top 10 surplus lines groups (including Lloyd's) for 2013 were also among the 10 leading groups a decade earlier (see **Exhibit 9**). Also growing in prominence among surplus lines groups in the past decade were Alleghany, XL Group and AXIS. The latter two are among a group of organizations that have Bermuda-based parents and have successfully entered and carved out niches in the very competitive surplus lines market.

While the top surplus lines groups historically have produced the majority of the market's DPW, the landscape has become more diverse, with a growing number of organizations and companies dedicating resources to surplus lines. In 2003, the top 25 groups held 85.3% of the surplus lines market (see **Exhibit 9**), nearly 10 percentage points greater than the 74.4% share held by the top 25 groups in 2013 – though this was a small reversal from the prior year as their DPW share was up 1.6 percentage points from the 74.1% recorded in 2012.

The leading 25 groups' growth in market share is tied to the continued growth of some of these groups through acquisitions, namely Fairfax Financial USA Group's (Fairfax) acquisitions of First Mercury Group in 2011 and American Safety Insurance Holdings in 2013; Allied World with its acquisition of Darwin Group in 2008; and Markel with its acquisition of Alterra in 2013. The M&A activity shows no sign of slowing, as major transactions continue to be announced, e.g., Sompo's acquisition of Canopius, Validus' pending acquisition of Western World, Endurance's hostile attempt at Aspen (now terminated), Amtrust/ACP Re's pending acquisition of Tower (ongoing and legacy business), and Enstar's acquisition of Torus.

Exhibit 9
U.S. Surplus Lines – Top 25 Groups (2003)
Ranked by direct premiums written.
(USD Thousands)

Rank	Company Name	Surplus Lines DPW	Total Surplus Lines Market Share (%)
1	American Inernational Group	8,017,607	24.4
2	Lloyd's	4,492,000	13.7
3	Zurich/Farmers	1,619,683	4.9
4	Markel Corp	1,409,675	4.3
5	Nationwide Group	1,300,170	4.0
6	St. Paul Travelers Cos	1,161,248	3.5
7	ACE INA Group	1,084,696	3.3
8	Berkshire Hathaway	990,769	3.0
9	W. R. Berkley	950,048	2.9
10	CNA Insurance Cos	725,325	2.2
11	Arch Capital Group	666,963	2.0
12	Royal & SunAlliance USA	574,604	1.8
13	Chubb Group	573,594	1.7
14	Hartford Insurance Group	486,159	1.5
15	Great American P&C	470,400	1.4
16	United National Group	445,591	1.4
17	HDI U.S. Group	400,694	1.2
18	Argonaut Insurance Group	377,365	1.2
19	IFG Companies	369,294	1.1
20	HCC Insurance Group	365,573	1.1
21	RLI Group	347,080	1.1
22	GE Global Insurance Group	345,654	1.1
23	XL America group	298,700	0.9
24	Everest Re US Group	268,469	0.8
25	Western World Insurance Group	248,816	0.8
	Subtotal	**27,990,177**	**85.3**
	Total U.S. Surplus Lines Market	**32,798,642**	**100.0**

Source: A.M. Best Special Report *Annual Review of the Excess & Surplus Lines Industry*, September 2004.

Additionally, some of the new formations that have emerged in past years, and continue to grow in prominence relative to top-line growth, have been those with well-capitalized, Bermuda-based parents such as Ironshore, AXIS and Arch. Some believe that many of these newer surplus lines insurers have driven competition in the surplus lines market. Despite changes in names and/or ownership, 16 of the top 25 groups/carriers have remained the same. Typically, changes in the top 25 over the past decade have resulted from market consolidations and new company formations, by way of either Bermuda-based parents or Lloyd's. Several large insolvencies or strategic changes at the corporate level caused other shifts.

A.M. Best believes top-tier surplus lines insurers will continue to dominate the market as these insurers look for ways to expand their footprint through innovative products, closer relationships with agents and brokers, and enhanced value propositions through customization. Insurers in this space also tend to have large balance sheets, widely recognized areas of expertise and strong market profiles, some of which have been bolstered through acquisitions. Moreover, leaders in surplus lines generally are viewed as underwriting specialists that fully understand the insured, the unique risk classes involved and the various coverage options available. In addition, diverse, strong and well-established distribution platforms have played a key strategic role in these groups' ability to attain consistently excellent results.

The surplus lines market continues to spark investors' interest in the years after the last hard market, as evidenced by the formation of several new surplus lines companies. Arch and AXIS are two of the more recent groups to join the fray. Both are members of well-capitalized, Bermuda-based parent companies that own other insurance and/or reinsurance companies. Both parents benefited greatly from the timing of the formation of their lead surplus lines companies – Arch Specialty Insurance Co. and AXIS Surplus Insurance Co. – at the onset of the hard market. These market opportunities also have enabled Bermuda organizations to diversify away from the catastrophe business that was their origin, and into other classes at better rates.

The Bermuda start-ups that launched in 2005, such as Ironshore (the No. 12 surplus lines insurance group by DPW in 2013), Alterra (now part of Markel) and Endurance Specialty Group (No. 37), since have established domestic U.S. operations in the surplus lines and specialty markets. These insurers brought a great deal of additional capacity to the marketplace. However, as market conditions have turned more competitive, thereby shrinking available profit margins, it has been more challenging for them to find appropriate opportunities to deploy available capacity.

A.M. Best believes newer surplus lines organizations will continue to face a significant challenge to settle into a more stable, maturing position in the market with successful long-term prospects. This is compounded by the stresses stemming from the still-recovering economy; the tenuous firming of prices noted to date; the persistent competitive market conditions in some lines; the increasing excess capacity; and the rising severity of recent catastrophe-related losses (absent 2013). Despite the more than ample capacity, there are fewer opportunities for it to be used on business that produces the desired profit margins. Since primary market carriers have been purchasing less reinsurance, it has driven Bermuda reinsurers to deploy significant portions of their capital into writing direct surplus lines business to diversify into opportunities for profit.

The Lloyd's Market

Lloyd's has been active in the United States since the late 1800s. As the top writer of nonadmitted business from 2010 through 2013, it plays an extremely important role in the surplus lines market. The United States continues to be Lloyd's biggest market, with surplus lines and reinsurance activities generating the majority of Lloyd's U.S.-sourced revenues. Risks underwritten by Lloyd's vary considerably, encompassing both property and liability loss exposures. With almost $7.1 billion in DPW in 2013, Lloyd's represents approximately 19% of the surplus lines market.

Over the past decade, Lloyd's surplus lines premium volume has increased because of several factors, including increased marketing activity, new agency appointments, risk-bearing affiliates of syndicates and the enhanced awareness of Lloyd's security ratings among buyers and producers. In 2012 and 2013, Lloyd's surplus lines premium has been greater than its combined U.S. reinsurance and direct business. This recent trend is a departure from historical results and reflects Lloyd's enduring interest in U.S. surplus lines business. Overall, A.M. Best believes Lloyd's will continue to maintain its substantial participation in the U.S. surplus lines market, despite the volatile earnings inherent in this business.

Current Challenges

Like the rest of the property/casualty insurance industry, surplus lines insurers continue to encounter numerous hurdles in the current marketplace. Chief among the challenges is the overriding importance of generating profitable underwriting results, which data show has become even more important in recent years. The importance of underwriting profitability has been magnified by the persistently low interest rate environment, which has hampered investment returns, and the depletion of historically favorable loss-reserve development.

Other key challenges include the ability of surplus lines insurers to differentiate themselves by leveraging their value proposition through innovative products, customization and service. With the bountiful capacity currently flooding the market, leading directly to heightened competition, the most successful surplus lines insurers likely will be those that can preserve strong relationships with their distribution partners and maintain high policy retention. Many are investing heavily in developing, implementing and using technological platforms to support those distribution relationships and improve their competitive positions. Adherence to strict risk selection and pricing fundamentals to strengthen the quality of business portfolios will, of course, also be a cornerstone of future success for surplus lines companies, especially given the higher hazard risks that surplus lines carriers entertain.

The ability to meet the challenge of covering emerging risks such as cyber liability (currently in most cases on a sublimit basis), environmental liability and those exposures brought about by new scientific, economic or technological advancements is another characteristic that the most successful surplus lines insurers need. The development of expert capabilities on emerging risks always has been a hallmark of the surplus lines industry. Additionally, the continued use of refinements in technology platforms will increase in importance as competencies in new systems provide for competitive advantages, despite the initial cost of developing them. The most successful surplus lines insurers over the near term are likely to be those that can maintain strong relationships with their distribution partners while developing specialty insurance products that can strengthen established ties and open avenues to new relationships. Effective management of underwriting, pricing and claim functions through deployment of enhanced predictive modeling and other analytical tools has helped insurers to control expenses more effectively. These expense-cutting tools enhance underwriting profitability despite soft market conditions. Effective use of sophisticated underwriting and pricing tools to help identify preferred risks, and to target the appropriate price changes to retain the best accounts, also will separate successful companies from laggards.

Databases have grown exponentially and have improved markedly in recent years, making robust analytical tools more useful and valuable. This helps decision-makers to determine which products, lines of coverage and risks offer acceptable profit margins. As a result, companies are investing significant resources to further refine their risk appetites and risk profiles, including making tough strategic decisions to nonrenew accounts and programs that fall short of selected return hurdles. The additional analysis also helps companies to know when to curtail sales of certain products or to exit particular lines of business completely. No matter how sophisticated the modeling tools are, however, well-thought-out and effectively executed strategies, along with underwriting discipline, are irreplaceable as keys to driving long-term success and navigating the market's vagaries.

While surplus lines insurers have reported success in implementing rate increases to varying degrees on most lines of coverage, the overall trend shows these increases have been moderating from the beginning of 2013 through the first half of 2014. Some lines of coverage remain highly competitive, with rates flat or close to it. With robust capacity in the market, rate increases are likely to continue moderating in the second half of 2014 and the early part of 2015. While some of the more distressed lines are still yielding moderate rate increases, further significant increases may become more challenging given the ample capacity available. Still, with their strict focus on underwriting fundamentals, some insurers are letting business go when the internally mandated rates are not available for the selected risk.

It appears a fair amount of traditional surplus lines business returned to the market in 2013 and extending into 2014. This comes despite admitted carriers' successful use of enhanced technology platforms to acquire some borderline surplus lines business in previous years. In some cases, those standard market insurers still are looking to retain or retrieve these accounts, particularly if their business profiles have changed and they now consider that business core to their present strategies. Traditional, higher hazard surplus lines risks, however, often require specific loss-control and claims-handling expertise, which increases the expense of competing for this business. While surplus lines insurers may find fewer standard market carriers to compete for higher hazard risks, they still will have to balance selectivity with the need to service producers and ultimately policyholders with the customized insurance solutions they desire. The development and execution of expert capabilities on emerging, specialized liabilities always has been a hallmark of the surplus lines industry, and brokers and agents continue to count on it.

Mergers & Acquisitions

For companies throughout the insurance industry, achieving organic, top-line growth continues to be a distinct challenge. For surplus lines insurers, growth usually is determined by flow of submissions, which is dictated largely by the expansion and contraction of admitted carriers' underwriting guidelines. As a result, opportunistic consolidations play a key role for some organizations in reaching desired top-line growth. Despite the challenging operating environment in recent years, surplus lines insurers generally have fared well and remain well capitalized.

Notwithstanding some of the recent organizations creating negative headlines, specialty and surplus lines insurers still have attracted a great deal of interest from potential acquirers. Foreign insurers and private-equity firms are among those that continue to express interest in specialty and surplus lines companies, recognizing their strong niches and discernible competitive advantages. During a relatively uneventful 2012 compared with prior years, there was somewhat of a dearth of completed M&A activity. The instability of financial markets and divergent views on valuations were a couple of major reasons for the lack of completed deals. In late 2013 and so far in 2014, the climate for M&A deals involving surplus lines entities began to heat up considerably.

In April 2014, Torus Insurance Holdings Ltd. (Torus Holdings) was acquired by Enstar Group Ltd. and Stone Point Capital LLC. A.M. Best believes this acquisition will give Torus Holdings access to stronger parental support as it looks to bolster its U.S. market presence through its surplus lines entity, Torus Specialty Insurance Co.

In May 2014, Canopius Group Ltd. (Canopius), the parent organization of Canopius US Insurance, Inc. (Canopius US), was acquired by Sompo Japan Insurance Inc. (Sompo Japan), a subsidiary of NKSJ Holdings Inc. and among Japan's largest insurers. With this acquisition, Canopius is now a member of a much larger and stronger group. Although the exact role and strategic importance that Canopius US will have is still to be fully determined, A.M. Best expects this acquisition to further expand Sompo Japan's U.S. footprint and diversify the organization further beyond its traditional reverse-flow insurance program.

Finally, in June 2014, Validus Holdings, Ltd. (Validus) announced an agreement to acquire Western World Insurance Group (Western World), with the transaction expected to close in late 2014. From a strategic standpoint, Western World, in business for 50 years, will provide Validus with immediate access to a well-established U.S. surplus lines platform that is well regarded among its peers.

The question remains as to whether these acquisitions just set the table for more activity in 2014. Already there is a fair amount of speculation over the potential for other deals in the near term involving surplus lines and specialty organizations. Given the subdued outlook in the reinsurance market, there appears to be interest by predominantly reinsurance-oriented organizations in either pursuing start-up opportunities or acquiring more established, "bolt-on" entities that can be used to diversify their operations.

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

A.M. Best views the surplus lines insurance market as stable but does have concerns that profit margins may shrink in the near future, as the magnitude of average rate increases on different lines of coverage dissipates. Over the past few years, the balance sheets of professional surplus lines carriers have withstood numerous challenges and maintained considerable strength on which to execute future operating plans. Accident-year reserve development for surplus lines companies has been slightly more favorable than that of the overall P/C industry. However, the gap has tightened in recent years as the markets struggle with excess capacity, low interest rates and capital outlays to enhance operational efficiencies. A.M. Best believes underwriting fundamentals among surplus lines insurers should remain strong.

Although commercial lines rates continue to moderate, the surplus lines market still appears to be in a good position to produce healthy returns and net operating profits in 2014. Losses related to the polar vortex, which brought record and near-record cold temperatures across much of the northern United States, impacted first-quarter underwriting results. The impact is not expected to have an overriding, adverse effect on this segment's full-year 2014 results, barring any significant increase in catastrophe and weather-related events compared with 2013 totals. Should storm activity remain on par with the relatively quiet 2013, versus returning to more historical levels, A.M. Best expects that aided by the other aforementioned factors, year-end 2014 results could be comparable to 2013 results. Nonetheless, loss reserves and the sustained low interest rate environment still present ongoing challenges to this segment and the entire insurance industry.

Relative to commercial lines insurers, A.M. Best remains concerned with the levels of loss reserves some insurers hold and believes that commercial lines reserves in the aggregate are deficient. This stems from A.M. Best's belief that calendar-year operational results are not truly reflecting recent accident-year loss ratios. This view applies to nearly all commercial lines of business (except for medical professional liability), particularly workers' compensation, general liability and commercial multiperil. These concerns extend to surplus lines insurers as well, even though current reserve positioning is considered slightly better than that of the overall commercial lines market. The onus has been on insurers to be conservative and accurate with their loss picks. If they are successful, reserve development still will have a positive near-term impact.

A.M. Best also believes the importance of rate adequacy remains heightened in the sustained low interest rate environment, which has suppressed investment income in recent years. With few high-yielding, lower risk alternative investment vehicles available to optimize overall investment income, surplus lines writers are expected to remain focused on sharpening their underwriting fundamentals, conservative pricing and more efficient technological platforms. While A.M. Best recognizes that overall rates have been increasing, especially for more traditional, unique, higher hazard surplus lines such as medical manufacturing risks or home builders in windstorm-prone areas, it is important to note that many lower hazard classes and lines of business have seen relatively flat or declining rates due to competitive market conditions.

A.M. Best also notes that some borderline business, which had found its way into the admitted markets in recent years, has been returning slowly to the surplus lines market. While competition and the wealth of available capacity signal that there is no impending hard market, selected rate increases, as well as the continued flow of business from the admitted markets, remain good indicators that surplus lines insurers could enjoy further top-line growth over the near term. Furthermore, A.M. Best believes that as overall economic indicators continue to improve, the need for capable surplus lines insurers to cover expanding exposures will increase, especially in industries presenting tougher exposures such as construction, transportation and health care.

Given the challenging investment climate and the potential need to maintain adequate loss reserves for older accident years, companies clearly recognize that profitable underwriting remains of the utmost importance. Better risk assessment and selection, aided by the adoption of predictive analytics, likely will drive underwriting performance. A.M. Best notes that predictive analytics are being adopted in a fashion similar to that by which insurers are implementing new programs as part of their overall enterprise risk management processes. The larger insurers in all segments, which can access more data and better leverage technology, are among the earliest to adopt these technologies. As the benefits have become more clear and robust technology has become more readily available, smaller companies, particularly those with niches in relatively homogenous lines, also have adopted them. For some lines of coverage, the use of predictive modeling and metadata analyses has reached a point where insurers not using these types of products in some form may be more vulnerable in the marketplace.

A.M. Best believes successful insurers likely will be those that best leverage data, technology and talent in ways that optimize profits, and those that differentiate themselves through innovative products and better risk management, pricing metrics, speed of delivery and operational efficiency. Establishing appropriate reserves, maintaining conservative portfolio allocations and consistently applying underwriting guidelines, pricing and policy terms and conditions should remain hallmarks of the most successful surplus lines insurers.

For the remainder of 2014, A.M. Best expects limited improvement in pricing to continue for most lines and in certain geographic areas, but not across the board. Additionally, for some lines, particularly non-catastrophe-exposed property, an overabundance of capacity may lead to rates trending down for the balance of 2014. If the current trend of the standard market narrowing its focus continues, “fringe” classes of business currently written in that market likely will return to the surplus lines market. This business is likely to be written with tighter terms and conditions and at higher average rates by those surplus lines companies that seize the opportunities. Also, overall economic factors (interest rates, inflation and employment) will continue to present variables that impact both top- and bottom-line results for the near term.

The favorable prior-year loss-reserve development that the domestic professional insurers have experienced in recent years exhibits the benefit of rates that to date have proved adequate. Reserve releases in 2013 included those from recent accident years. As it has stated in recent years, A.M. Best remains skeptical about whether more recent accident years’ reserves for the entire industry were established at levels that support the redundancies recognized to date. As a result, there is concern with the industry’s loss-reserve position, given the impact of the extended soft market conditions and the resulting erosion of rate adequacy that has led to a reduction in the available loss-reserve cushion.

Significant reserve charges during 2013 from surplus lines groups such as QBE, Meadowbrook and Tower Group support the trepidation concerning reserve adequacy, although on the whole, surplus lines insurers experienced favorable prior-year development. Costs associated with claims from other long-tailed lines may have been suppressed by sluggish economic conditions in recent years, particularly in light of the relatively moderate growth in medical costs. As the economy improves and even modest levels of inflation emerge, reserves established for these more recent years may prove to be insufficient, particularly given the level of favorable development that already has been recognized.

With all factors considered, including declining loss-frequency trends, underwriting results remain under pressure to drive operating profitability. Coupled with the decline in claim frequency, A.M. Best expects the current trend of reserve releases for recent accident years to continue through the end of 2014, although most likely at a reduced level compared with last year. If loss-reserve adequacy does indeed dissipate, companies will be pressured to get to more adequate current-year pricing, meaning the quality of underwriting decisions will have to be augmented to produce results equal to or better than those generated in 2013.

Conclusion

Through the first half of 2014, general market conditions have continued the momentum that began during 2013, when moderating rate increases became more prevalent. On many lines of coverage, particularly long-tail casualty lines, the ability to raise rates to outpace loss-cost trends still exists, but the gap is narrowing. The exceptions to that trend include risks in the energy sector and high-hazard product liability risks. Some hardening continues on these risks, as expiring rates in many cases still are deemed insufficient because of unfavorable experience that hampers companies' ability to produce a reasonable return. Renewals for commercial property risks have been relatively flat, also reflecting a continuation of the trend exhibited in 2013, and impacted by declining reinsurance costs. With the extended cold weather across parts of the country this past winter generating greater losses, and with severe storms in June in parts of the United States that included large hailstorms, windstorms and flash floods, the possibility remains that 2014 could present more significant weather-related losses than 2013.

As usual, activity that occurs during the upcoming Atlantic hurricane season will greatly influence the aggregate impact of catastrophe losses on the insurance industry in 2014. With persistently low interest rates providing only marginal investment returns, underwriting performance once again will take center stage as the leading driver of operating performance. If companies are able to retain the majority of their higher yield assets and capitalize on favorable positions with others, total investment income, including realized gains, again could provide additional support to income and surplus.

The performance of the commercial lines and surplus lines markets in 2014 also will depend greatly on the extent to which macroeconomic factors, such as sluggish economic growth and high unemployment, enable market dynamics to impact bottom-line profitability.

Historically, the best surplus lines insurers have focused on maintaining the underwriting and pricing integrity that have been the hallmark of this market segment. These companies typically focus more on bottom-line profits than top-line organic growth, utilizing the segment's freedom of rate and form, while providing coverage for the varied, nonstandard risks that they underwrite. This focus gives these insurers the best chance to withstand adverse market circumstances and succeed over the long term. A.M. Best expects surplus lines insurers to concentrate on using proven fundamentals to overcome the execution risk presented by current underwriting and investment market conditions, while also remaining prepared for the unforeseen challenges that historically have moved the market and altered behavior.

Section II – Financial Condition & Rating Distribution

DPSL Peer Composite Overview

The domestic professional surplus lines (DPSL) peer composite (see sidebar **A.M. Best's DPSL Peer Composite Defined**) experienced a sharp rebound in profitability during 2013. This followed a rather difficult 2012, in which the DPSL composite's pretax gains were pared by more than 26% and net income by 12.6% year over year. In 2013, both pretax and net income more than doubled for the composite, with pretax income growing to almost $3.1 billion, up from $1.3 billion in 2012, and net income of $3.4 billion versus $1.6 billion reported in 2012. These advances were largely attributable to a return to underwriting profitability in the year, supplemented by strong growth in investment gains, including realized capital gains as companies locked in a portion of their gains from common equities.

Returning to form in 2013, the DPSL composite's results outpaced the underwriting and operating results posted by the total P/C industry (including the mortgage and financial guaranty market segment). A year after weather-related events, led by Superstorm Sandy, drove a notable deterioration in results, the composite benefited from relatively benign weather conditions, as loss ratios improved across liability lines and allied lines drove bottom-line success. Strong underwriting performance led the composite to reflect the DPSL industry's first net underwriting profit since 2009. Underwriting results also benefited from the growth in direct premium writings in 2013 and the improved rate environment from late 2011 through 2013. The DPSL composite's 2013 combined ratio (after policyholder dividends) improved considerably to 92.4 from 110.1, better than the total P/C industry's 2013 combined ratio of 95.8. In addition, during 2013, the DPSL composite regained its net loss ratio advantage over the P/C industry, an advantage that had persisted until it was reversed suddenly in 2012.

The benefits of a benign catastrophe year notwithstanding, the composite continued to struggle in 2013 with low investment yields and competition driven by excess capacity. Entering 2013, the composite had continued to sustain operating profits despite a sluggish U.S. economy, a record-low interest rate environment and a setback in underwriting profitability over the prior three years. Driving the less than favorable underwriting results in recent years has been the composite's higher pure net loss ratios in general liability, commercial multiperil

A.M. Best's DPSL Peer Composite Defined

The analysis in this section is based on the statutory financial data of 73 U.S.-based domestic professional surplus lines (DPSL) companies. To determine the population of true DPSL companies for the purposes of this section and the comparisons herein, A.M. Best excludes from this composite surplus lines companies that are members of intercompany pools that predominantly write admitted business as opposed to surplus lines; those companies that reinsure all of their business with an affiliate; and companies that write a relatively small amount of premium. This DPSL composite produced approximately $15.4 billion in direct premiums written (DPW) in calendar year 2013, representing approximately 57% of the total U.S. DPSL market as defined in this report.

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

and allied lines. In 2013, general liability's pure net loss ratio improved by more than 17 points, a trend that other lines replicated to varying degrees in their loss ratios.

Given their role as a market of last resort, surplus lines insurers often find new opportunities, determined by market supply and demand. As such, surplus lines companies, their brokers and agents continue to seek new business opportunities and push for incremental rate increases, while any enhancement to results through investment returns remains elusive. Unfortunately, rate firming that most product lines experienced in recent years appears to be moderating in 2014. While there will always be isolated opportunities to raise rates and/or modify terms and conditions in certain territories or risk classes, the momentum broadly appears to have stalled, and this softening is likely to affect surplus lines insurers.

Despite the upward movement in rates in recent years, this shift never got past the firming stage or became prominent enough to constitute a hard market. Even with reserve releases remaining the norm throughout the P/C industry, A.M. Best still believes companies must remain committed to sound underwriting and disciplined pricing to guard against diminishing prior-year reserve releases and any unexpected changes in loss-cost trends.

Operating Performance

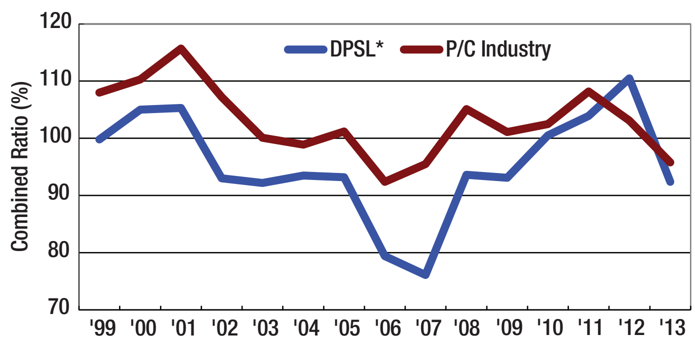
As previously noted, with the exception of 2012, the DPSL composite's results clearly outpace those of the total P/C industry, as reflected in the composite's 100.1 and 92.9 five- and 10-year average combined ratios, compared with 102.0 and 100.3, respectively, for the total P/C industry. Underwriting results have benefited from both higher premiums and lower incurred losses. Rate increases in recent years have outpaced increases in loss costs. Absent the substantial impact of weather-related losses, the trends for both the surplus lines composite and the P/C industry have been good. However, the impact of severe weather on insurable exposures has pushed the five- year average combined ratio for both above 100.

The impact on surplus lines insurers' underwriting profitability from years with large weather-related losses bears out the market's role in insuring the tougher exposures, not the least of which are catastrophe-exposed risks. Nonetheless, the composite's core book of business is underwritten carefully and priced well. Given the lack of any extraordinary weather events in 2013, underwriting profits soared, leading to increases of 131% in pretax income and 120% in net income. This outpaces the still impressive 82% and 69% increases in these measures experienced by the total P/C industry. Policyholders' surplus was a different story, however. While the P/C industry's surplus increased by 11.6% in 2013, that of the DPSL composite actually declined by 1.2%. This is in part due to a substantial increase in shareholder dividends paid during the year, well more than double the amount paid in any of the prior four years. These dividends reflect companies' desire to deliver profits to their shareholders, as well as deploy capital for other general corporate purposes. These dividends can be viewed as a positive action if they help eliminate more aggressive pricing, since lessened capacity reduces chances for pushing the market competitively.

Until 2012, the DPSL composite historically maintained a slightly more favorable underwriting expense ratio than the total P/C industry. As with other key profitability measures, the calendar-year results for 2012

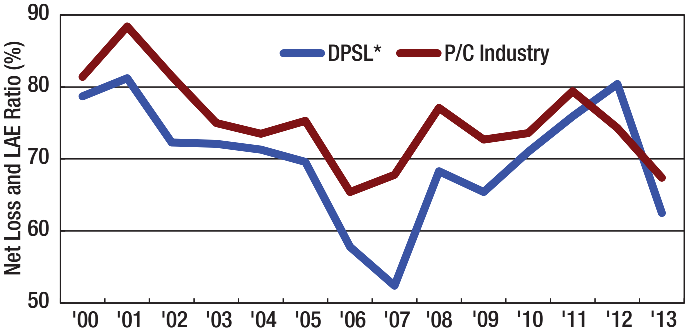
Exhibit 10

U.S. DPSL* – Combined Ratios vs. U.S. P/C Industry



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

Exhibit 11
U.S. DPSL* – Net Loss & Loss-Adjustment Expense Ratios vs. U.S. P/C Industry



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

were counter to historical norms, with the composite's expense ratio slightly exceeding that of the total P/C industry. While the composite's key loss and loss-adjustment expense (LAE) ratio remained better than the P/C industry's five-year average, its expense ratio remains comparatively elevated. Commissions paid by surplus lines insurers are typically higher than for the P/C industry, but the difference in their net commission ratio is not large enough to overwhelm the advantage in terms of loss ratio.

The surplus lines composite's reported 2013 combined ratio of 92.4 was 3.4 percentage points lower than the P/C industry's 95.8 (see **Exhibit 10**), yet both reflect favorable loss frequency and severity trends. The gap might have been wider in the composite's favor if not for its underwriting expense ratio, which at 29.9 was almost two points higher than that of the P/C industry at 28.0 for the year. The composite also ceded more of its gross written premium to reinsurers comparatively, though this should have generated more offsetting ceding commissions to benefit the expense calculations. The P/C industry benefited from a slight increase in prior-year reserve releases, while the impact of these favorable prior-year adjustments for the surplus lines composite was relatively flat.

Impact of Weather-Related Losses

On a normalized basis, the DPSL composite has outperformed the total P/C Industry, generating a lower net loss and loss-adjustment expense ratio in years without extraordinary weather-related events (**Exhibit 11**). Perhaps the most pronounced disparity between surplus lines insurers and the P/C industry is in allied lines. A.M. Best believes this reflects the unique, customized nature of the surplus lines business and the various coverage options that are tailored to these risks. Sandy-related losses were, for the most part, included in the allied lines segment.

The spread between the DPSL allied lines loss ratio and that of the P/C industry widened from 59.4 points in 2010, to 88.9 points in 2011 and 95.6 points in 2012, the latter due to Sandy. In 2012, allied lines for the surplus lines composite finished the year at a 186.5 pure net loss ratio (excluding LAE), while the P/C industry ended the year at 90.9. The extraordinary loss ratio also reflects the surplus lines industry's risk appetite and its willingness to write coastal properties in areas where standard carriers may not. The disparity settled to a more historical level in 2013, with the composite reporting a 70.4 pure loss ratio in allied lines and the P/C industry 62.0.

In response to the impact of past weather events on results and the potential impact of future such events on underwriting profitability, more companies are employing recent loss data in their current pricing models and exposure management decisions. Surplus lines companies have been active in enhancing the quality of data collection and in augmenting the sophistication of the modeling tools used to help make decisions on managing aggregate exposures, as well as for pricing decisions on catastrophe-exposed risks.

The greater frequency and severity of catastrophe losses in recent years has had a material impact on ultimate calendar-year results for the total industry, especially for the DPSL composite. However, the surplus lines industry is able to mitigate these losses to some degree with its freedom to set pricing and coverage terms.

Exhibit 12
U.S. DPSL* Composite – Investment Performance vs. P/C Industry
(USD Billions)

	DPSL* 2012	DPSL* 2013	Year/ Year Change (%)	Total P/C Industry 2012	Total P/C Industry 2013	Year/ Year Change (%)
Net Investment Income	2,121.9	2,357.4	11.1	49,237.0	49,482.0	0.5
Realized Capital Gains or (Losses)	416.4	553.6	32.9	9,033.0	12,164.0	34.7
Net Investment Gain	2,538.3	2,911.0	14.7	58,270.0	61,646.0	5.8
Unrealized Capital Gains or (Losses)	631.2	864.8	37.0	18,021.0	38,677.0	114.6
Total Investment Return	3,169.5	3,775.8	19.1	76,291.0	100,323.0	31.5

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

Investment Income Rises, Net Investment Gains Continue to Grow

The DPSL composite's net investment income – primarily dividends from stocks and interest on bonds – reversed course in 2013, increasing by 11.0% after falling by 3.8% in 2012. Meanwhile, the P/C industry experienced only a small decline of 1.1% in 2013, versus a 2.6% drop the preceding year. After a substantial 74.0% increase in the investment allocation to short-term investments and cash during 2012, the DPSL companies removed some of these funds in favor of short-term bonds and a very substantial 34% boost in common stocks. The latter, however, may not be quite the elevation of equities to investment vehicle of choice that it might first appear; rather, it may reflect the increase in prices of current holdings due to appreciation in the equity markets. Also, the common stock label in statutory reporting is extended to placements in bond mutual funds. Still, with the vast majority of money allocated to cash, bonds and quick assets, interest earnings are minimal for the time being and expected to remain so. The sustained lower interest earned on fixed-income securities, as well as an increase in allocated funds to short-term investments and cash, have impacted the investment income generated by the P/C industry as a whole.

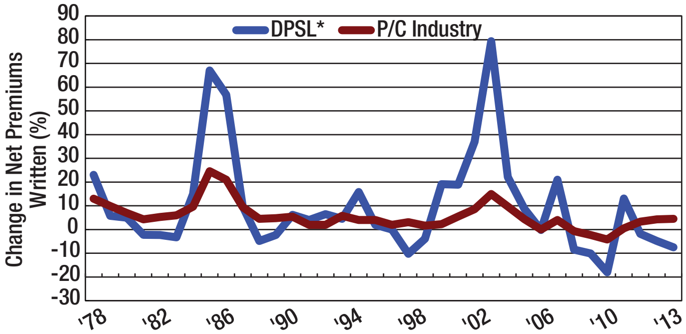
In 2013, the composite's realized gains of approximately $554 million and unrealized gains of nearly $865 million on investments led to a 19.1% increase in total investment return (net investment gain plus unrealized gains or losses), as shown in **Exhibit 12**. A large portion of the unrealized gain was generated among composite members that are part of Berkshire Hathaway. The P/C industry similarly experienced a considerable (approximately 31%) increase in its total investment return. In both cases, gains were registered in unrealized and realized valuations of securities in portfolios.

Favorable Loss-Reserve Development

Over the past few years, favorable prior-year loss-reserve development has augmented the overall P/C industry's underwriting profitability. Favorable development reduced the DPSL composite's combined ratio by 8.5 points in 2013, which was slightly more than the 7.3 points in 2012. These reserve takedowns compare favorably with the 3.6- and 2.8-point reductions in 2013 and 2012, respectively, for the total P/C industry. In 2013, commercial lines reserves developed positively, equating to 2.1 points of favorable development on the segment's combined ratio.

A.M. Best remains concerned that the favorable reserve development may continue to dissipate, albeit gradually. A.M. Best believes loss reserves for the P/C industry are already deficient for commercial insurers, and reserve margins are tightening greatly as well. As such, A.M. Best believes reserve margins for surplus lines insurers also are constricting. Despite this, both groups are expected to continue to post reserve redundancies through the end of 2014. A.M. Best also believes insurers that have reserved conservatively will be best positioned to take advantage of market opportunities through the cycle as others are forced to recognize deficient reserves, leading to eroding underwriting results and surplus positions.

Exhibit 13
U.S. DPSL* Composite – NPW Growth vs. U.S. P/C Industry



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

Commercial casualty reserves (combining the other liability, medical professional liability and products liability lines), which in 2013 made up almost 80% of the surplus lines composite's reserve base, characteristically have longer loss-payout patterns. As such, A.M. Best is cautious in its view of the impact of recent accident-year takedowns and their future effect on the composite's reported underwriting profitability.

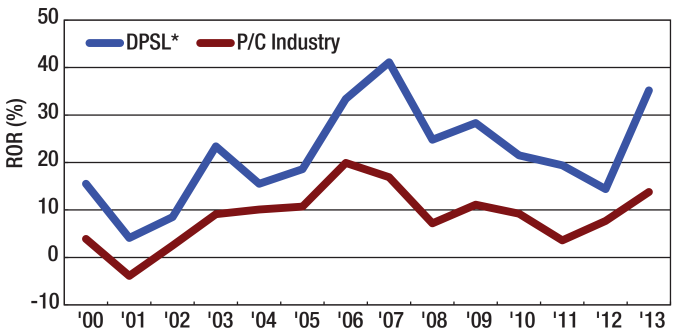
The DPSL composite's reported accident-year combined ratio, which excludes prior-year loss-reserve development, was 97.4, moderately better than the 115.4 posted in 2012. This result reflects the significant effect on bottom-line results caused by the presence or absence of weather-related catastrophe losses. Similarly, some of the favorable movement can be attributed to better pricing and risk selection by the members of the DPSL composite.

Comparatively, the P/C industry's reported accident-year combined ratio was 99.6, down from 103.8 in 2012. Improvement in the profitability of the homeowners, workers' compensation and automobile physical damage lines spurred the lower accident-year combined ratio for the P/C industry. However, A.M. Best remains concerned that a number of P/C insurers, including surplus lines companies, continue to be too optimistic about loss trends, which could lead to the premature release of loss reserves, particularly from accident years that have yet to mature.

DPSL's Growth Rate Less Than Total P/C Industry's

In 2013, the DPSL composite posted a 3.5% increase in direct premiums written, marking the third consecutive year of growth in this sector. Conversely, net premiums written for the DPSL composite contracted again in 2013 by a substantial 7.5% versus a decline of 4.2% the prior year (see **Exhibit 13**). This reduction in NPW reflects a continued pattern of ceding a considerable amount of gross writings to third-party reinsurers. Some of this may relate directly to surplus lines insurers taking advantage of less expensive reinsurance and optimizing their reinsurance placements. Results for the most recent five years show surplus lines insurers with a compound annual growth rate (CAGR) in NPW of -3.5%, compared with +1.7% for the total P/C industry. This also in part shows the significant impact of prolonged competitive market conditions on surplus lines insurers compared with the rest of the market, whereby standard market companies compete for traditional surplus lines accounts.

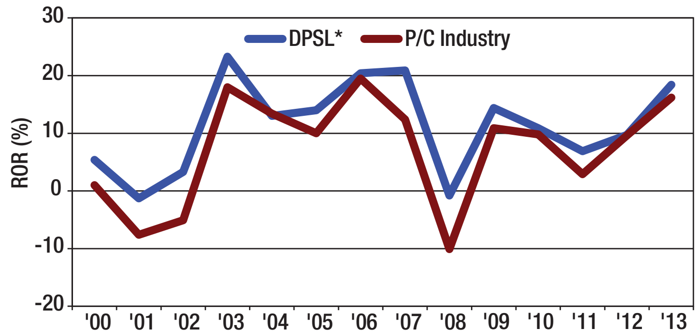
Exhibit 14
U.S. DPSL* – Pretax Returns on Net Premiums Earned (NPE) vs. U.S. P/C Industry



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

The five-year change in NPW reflects the composite's 16.3% contraction in net premiums compared with the P/C industry's 8.8% increase. The shift of business out of the surplus lines market and into the admitted market exemplifies the standard market's historical willingness to write some borderline classes of business in the admitted market, especially some general liability and property classes, during particularly competitive periods in the market cycle. It also reflects both the impact of weak macroeconomic factors and the discipline of surplus lines insurers, particularly the market leaders, which are willing to pull back from the market when underwriting terms become unfavorable. One further factor that has some impact on the nominal figures is a situation where surplus lines carriers are affiliated with standard market carriers under common management. As conditions dictate, some writings may fluctuate among these entities and be reported in different lines or segments over the years.

Exhibit 15
U.S. DPSL* – Total Returns on Surplus vs. P/C Industry



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

DPSL Outperforms Total P/C Industry in Overall Operating Profitability

The profitability of the DPSL composite in 2013 reversed the less favorable recent trend from 2010-2012 with a strong underwriting and operating performance in 2013. The DPSL composite's overall operating profitability, as measured by returns on revenue, remains excellent and superior to that of the total P/C market, as demonstrated by the one-year and five-year average returns on net premiums earned (see **Exhibit 14**).

Both the surplus lines composite and the overall P/C industry continued the trend established in 2012 with an uptick in total return on surplus (equity) in 2013. The composite once again outpaced the total P/C industry by a small margin, producing an 18.4% return, up from 9.7% in 2012 (see **Exhibit 15**). The higher total return for the composite was driven by the substantial increase in net income and notable increases in both realized and unrealized investment gains, despite prevailing interest rates remaining relatively low. The composite's improved total return on equity in 2012 and 2013 was directly attributable to the huge turnaround from an unrealized loss of more than $233.0 million in 2011, to an unrealized gain of more than $631.0 million in 2012 and a further improvement in 2013 of $865.0 million. Likewise, the P/C industry benefited greatly from investment gains the past two years, posting an unrealized gain of more than $38.0 billion in 2013, almost double the $18.0 billion unrealized gain in 2012. As with the DPSL composite, the P/C industry's 2012 unrealized gain represented an enormous turnaround from a loss of almost $3.7 billion in 2011.

While the composite's returns on surplus also have compared favorably with those generated by the P/C industry as a whole, the difference is less significant than the margin for returns on revenue (earned premium). This is partly due to the surplus lines market historically maintaining lower underwriting leverage than the P/C industry. In general, surplus lines insurers meeting with A.M. Best during the first half of 2014 reported that premiums are shifting back to surplus lines companies from standard market insurers, and submissions are plentiful. However, they also expect a continuing moderation in the upward trend of rates and price firming for most commercial lines of business. With considerable interest in specialty lines business, especially surplus lines risks, the market landscape appears more competitive for the near future.

Balance Sheet Strength

Surplus lines insurers generally remain very well capitalized, as these companies need strong balance sheets, given the unique or more hazardous risks they insure. Since these insurers typically provide more complex and flexible coverage options than standard market carriers, conservative underwriting fundamentals are extremely important. In addition, a very competitive marketplace, coupled with low investment returns, weather-related events during the first half of 2014 and the possibility of catastrophic activity during the Atlantic hurricane season, has increased the focus on making sound underwriting decisions to fuel profitability. Despite the competitive market conditions, surplus lines insurers generally have been adequately managing the market cycle, introducing new products and coverages while maintaining their balance sheet strength with conservative investment strategies. In addition, surplus lines insurers have improved income levels through rate increases where deemed necessary. This remains particularly true of the leading surplus lines carriers that have well-established books of business.

Overall, surplus lines insurers continue to benefit from their largely strong capital base, which better positions these companies to withstand periods of heightened competition, low interest rates and weather-related catastrophe losses, while still maintaining more than adequate capitalization.

In 2013, the DPSL composite's policyholders' surplus declined by 1.2%, despite generating $3.4 billion in net income. The surplus decline was driven directly by the increase in dividends paid by the composite's insurers as profits were shared with shareholders. The improvement in the equities markets generated substantial unrealized and realized capital gains, which contributed to the composite's strong capital position, despite the impact of the substantial dividend payments as discussed previously.

The P/C industry's almost 69.0% growth in net income, combined with more than $12.0 billion in realized gains, led to an 11.6% increase in policyholders' surplus. Over the long term, however, the DPSL composite's growth in surplus – 96% over the past 10 years – is modestly greater than the 90% change for the total P/C industry.

In 2013, the DPSL composite continued to maintain slightly lower net premium leverage (the ratio of NPW to policyholders' surplus) than the total P/C industry. The composite also maintained lower net leverage (net premium leverage plus net liability leverage). The composite's gross leverage measure (net leverage plus ceded reinsurance leverage), at 2.4 times surplus, was also below the total industry average of 2.8 times surplus. Surplus lines companies historically have used reinsurance to protect their balance sheets to a slightly greater degree than the total industry, reflecting the higher limits provided, as well as larger catastrophe exposure associated with property risks. This results in the composite having slightly higher ceded leverage, comparatively.

The DPSL composite's strong risk-adjusted capitalization is supported further by its relatively conservative investment portfolio, with U.S. government and National Association of Insurance Commissioners (NAIC) Class 1 bonds making up the vast majority of total invested assets. In addition, a conservative loss-reserve position augments the composite's capitalization.

Ratings Distribution

Over the past 10 years, DPSL insurers consistently have maintained a higher proportion of "Secure" ratings than the overall P/C industry (see **Exhibit 16**). A Secure rating is defined as an A.M. Best rating in the range from A++ (Superior) to B+ (Good). As of late August 2014, all of the A.M. Best-rated DPSL rating units held Secure ratings.

The term "rating unit" applies either to individual insurers or to a consolidation of affiliated companies. The rating unit forms the financial basis upon which A.M. Best performs its rating evaluation.

Exhibit 16

U.S. Domestic Professional Surplus Lines – Best's Rating Distribution by Rating Unit vs. U.S. P/C Industry

Best's Financial Strength Rating (FSR)		Domestic Professional Surplus Lines		Total P/C Industry	
Level	**Category**	**# of Rating Units**	**Percentage**	**# of Rating Units**	**Percentage**
		SECURE RATINGS			
A++	Superior	7	7.29%	26	2.87
A+	Superior	22	22.92%	80	8.83
	Subtotal	**29**	**30.21%**	**106**	**11.70**
A	Excellent	46	47.92%	300	33.11
A-	Excellent	18	18.75%	291	32.12
	Subtotal	**64**	**66.67%**	**591**	**65.23**
B++	Good	3	3.13%	104	11.48
B+	Good	0	0.00%	58	6.40
	Subtotal	**3**	**3.13%**	**162**	**17.88**
Total Secure Ratings		**96**	**100.00%**	**859**	**94.81**
		VULNERABLE RATINGS			
B	Fair	0	0.00%	31	3.42
B-	Fair	0	0.00%	5	0.55
	Subtotal	**0**	**0.00%**	**36**	**3.97**
C++	Marginal	0	0.00%	4	0.44
C+	Marginal	0	0.00%	3	0.33
	Subtotal	**0**	**0.00%**	**7**	**0.77**
C	Weak	0	0.00%	3	0.33
C-	Weak	0	0.00%	1	0.11
	Subtotal	**0**	**0.00%**	**4**	**0.44**
D	Poor	0	0.00%	0	0.00
E	Under Regulatory Supervision	0	0.00%	0	0.00
F	In Liquidation	0	0.00%	0	0.00
	Subtotal	**0**	**0.00%**	**0**	**0.00**
Total Vulnerable Ratings		**0**	**0.00%**	**47**	**5.19**
Total Rating Opinions		**96**	**100.00%**	**906**	**100.00**
Total NR Ratings		**1**		**1,054**	
Total Reported Rating Units		**97**		**1,960**	

1 Domestic professional surplus lines ratings are as of August 28, 2013
2 Total industry ratings distribution data is as of July 18, 2013
Source: A.M. Best data & research

The percentage of DPSL insurers in the top-tier rating categories, Excellent to Superior, relative to all rating opinions remained extremely high at almost 96.9% (93 out of 96 rating units in the top tier), essentially the same as last year's 97.9% (95 of 98 rating units). The decline in the number of rating units over the past couple of years, from 103 in 2011 to 98 in 2012 and 96 in 2013, is due mainly to intragroup consolidations involving organizations such as Fairfax Financial Group, W.R. Berkley Insurance Group and QBE North America Group. 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 a part of group rating units as defined by A.M. Best.

For the total P/C industry, the number of rating units in the Excellent to Superior rating categories has remained stable over the past year, with 76.9% of the ratings in the top tier, compared with 76.0% one year before. 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.

Outlook

The DPSL composite started 2014 with excellent results in the first quarter, reporting almost $700 million in net underwriting income and approximately $928 billion in pretax income.

Noteworthy improvement in underwriting profitability led to a 69.2 combined ratio, driven by an extraordinarily low 38.4 loss and loss-adjustment expense (LAE) ratio. These results compared favorably with a reported combined ratio of 99.7 and a loss and LAE ratio of 60.2 through the first quarter of 2013. The loss ratio was aided by 4.8 points of favorable prior accident-year development, which was essentially on par with the impact of favorable development on the P/C industry's first-quarter loss ratio.

The sustained low interest rate environment, coupled with a lack of risk-averse investment alternatives, likely will continue to make it difficult for insurers to offset any underwriting losses with investment gains. A.M. Best believes this likely will result in a continued focus on underwriting profitability as of paramount importance to a company's bottom line and, ultimately, to its balance sheet strength.

Looking further at first-quarter 2014 results and trends for the total P/C industry, pretax income was $14.3 billion and net income was $14.5 billion, with both results, although favorable, falling short of 2013's results, due largely to the industry's underwriting gain declining to about $2.5 billion from almost $6.9 billion in the first quarter of 2013. Underwriting profitability for the P/C industry, as measured by the 68.5 loss and loss-adjustment expense ratio and a 97.1 combined ratio, also slightly lagged the 2013 ratios of 64.5 and 92.8, respectively. These underwriting results were augmented by 4.4 points of favorable impact on the combined ratio from current-year development of prior accident years' reserves. Compared with the 6.1 points of positive impact in the first quarter of 2013, the 2014 result tracked with A.M. Best's belief that companies will be able to rely less on the depth of reserve redundancies to enhance current calendar-year profitability.

A.M. Best believes overall rate changes should remain positive as long as interest rates remain at record lows. However, it is not yet clear whether rate adjustments will keep pace with future loss costs and inflation. Additionally, despite the U.S. economy lingering in a sluggish recovery mode, there is more than enough capacity to prevent the onset of a full-blown hard market any time soon.

The compilation of second-quarter total P/C industry results has not been completed at this writing. Severe weather in May and June caused insured losses of more than $2.0 billion in the United States. Despite these occurrences, and the losses from the difficult winter months in early 2014, A.M. Best feels the results for the P/C industry may be able to remain on track for the rest of the year with the results through the first quarter if companies continue to report rising premiums in most lines of business. The caveat is that catastrophe losses will need to stay close to normal levels and continue to have only a modest impact on results. With only incremental improvement in rate levels expected for the remainder of the year, potential losses from the current Atlantic hurricane season, which ends Nov. 30, will be a concern as always for the surplus lines market and the total P/C industry. A.M. Best expects the surplus lines market segment to stay on course, exhibiting disciplined underwriting, generating sustained operating profitability and maintaining sound balance sheet strength.

Section III: Regulation and Legislation

Several pieces of legislation that could impact the surplus lines industry have been introduced in the 113th Congress (2013-2014). Two of these legislative items, the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) of 2014 and the Flood Insurance Reform Act, are measures that would reauthorize and modify existing federal programs.

Exhibit 17
Federal Terrorism Backstop

Terms	TRIPRA (Current Program)	Senate Bill (S.2244)	House Bill (HR.4871)
Extension	NA	7 years	5 years
Co-Participation	15%	Up to 20% from 15%	15% for NCBR, 20% for non-NCBR
Deductible	$27.5 billion	$37.5 billion (over 5 years)	Sum of industry's deductibles
Trigger	$100 million	$100 million	$100 M for NCBR, $500 million by 2019 for non-NCBR
Recoupment	133%	133%	150%
Timeline for Certification	Not Specified	Not Specified	90 days

Source: A.M. Best research

Another bill, the National Association of Registered Agents and Brokers Reform Act (NARAB II), which had been introduced in previous congressional sessions, is advancing in the current Congress by being attached to other legislative proposals.

The chart summarizes recent federal and state legislative and regulatory proposals that could affect the surplus lines industry. Following the chart, the section continues with an update on the implementation of the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA).

2013-2014 Federal Legislation/Regulation

Bill/Sponsor	Key Provisions & Actions
Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) **• S.2244; introduced April 10, 2014 by Sen. Charles Schumer (D-NY)** **• H.R. 4871 Introduced June 17, 2014, by Rep. Randy Neugebauer (R-TX)**	Before Sept. 11, 2001, insurance coverage for losses as a result of a terrorist attack was included in general insurance. After the attacks, such coverage became very expensive, if offered at all. Congress responded to this disruption by passing the Terrorism Risk Insurance Act of 2002, providing a government reinsurance backstop so commercial insurers would offer terrorism coverage. The lack of available insurance caused fears of a major impact on the economy, as companies would remain idle due to uncertainty. The act – extended and amended in 2005 and 2007 and now known as the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) – is set to expire on Dec. 31, 2014. The looming expiration once again created uncertainty among insurers throughout 2014 as they renewed their commercial policies. In the event TRIPRA is not renewed or its protection is altered materially, insurers would have to obtain private reinsurance if they don't have it already. In 2014, the following bills were introduced in both the Senate and the House of Representatives: **S. 2244** Introduced in the Senate Banking Committee April 10, 2014. The bill, which would continue the federal backstop another seven years through 2021, proposes to increase the: • Insurer copay to 20% from 15%; and • Mandatory recoupment threshold amount to $37.5 billion from $27.5 billion, gradually over a five-year period. On June 3, the committee unanimously approved the bill, and on July 17, the Senate passed the bill by a vote of 93-4. **H.R. 4871** Referred to the House Committee on Financial Services on June 17, 2014. On June 20, the committee approved the legislation by a 32-27 vote. In addition, the Committee approved an amendment to add the **National Association of Registered Agents and Brokers Reform Act of 2013 (NARAB II)** as **Title II** in this legislation. A side-by-side comparison of these two bills is shown in **Exhibit 17.** It can also be found in greater detail in the Best's Briefing: *Federal Terrorism Backstop Bill Would Place Greater Onus on Insurers*, July 21, 2014. This bill has yet to be voted on by the full chamber.

Bill/Sponsor	Key Provisions & Actions
Flood Insurance Reform Act of 2012 The following bills were introduced in the 113th Congress in: ***October 2013:*** • **H.R. 3370**, by Rep. Michael Grimm (R-NY) Passed in March 2014. • **H.R. 3312**, by Rep. Gus Bilirakis (R-FL) • **S. 1601**, by Sen. John Hoeven (R-ND) • **S. 1610**, by Sen. Robert Menendez (D-NJ) ***November 2013:*** • **H.R. 3511**, by Rep. Michael Capuano (D-MA) ***December 2013:*** • **H.R. 1846**, by Sen. Robert Menendez (D-NJ) ***January 2014:*** • **H.R. 3815**, by Rep. Tom Marino (R-PA) • **H.R. 3834**, by Rep. Kevin Cramer (R-ND) • **S. 1926**, by Sen. Robert Menendez (D-NJ) ***May 2014:*** • **H.R. 4558**, by Rep. Dennis Ross (R-FL) and Rep. Patrick Murphy (D-FL) • **S. 2381**, by Sen. Dean Heller (R-NV) and Sen. Jon Tester (D-MT)	In July 2012, before Superstorm Sandy, the Biggert-Waters Flood Insurance Reform Act of 2012 was passed. It required the Federal Emergency Management Agency (FEMA) and other agencies to change the National Flood Insurance Program (NFIP). Key provisions of the legislation required the NFIP to raise rates to reflect true flood risk (a 25% increase in premium rates each year), make the program more financially stable and change how updates to flood insurance rate maps impact policyholders. In 2013, other legislation to amend NFIP was introduced, but only **H.R. 3370** was passed – becoming **Public Law 113-89** on March 21, 2014. It amends the National Flood Insurance Act of 1968 (NFIA). Certain aspects of Biggert-Waters – such as prohibiting flood insurance premium subsidies to prospective insureds for property that was purchased after the Act's passage – were repealed. In January 2014, S. **1926**, the Homeowner Flood Insurance Affordability Act, also was introduced to delay the implementation of certain provisions of Biggert-Waters – as stated in Title I of the bill. However, it also included legislative text – as stated in Title II of the bill – from the National Association of Register Agents and Brokers Reform Act of 2014 (NARAB II). It was removed, however, from the bill ultimately passed by both chambers. **H.R.4558** and **S. 2381**, the Flood Insurance Market Parity and Modernization Act, introduced in May 2014, would ensure that surplus lines insurers are eligible to offer private market solutions and alternatives to consumers needing coverage of unique and complex flood risks. The surplus lines industry is closely watching these measures.
National Association of Registered Agents and Brokers Reform Act. Known as NARAB II (H.R. 1155 and S534) • 113th Congress - Reintroduced by Rep. Randy Neugebauer, R-Texas (**H.R. 1155**) on 3/14/13 and by Sen. Jon Tester, D-Mont. (**S. 534**) on 3/12/13 and as part of **S. 2244** on 7/17/14	**NARAB II:** • Would streamline and improve the licensing process for approved nonresident insurance producers, eliminating duplicative licensing requirements for businesses operating in multiple states. This act would improve the licensing process for nonresident insurance producers and strengthen oversight by state insurance regulators. • Would create the National Association of Registered Agents and Brokers (NARAB), a national licensing organization. It would allow agents to operate in multiple states more efficiently, as nonresident insurance producers, after meeting and maintaining certain eligibility criteria for which they pay a licensing fee. • Would preserve state insurance regulation and consumer protection provisions. • Would help surplus lines brokers by facilitating the acquisition of nonresident surplus lines licenses. • Last Action on **S. 534**: July 2013. Placed on the Senate Legislative Calendar under General Orders. Calendar No. 151. • Last Action on **H.R. 1155**: September 2013. Passed in the House of Representatives. It was then sent to the Senate, where it was placed on the Senate Legislative Calendar. • On Jan. 30, 2014, NARAB II passed in the Senate as part of another bill – Title II of **S. 1926** – that was related to the National Flood Insurance Program. The House passed NARAB II in September 2013 as a stand-alone bill. However, the NARAB legislation was not ultimately included as part of the flood legislation passed by Congress in March 2014. • On June 20, 2014, NARAB II was included in the language of **H.R. 4871**, the TRIA Reform Act of 2014, by the House Financial Services Committee. • On July 17, 2014, **S. 2244**, Terrorism Risk Insurance Program Reform Act (TRIPRA) of 2014, was amended to include NARAB II as Title II. This legislation was still pending when Congress adjourned for its August recess.

2013/2014 State Level Legislation/Regulation

State Legislation	The following are bills proposed or enacted at the state level regarding surplus lines:
California	• **Assembly Bill 2734:** This bill would raise the threshold for making monthly installment payments to $20,000 or more in annual tax for the preceding calendar year and would authorize the commissioner to relieve a surplus line broker of his/her obligations to make monthly payments if the current year annual tax would be less than $20,000.
Florida	• **HB 5403**, signed by the governor on June 2, 2014, and took effect that day. Passed by the Florida House and Senate on May 2, 2014. The bill amends and repeals various sections of Chapter 2009-70, Laws of Florida, in which 100% of surplus lines tax proceeds are distributed to the general revenue fund. • When this law was to sunset on July 1, 2014, all distributions would have reverted to the prior law's designation. The passing of this bill has nearly 9% of surplus lines tax revenues being directed to the Insurance Regulatory Trust Fund and more than 91% being deposited into the general revenue fund.
Kentucky	• **HB 375**, signed by the governor on April 7, 2014. It authorizes associations and member underwriters, authorized to transact insurance in the state, to also qualify as eligible surplus lines insurers. • **HB 432**, signed by the governor on April 10, 2014. It is an amendment to exempt from tax any premiums paid to an insurance company or surplus lines broker by nonprofit self-insurance groups whose membership consists of school districts.
Massachusetts	• **S 464**, introduced in 2013, still in the Senate as of March 2014. The bill states that no affidavit is required to be completed for any insurance or coverage under an insurance policy procured by a special insurance broker for which a special insurance broker has previously completed an affidavit; provided, however, prior to renewing, continuing or extending any insurance policy, the special insurance broker confirms that the insurer is on the Division of Insurance's list of approved surplus lines insurance companies.
Missouri	• **HB 1361,** approved by the governor on June 19, 2014, repeals certain sections of the existing language and introduces new language relating to domestic surplus lines insurers, such as stating that risk retention groups are not included in the definition of a surplus lines carrier. This bill also specifies that a nonadmitted insurer that is domiciled in the state must be deemed a domestic surplus lines insurer if the: » Insurer possesses policyholders' surplus of at least $20 million; » Insurer is an approved or eligible surplus lines insurer in at least one jurisdiction other than Missouri; » Board of directors of the insurer has passed a resolution seeking to be a domestic surplus lines insurer in Missouri; and • Director of the Department of Insurance, Financial Institutions and Professional Registration has given written approval for the insurer to be a domestic surplus lines insurer
Tennessee	• **HB 805** and **SB 356**, signed by the governor on April 4, 2014. This bill repeals the authority of the state to participate in the Surplus Lines Insurance Multi-State Compliance Compact. (SLIMPACT).
Utah	• **HB 129**, signed by the governor on March 31, 2014.This bill amends the existing law for surplus lines transactions in the state entered on or after May 13, 2014. It requires surplus lines insurers to initiate an audit within six months of the expiration of a policy period. After May 13, 2014, the following applies: » A surplus lines insure may not consider as earned premium more than 50% of the initial premium paid by an insured until the earlier of: (i) the completion of an audit; or (ii) expiration of the term of the surplus lines insurance contract and lapse of the time to conduct an audit. » Further, if the actual exposure covered by the auditable portion of the surplus lines insurance contract: ◆ Exceeds the estimate on which the initial premium is based, the surplus lines insurer is entitled to additional premium. ◆ Is less than the estimate on which the initial estimate is based, the insured is entitled to a refund of that portion of the initial premium that represents the reduction of exposure.
State Reporting Changes	The following states issued bulletins or legislative changes regarding surplus lines taxes:
Arkansas	• **Bulletin 11:** Dated July 7, 2014, this bulletin informs insurers of modifications to the reporting requirements/eligibility for Lloyd's of London surplus lines transactions.
Connecticut	• **Bulletin FS-4SL-13:** Dated Dec. 3, 2013, this reminds surplus lines insurers of their obligations regarding the filing of annual statements with the insurance commissioner.
Delaware	• **SL Bulletin No.14:** This bulletin notifies surplus lines licensees of a tax rate increase, to 3% from 2%, on premiums for policies written with nonadmitted insurers covering risks for which Delaware is considered the home state of the insured. The new 3% tax rate is effective for premiums on all policies issued after July 30, 2014. Policy premiums for surplus lines business with an effective date on or before July 30, 2014, will be taxed at the former 2% rate.
Florida	• **2013-1:** This bulletin informs insurers that, effective April 1, 2014, the service fee charged by the Florida Surplus Lines Service Office will be decreased from 0.2% to 0.175%.

Indiana	• **Bulletin 206:** This informs insurers that, beginning Jan. 1, 2015, all insurance companies must submit their annual premium tax, quarterly estimated tax, and annual renewal fees and payments electronically. Also, surplus lines producers must electronically submit their semi-annual tax filings. Beginning Feb. 1, 2015, surplus lines producers must electronically submit all filings and payments, except for monthly affidavits and policy details, which still must be submitted in hard copy.
Michigan	• **Bulletin 2014-04:** The department has adopted the application for verifying eligibility as a surplus lines insurer in the state.
New York	• **Insurance Reg. 41 (11 NYCRR Part 27):** Titled the Proposed 14th Amendment to Insurance Regulation 41, this amendment applies to the excess line placements governing standards to conform to the Nonadmitted and Reinsurance Reform Act of 2010 (NRRA). This has not yet been adopted.
Oklahoma	• **Bulletin 2013-10:** Dated Sept. 25, 2013, this bulletin clarifies the responsibilities of surplus lines brokers within Oklahoma.
Pennsylvania	• **Bulletin 13-1982:** Dated Oct. 23,2013, this bulletin amends Chapter 124,which sets forth the duties and requirements governing surplus lines agents, writing producers and surplus lines insurers doing business in the state. The measure took steps to bring state rules into conformity with the federal Nonadmitted and Reinsurance Reform Act of 2010 (NRRA).
Tennessee	• The Tennessee Department of Commerce and Insurance has joined the Nonadmitted Insurance Multi-State Agreement, Inc. (NIMA) as an associate member, signed June 26, 2014. • Effective Oct. 1, 2014, all single and multistate policies issued or renewed on or after that date, and any subsequent endorsements to those policies, in which Tennessee is deemed the home state, should be filed with the Surplus Lines Clearinghouse.
Wisconsin	• **OCI Bulletin 05-14:** This bulletin informs surplus lines insurers of changes to filing requirements, effective July 1, 2014. This is the result of the Wisconsin Office of the Commissioner of Insurance (OCI) joining the Nonadmitted Insurance Multi-State Agreement, Inc. (NIMA) as an associate member for one year.

Source: Library of Congress, National Association of Professional Surplus Lines Offices, Ltd. (NAPSLO) and individual states' legislative websites.

Update on Nonadmitted and Reinsurance Reform Act of 2010 (NRRA)

By 2014, every jurisdiction except Michigan and the District of Columbia (both of which follow the NRRA in practice) had enacted legislation to implement the NRRA. The NRRA, which was passed by Congress in July 2010 and took effect one year later, set in motion the following reforms related to surplus lines/nonadmitted insurance:

• Limited the regulation and taxation of surplus lines/nonadmitted insurance transactions to only one state – the home state of the insured, i.e., the state where a commercial insured's principal place of business is located or, if the insured is an individual, the individual's state of residence.

• Established uniform, nationwide eligibility standards based on two sections of the National Association of Insurance Commissioners' Nonadmitted Model Act for U.S.-domiciled nonadmitted insurers. The model act defines an eligible surplus lines insurer as being authorized in its state of domicile to write the coverage being offered on a nonadmitted basis; and meeting specified capital and surplus standards. The NRRA also requires states to allow licensed surplus lines brokers to place or procure insurance from any alien (non-U.S.-based nonadmitted insurer) that is on the NAIC Quarterly Listing of Alien Insurers.

• Created a nationwide definition of an exempt commercial purchaser (ECP), applicable in each state, for which a broker can access the surplus lines market without the need of a diligent search being performed.

The NRRA also called on each state to adopt nationwide, uniform requirements, forms and procedures for the reporting, payment, collection and allocation of surplus lines premium taxes and recognized, but did not require, that the states may form compacts or other mechanisms to share surplus lines premium taxes paid to an insured's home state.

The states have universally accepted the use of the NAIC's Quarterly Listing of Alien Insurers to, in effect, establish eligibility for alien (non-U.S.) insurers that appear on the list.

Since the NRRA was enacted, a number of states have moved to create their own, “voluntary” lists of eligible U.S.-based carriers. California’s interpretation, like most other states, is that the NRRA no longer allows for a mandatory “white list” of eligible surplus lines insurers. Instead, in 2011 the California Insurance Code was amended to establish the List of Approved Surplus Line Insurers (LASLI), an optional listing brokers may rely upon. Approved carriers on this list have been pre-reviewed for compliance with California capitalization levels, quality of assets, and officer and director backgrounds – but insurers not on the list also may meet these criteria.

Louisiana in 2013 became the latest state to migrate from a mandatory to a voluntary listing. While these lists are voluntary for carriers, many nonadmitted insurers may feel compelled to participate, lest their absence from the list place them at a disadvantage in the market.

NAPSLO supports efforts to maintain strong supervision of surplus lines insurers’ solvency, including some highly sophisticated tools that have been developed at the state level. But the association would oppose any effort to gather data beyond what states and the NAIC already collect for purposes of solvency regulation.

The nationwide definition of ECP found in the NRRA was designed to cover large, sophisticated commercial buyers. Since some states already had their own definitions of ECP, which were broader than the NRRA’s provision, not every state has adopted the NRRA definition.

While the NRRA recognized that the “states may enter” tax-sharing arrangements for surplus lines premium tax, 46 jurisdictions currently do not participate in any such arrangement. Tax sharing for surplus lines would only impact a small number of transactions and a limited amount of premium, since it only applies to transactions with multistate exposures. These are estimated to be around 5% of surplus lines transactions.

After the enactment of the NRRA, two tax-sharing models were put forth under which states could share surplus lines tax revenue: the Surplus Lines Insurance Multi-State Compliance Compact (SLIMPACT) and the Nonadmitted Insurance Multi-State Agreement (NIMA). Only NIMA, with a membership of six jurisdictions (Florida, Louisiana, South Dakota, Wyoming, Utah and Puerto Rico), has become operational to date.

Section IV: Current Distribution Issues

Consolidation and specialization are reshaping the surplus lines distribution system, as intermediaries maneuver to hold their positions or stake out new ones in a competitive marketplace. With rates generally flat across most lines of business, it is increasingly important for distributors to build scale or unique skills that set them apart, while keeping abreast of technology that promotes efficiency and simplifies interactions with customers.

Different but mutually reinforcing types of consolidation are under way. On the retail side, mergers and acquisitions are active, especially in the form of large players snapping up smaller firms. Sellers are driven by a variety of incentives, which may include cost factors such as keeping technology current; older owners' desire to cash out rather than sell to the next generation; and the generous prices being offered.

It's a demand-driven market, with increasingly large acquirers willing to pay top dollar, and not enough sellers to go around – although there are strong incentives for smaller players to cash out. Industry observers note, however, that new agencies are plentiful, helping to offset those making their exit through M&A transactions.

Large retailers are engaged in another form of consolidation at the same time: They are reducing their stables of approved wholesalers to a handful of sizable players, placing pressure on the larger wholesalers to maintain the size that will keep them on the short list with their desired partners. It is a struggle to see and be seen, with carriers, retailers and wholesalers all striving to be big enough to play. This in turn has fostered the perception that the wholesale brokerage business is ripe for M&A activity.

Of concern, however, is that consolidating business partners to gain volume-based discounts on commissions may come at the price of a lower level of service and less optimal outcomes for customers, and thus prove to be a short-term strategy.

One strategy for survival in this environment is specialization, especially in the form of program business that addresses very specific needs for coverage among groups of similar commercial customers. A number of wholesalers are reporting plans to develop new programs in the coming months, tapping the seemingly endless variety of risks for which coverage can be written – from ice vending to daycare centers to medical devices.

Competition at Every Turn

All of this is occurring against a backdrop of generally flat or falling rates driven by an oversupply of capacity flooding the market, as nontraditional sources of capital continue to find insurance an attractive investment. Where rates are up at all, the percentage increases tend to be in the low to mid-single digits. The few exceptions primarily consist of catastrophe-exposed property business and individual accounts with poor loss histories. In general, it is difficult to fight for higher rates because that is likely to produce adverse selection, as only the hardest to place risks are willing to pay extra for coverage.

The growth surplus lines distributors are seeing reflects volume perhaps more than rates, as certain business is more apt to migrate from the admitted market. Classes making this jump include catastrophe-exposed property and products liability. Volume also ebbs and flows as companies maneuver to poach business from competitors to compensate for flattened rates.

Technology has set new benchmarks for competitiveness among insurance intermediaries of all stripes, and this increasingly applies to surplus lines distributors. Apart from the efficiencies technology affords, the new standards include capabilities such as online quoting, as well as response times that are measured in hours instead of days. Keeping a competitive level of technology and the ability to connect with the varied systems of business partners can spell the difference between an intermediary being able to go it alone, and needing to seek a sale or merger. Surplus lines carriers want data on the risks they write, and they are looking to intermediaries as a key source.

Some participants in the market caution, however, that the human element of the business – especially the judgment and creativity needed to underwrite the unique risks that come to surplus lines – cannot be replaced by machines or software.

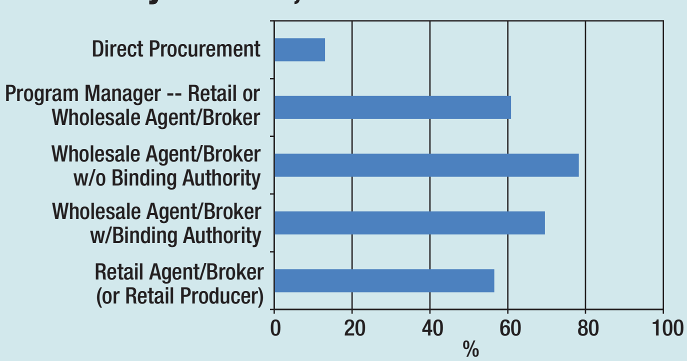
Changes in surplus lines distribution have come at a measured, evolutionary pace over the past 20 years. Distributors have become an important sounding board for underwriters as they develop new products and respond to new demands from the marketplace. Boundaries have blurred, with more organizations keeping multiple types of operations under one corporate umbrella – carriers, wholesale brokers and managing general agents (MGAs), which have evolved from agencies that had much more authority than is typical today. Single-state wholesalers have seen their presence diminish over the years as organizations went regional or national. This was aided by the 1999 Gramm-Leach-Bliley Act, which included the first National Association of Registered Agents and Brokers (NARAB) provision and created access to nonresident surplus lines licenses in all states. Competition has grown more intense, and as noted above, consolidation – the drive to develop stables of fewer but larger business partners – has become a major factor in the market.

Robust M&A activity is hardly new, however. At different times, in both soft and hard markets, such transactions have been attractive both to buyers seeking greater scale and market share, and to sellers cashing out their investments.

This activity hasn't quenched the entrepreneurial spirit at the heart of the surplus lines business, however. While large, acquisitive competitors have gobbled up many smaller operators, start-ups continue to enter the field. What's not clear is to what extent the newcomers offset the effects of the acquisition binge that has continued to enlarge the bigger players.

Surveying the Landscape

Exhibit 18
U.S. Surplus Lines – Use of Distribution Sources by Insurers, 2013

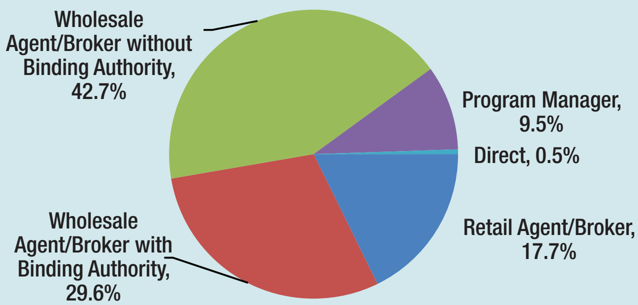


Note: Total exceeds 100% because most insurers use more than one distribution channel.
Source: A.M. Best Surplus Lines Distribution Survey

The distributors with the greatest presence in the surplus lines market continue to be wholesale agents and brokers without binding authority, according to a survey of surplus lines writers developed and administered by A.M. Best with NAPSLO. More than three-quarters of respondents reported selling through this channel (see **Exhibit 18**), which accounted for about 43% of the premium volume for this group of insurers. It was the No. 1 channel for more than half of the companies reporting (see **Exhibit 19**), and wholesalers with and without binding authority together were the top choices overall.

Wholesale agents and brokers with binding authority were second most popular, used by about 70% of respondents and commanding 29.6% of premium

Exhibit 19
U.S. Surplus Lines – Share of Premium by Distributor, 2013



Source: A.M. Best Surplus Lines Distribution Survey

volume. Retail agents and brokers were third by premium volume at 17.7%, although they were fourth by percentage of respondents using this channel. Program managers trailed far behind on premium volume – less than 10% – although they were the third most popular channel by percentage of users at about 61%. Direct procurement accounted for 0.5% of premium as three of the 24 respondents, or 13%, reported using this channel.

The responding insurers covered a wide range of sizes, with 2013 surplus lines direct premium written ranging from slightly more than $100 million to more than $1.5 billion. Together the respondents had surplus lines direct premium written of almost $9.4 billion, compared with $5.9 billion among respondents to the 2013 survey. Median surplus lines premium of respondents was $280.0 million, and the mean was $406.8 million.

While respondents overall favored distribution through wholesale producers without binding authority, those with premium volume below the median were equally likely to use wholesalers with binding authority, while those above the median placed retail channels a clear second. Just three respondents reported running their entire surplus lines premium through a single channel; all had premiums below both the median and mean. Two of these used exclusively wholesale producers with binding authority, while the third used only retail producers.

Section V: Impairment Trends

Financial impairments in the U.S. admitted property/casualty (P/C) industry in 2013 plunged to their lowest level since 2007, amounting to little more than half of both the historical average and the 2012 impairment count. Year over year, impairments were down 26.5% for 2012 and 44.0% for 2013.

For the surplus lines market, 2013 marked the 10th consecutive year without a financial impairment.

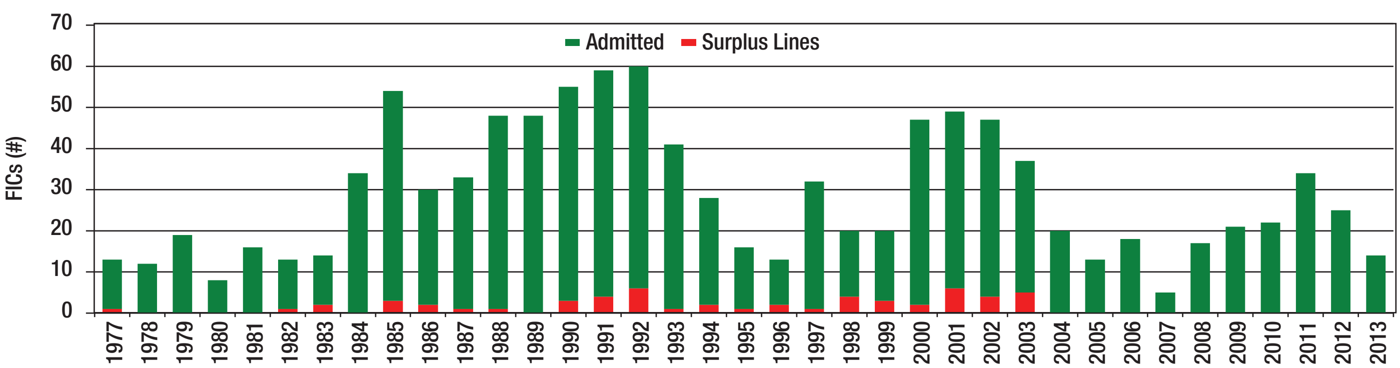
P/C Industry Impairment Experience

The 14 known P/C impairments in 2013 (see **Exhibit 20**), compared with 25 in 2012 and 34 in 2011, were more in line with figures seen consistently during the 1970s. So far, six admitted P/C companies have been reported impaired in 2014. A.M. Best assigned ratings to three and reported on seven of the 14 impairments in 2013. Of the three rated, none carried a Secure rating in the year of impairment.

Additional financial impairments for 2013 and prior years could emerge, however. There may be a lag in reporting of impairments due to the increasing use of confidential actions by insurance regulators, who are reluctant to publicly disclose impairments until all avenues to rehabilitate or find a buyer for troubled insurers have been exhausted.

Exhibit 20

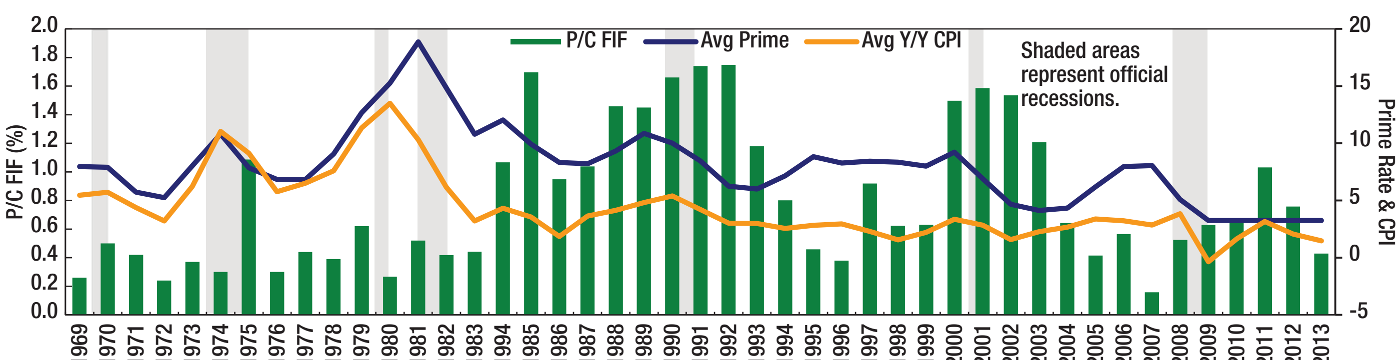
U.S. Property/Casualty – Annual Impairment Count, Admitted Companies vs. Surplus Lines



Source: A.M. Best data & research

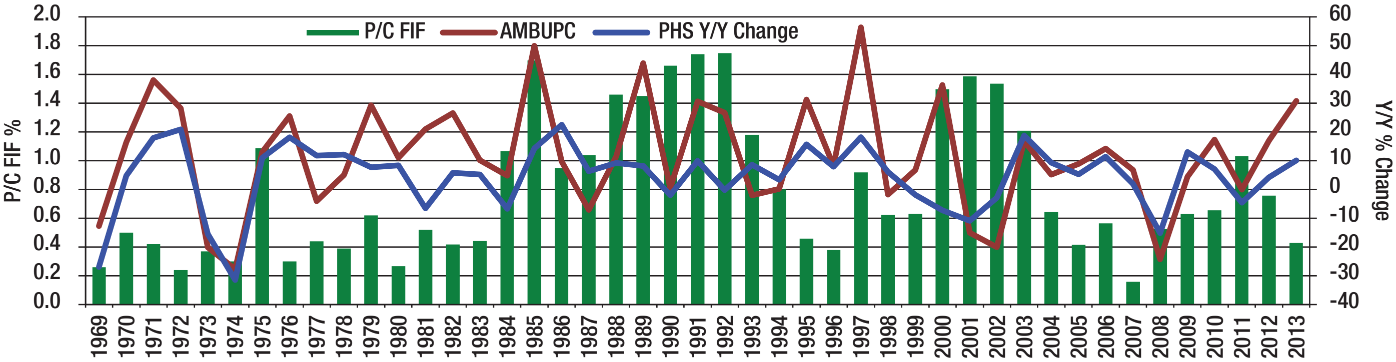
Exhibit 21

U.S. Property/Casualty – Financial Impairment Frequency vs. Economic Climate



Source: A.M. Best data & research, BESTLINK *Best's Statement File – P/C, U.S.*, Bureau of Labor Statistics, Federal Reserve Board, National Bureau of Economic Research

Exhibit 22
U.S. Property/Casualty – Financial Impairment Frequency vs. P/C Stocks & PHS



Source: A.M. Best data & research, BESTLINK *Best's Statement File – P/C, U.S.*, S&P Dow Jones Indices

A.M. Best has found there is an average 1.5-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.

The P/C industry's 2013 financial impairment frequency (FIF) – a more accurate indicator of impairment trends than a mere count – was 0.43%, below the industry's historical average of 0.81. In the current era, the 2011 FIF of 1.05% seems to have marked the peak for impairment frequency after the 2007-2010 soft-market trough and the 2007-2009 recession (see **Exhibit 21**). 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.

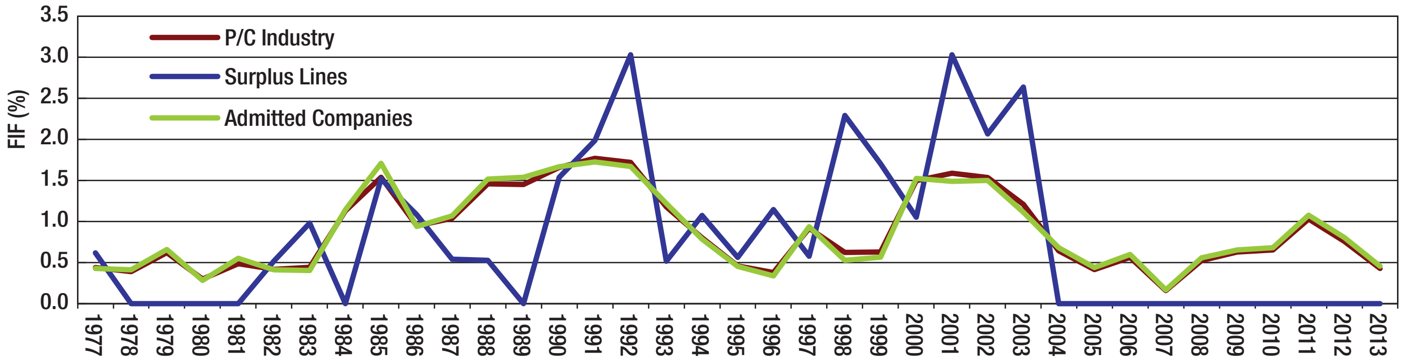
Most of the impaired companies were marked by several years of volatile and generally unprofitable underwriting results, even as the industry overall turned a corner in 2013, posting its first underwriting profit since 2009. Risk retention groups (RRGs) operating in a variety of fields – entertainment, trucking, taxicabs, medical professional liability, accident and health, and construction – represented half of the 2013 impairments. A.M. Best generally views RRGs favorably because of their focused business, low retentions, active loss control and robust risk management, but some of these entities have proven susceptible to under-reserving and too-rapid growth.

The conventional companies that became impaired were two private passenger automobile insurers, two workers' compensation insurers, one surety company and one multiline commercial insurer. Catastrophe losses did not appear to be a factor in any of the 2013 impairments.

The strength of the industry's capitalization and its redundant reserves – and to some extent, its greater attention to risk management – have combined to soften the effects of the weak economy and the high catastrophe losses in 2011 and 2012 on the P/C impairment rate. However, as insurers continue to absorb losses, and as capital and reserves are drawn down, their operating results have suffered and they have become more vulnerable to shock events in the operating environment.

A.M. Best has found increases in the insurance industry's FIF correlate strongly with preceding negative operating environments marked by events such as stock market booms and busts; economic recessions; and extraordinary cat losses that typically force the end of soft markets (see **Exhibits 23** and **24**). Evidence of these trends resides in the increased FIF rates during the periods 1988 to 1993 and 2000 to 2003.

Exhibit 23
U.S. Property/Casualty – Financial Impairment Frequency, Admitted vs. Surplus Lines



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

Rating trends are a key indicator of the financial health and stability of the insurance industry, because there generally is an accelerating trend in the degradation of ratings before impairments increase. A.M. Best maintains a stable rating outlook on the personal lines segment, which accounted for 14.3% of the 2013 impairments, a marked shift from the 57% of 2012 impairments that were personal lines insurers. The two personal lines insurers that became impaired in 2013 were auto writers.

In commercial lines, workers' comp and construction liability were the chief sources of impairments by line, with two each in 2013. As of the publication date of this report, A.M. Best has maintained a negative rating outlook on the commercial lines segment. This implies that while the vast majority of rating actions will be affirmations, negative rating actions will outnumber positive rating actions during 2014.

Exhibit 24
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	0.30	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	1.71
1986	30	2	28	0.95	1.08	0.94
1987	33	1	32	1.04	0.54	1.07
1988	48	1	47	1.46	0.53	1.52
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	1.73
1992	60	6	54	1.72	3.03	1.67
1993	41	1	40	1.18	0.52	1.22
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	20	3	17	0.63	1.70	0.57
2000	47	2	45	1.50	1.05	1.53
2001	49	6	43	1.59	3.03	1.49
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	13	0	13	0.42	0.00	0.44
2006	18	0	18	0.56	0.00	0.60
2007	5	0	5	0.16	0.00	0.17
2008	17	0	17	0.53	0.00	0.56
2009	21	0	21	0.63	0.00	0.65
2010	22	0	22	0.66	0.00	0.68
2011	34	0	34	1.03	0.00	1.08
2012	25	0	25	0.76	0.00	0.81
2013	14	0	14	0.43	0.00	0.45
1977-2011	**1016**	**55**	**961**	**0.85**	**0.81**	**0.85**

[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 research, BESTLINK – Best's Statement File – P/C, US

The stable rating outlook for the personal lines segment implies that the majority of 2013 rating actions for this segment are likely to be affirmations, with a fairly balanced distribution of negative and positive actions.

The personal lines segment has continued to experience divergent trends in its two main lines of business: automobile and homeowners. While A.M. Best expects normalized results in homeowners to improve further through risk management initiatives, private passenger auto insurers still face the challenge of keeping up with increases in claims costs while maintaining rate integrity.

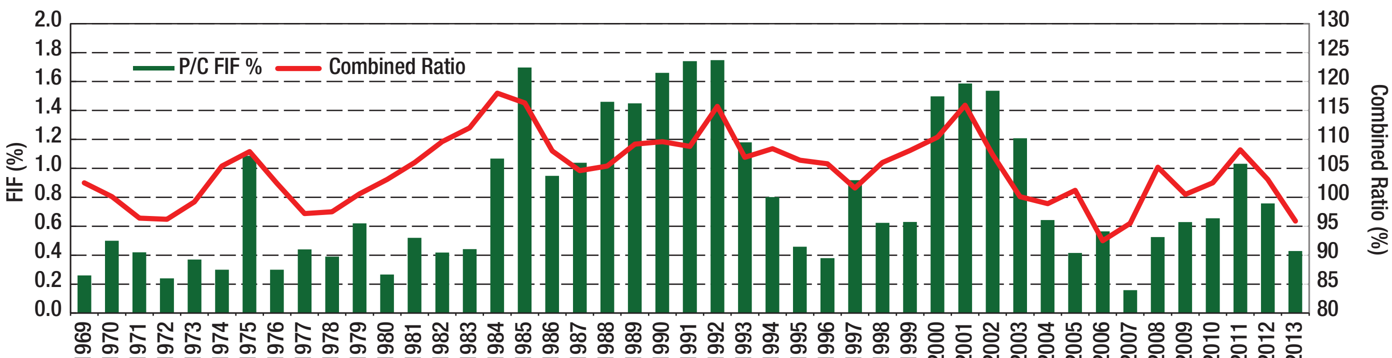
Commercial lines turned in a strong overall performance in 2013, led by improved underwriting results and low catastrophe experience. Contributing to the underwriting performance was an increase in favorable development recognized on core reserves. However, A.M. Best remains concerned that the commercial lines segment is not truly reflecting the more recent accident years' loss ratios, and the reserve takedowns are coming from an already deficient loss-reserve position on several lines, most notably workers' comp, other liability and commercial multiperil. All of these lines were represented among the 2013 impairments.

Surplus Lines Impairment Experience

Despite the absence of surplus lines financial impairments from 2004 to 2013, the surplus lines average FIF of 0.78% from 1977 to 2013 remains close to the admitted company average impairment rate of 0.88%. This reflects the surplus lines industry's significantly higher impairment frequencies during certain periods, in particular 1992, 1998-1999 and 2001-2003 (see **Exhibits 24** and **25b**). Since 2003, however, the historical impairment frequencies for admitted and surplus lines companies have been converging with each year that the surplus lines industry has experienced no financial impairments.

The absence of surplus lines impairments in the mid-2000s related primarily to the surplus lines industry's improved underwriting performance (i.e., underwriting discipline and adequate pricing). Other reasons for the lower impairment trend included improved systems and technology, and better management reporting and oversight. However, since 2007, underwriting profitability and operating performance have been deteriorating, as indicated by the surplus lines industry's combined ratio (see **Exhibit 25b**). As such, the absence of impairments in the latter 2000s and early 2010s has been related more to the overall capitalization of surplus lines companies than to underwriting performance.

Exhibit 25a
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 data & research, BESTLINK – *Best's Statement File – P/C, U.S.*

A.M. Best remains guardedly optimistic about the low trend in surplus lines impairments, with the offsetting factors being related to weak economic conditions that have prolonged the soft market and contributed to increasing combined ratios. Since 2008, the surplus lines industry also has not been able to offset any inadequacies in pricing with investment returns and capital markets. In addition, catastrophe losses in 2012 reached unprecedented highs.

Causes and Characteristics Of Financial Impairments

The causes and characteristics of financial impairments have remained generally consistent for both surplus lines and the admitted P/C industry over the course of A.M. Best's impairment study, most recently updated in the special report *U.S. Property/ Casualty – Impairment Review* (June 23, 2014).

Accounting for the largest portion of impairments among surplus lines and admitted companies were the related categories of deficient loss reserves/ inadequate pricing and rapid growth (see **Exhibits 26a** and **26b**). These two categories in combination accounted for 38.0% of surplus lines impairments and 58.5% of admitted P/C company impairments.

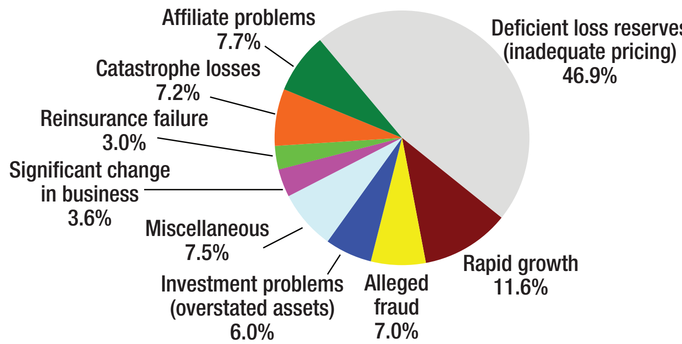
The second-highest cause of surplus lines impairment has been affiliate problems, at 20.0%, vs. 7.7% for admitted P/C companies. Some surplus lines companies became impaired when their parent companies, which were engaged primarily in the admitted market, were declared insolvent. The surplus lines failures of the past also highlight the extent to which poorly managed program operations of a parent company can impact its surplus lines affiliates.

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

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

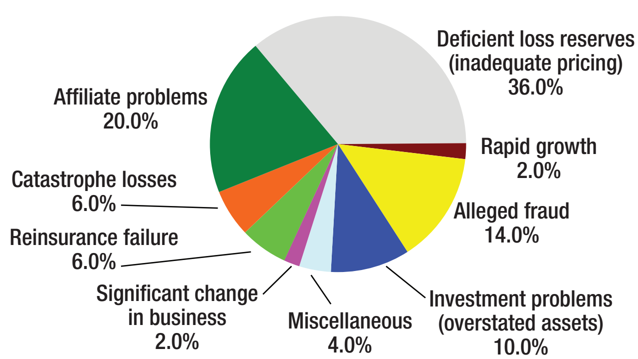
*A.M. Best's peer composite of 73 domestic professional surplus lines companies.
Source: A.M. Best data & research

Exhibit 26a
U.S. Property/Casualty Admitted – Primary Causes of Financial Impairment, 1977-2013



Note: Exhibit % based on companies where the cause of impairment was identified.
Source: A.M. Best data & research

Exhibit 26b
U.S. Surplus Lines – Primary Causes of Financial Impairment, 1977-2013



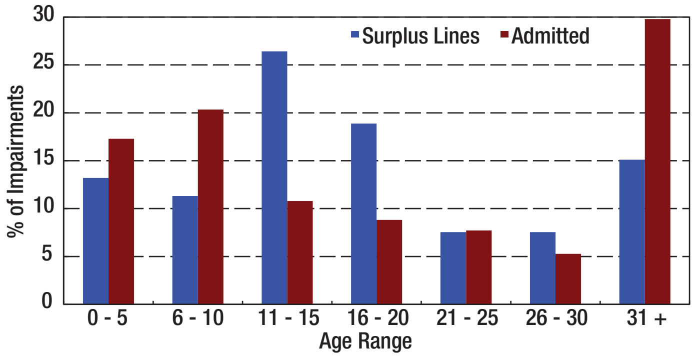
Note: Exhibit % based on companies where the cause of impairment was identified.
Source: A.M. Best data & research

The next highest cause of impairment among surplus lines companies was fraud, at 14.0% vs. 7.0% for admitted companies. All other causes of impairment for both surplus lines and admitted insurers accounted for 28% and 26.8%, respectively, of the identified impairments. A.M. Best believes all insolvencies are related to some form of mismanagement, except those directly related to catastrophe losses. Companies impaired because of cat losses tend to have been concentrated in one line of business and/or geographic

Exhibit 27

U.S. Property/Casualty – Financially Impaired Companies' Age Distribution, 1977-2013

Surplus lines vs. admitted.

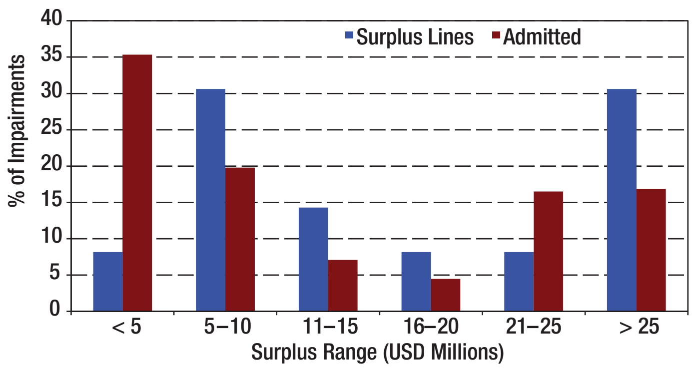


Note: Exhibit % based on companies where age was identified.
Source: A.M. Best data & research, BESTLINK – *Best's Statement File - P/C, U.S.*

Exhibit 28

U.S. Property/Casualty – Financially Impaired Companies' Surplus Range, 1977-2013

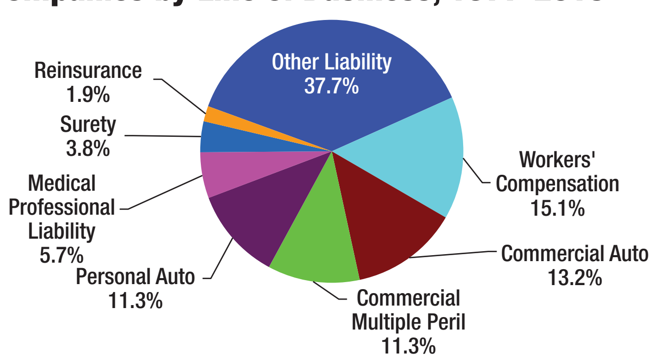
Surplus lines vs. admitted.



Note: Exhibit % are based on companies where surplus was identified. Surplus restated into 2013 dollars based on Consumer Price Index.
Source: A.M. Best data & research, BESTLINK – *Best's Statement File - P/C, U.S.*

Exhibit 29

U.S. Surplus Lines – Financially Impaired Companies by Line of Business, 1977-2013



Source: A.M. Best data & research

area or to have been weakened by several years of operating losses, and the shock losses became the last nail in the coffin.

As with admitted companies, surplus lines impairments overall tend to involve younger, smaller companies. At the time of impairment, about half of the identified surplus lines companies were 15 years or younger (see **Exhibit 27**). Also at the time of impairment, 38.8% of failed surplus lines companies had less than $10 million in surplus, while more than half had less than $15 million in surplus (see **Exhibit 28**). Stock companies tend to be the dominant organization type among financially impaired companies, especially in surplus lines, where 51 of the 53 impaired companies were in that category.

Looking at impairments by line of business, **Exhibit 29** shows the "other liability" category – directors and officers (D&O), errors and omissions (E&O), general liability, contractual liability, excess and umbrella – accounted for the highest percentage of surplus lines impairments over the course of A.M. Best's impairment study, followed by workers' comp and commercial auto. Again, workers' comp is not a significant surplus lines exposure, but a surplus lines insurer's impairment could result from adverse workers' comp experience of one or more admitted insurers in the same group of companies.

Surplus Lines Impaired Company Ratings Development

A.M. Best has analyzed the ratings development of financially impaired surplus lines companies in this study, beginning three years before the year of impairment. Overall, A.M. Best assigned ratings to a much higher percentage of the impaired surplus lines companies compared with admitted companies (see **Exhibit 30**).

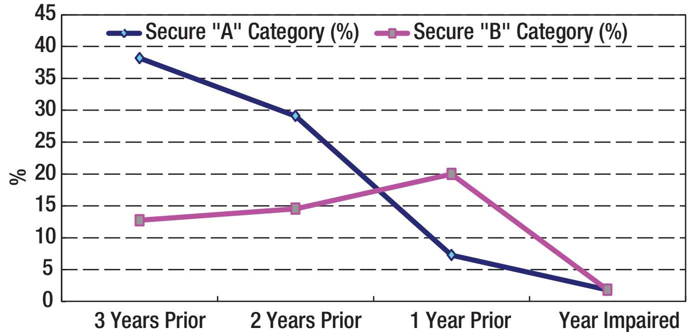
As shown in this exhibit, there generally is a steady degradation in ratings in the three years before impairment, with a slight increase in the Secure "B" category in the three years before impairment as the Secure "A" companies are downgraded into the Secure "B" category.

Overall, the higher the rating, the lower is the risk of impairment. Over the course of this study, 1977-2013, of the surplus lines impaired insurers with A.M. Best financial strength ratings or the equivalent, two of the 55 surplus lines impaired writers were in the Secure "A" or "B" rating category in the year of impairment; 28 were in the Vulnerable category; and the remaining companies were not rated or not formally followed by A.M. Best.

Exhibit 30

U.S. Surplus Lines – Financially Impaired Companies With Secure Best's Credit Ratings

0-3 years before impairment.



*Secure "A" category includes A++, A+, A, A-, and FPR 7, 8 & 9 ratings. Secure "B" category includes B++. B+, and FPR 5 & 6 ratings.
Source: A.M. Best data & research

Financially Impaired Companies Defined

A.M. Best designates an insurer as a Financially Impaired Company (FIC) as of the first official regulatory action taken by an insurance department, whereby the insurer's:

• Ability to conduct normal insurance operations is adversely affected;

• Capital and surplus have been deemed inadequate to meet legal requirements; and/or

• General financial condition has triggered regulatory concern.

State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation and certain administrative orders. A.M. Best emphasizes that the FICs in this study might not technically have been declared insolvent. Note that the above definition of an FIC is broader than that of a Best's Rating of "E" (under regulatory supervision), which is assigned only when an insurer is "no longer allowed to conduct normal ongoing insurance operations." Thus, a company may be designated as financially impaired in this study but may not have been assigned an "E" Best's Rating. Further, a Best's Rating of "F" (in liquidation) can reflect a liquidation as part of the impairment process, or it can indicate a voluntary dissolution. Unless they occur under financial duress, voluntary dissolutions are not counted as impairments. Before 1992, a Best's Rating of "NA-10" was used to indicate that a company was under regulatory supervision and/or in liquidation.

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. The most common revision to the data is a company's initial year of impairment. If any change places a company outside of this study's parameters, the company is eliminated from the study.

Confidential Supervisions

In addition to the regulatory actions that are announced publicly, there also are actions that insurance regulators undertake on a confidential basis. When A.M. Best becomes aware of an active confidential regulatory action, the impairment is counted in the aggregate analysis but is not reported on a company-specific basis to protect confidentiality. While the reporting of confidential actions likely is understated, A.M. Best believes a full accounting of these nonpublic actions would not change materially its impairment analysis.

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 risks that are not acceptable to the standard insurance market (also called the admitted market).

The insurers in the surplus lines market are property/casualty 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 coverage in the alternative risk transfer (ART) market.

The risks placed in the surplus lines market usually can be classified as one of the following:

• Distressed risks – characterized by unfavorable attributes, such as a history of frequent losses that have made them unacceptable to admitted insurers.

• Unique risks – so specialized or unusual that admitted insurers are unwilling or unprepared to insure them.

• High-capacity risks – requiring high insurance limits that may exceed the capacity of the standard market.

• New or emerging risks – requiring special underwriting expertise and flexibility that the surplus lines market can provide.

Examples of coverage written by surplus lines carriers include: property catastrophe, cyber risk, excess and umbrella liability, high-hazard products liability, directors and officers liability, errors and omissions liability, special events liability, environmental impairment liability and employment practices liability. The majority of surplus lines business is commercial lines, although some personal lines coverage is written on a nonadmitted basis, such as homeowners insurance in catastrophe-prone areas.

Surplus lines insurers are referred to as nonadmitted insurers because they are not licensed (admitted) in the state where the insurance buyer or the risk is located or resident. This state is known as the "home state of the insured" 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.

While 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 different 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 is seen as performing a safety valve function for the insurance marketplace.

The minimum capitalization requirement for surplus lines insurers is generally higher than for admitted insurers. This is done in order to provide 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 conditions 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 premiums 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.

Specialty admitted companies obtain the majority of their business from wholesalers (including wholesale brokers); managing general agents (MGAs); and intermediaries that have been approved by Lloyd's – as coverholders, who are authorized to bind coverage on behalf of Lloyd's underwriting syndicates; or as open market correspondents (OMCs), who are approved for placing coverage at Lloyd's either directly or through a Lloyd's broker. These same intermediaries produce business for surplus lines insurers. Generally, wholesalers have greater expertise than do retailers in identifying and placing distressed, unique, high-capacity and new or emerging risks. Wholesalers typically place a difficult-to-insure risk with an eligible surplus lines insurer only after it is deemed unacceptable by admitted or specialty admitted 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, MGAs, underwriting managers or Lloyd's coverholders or 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.

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 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 greatest portion of regulatory oversight occurs in the state where the insured's principal place of business is located or the state where the insured resides (known as the "insured's home state"), and the regulatory compliance focuses 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 determines whether the insurer 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, under a negligence standard, 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, 2013
Ranked by direct premiums written.
(USD Thousands)

Rank	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Current Best's Rating
1	**Lloyds**		**$7,099,000**	**13.2**	**$33,618,960**	**A**
2	**American International Group**		**$4,832,158**	**(4.2)**	**$8,036,002**	
	AIG Specialty Insurance Co	PROF	$834,417		$741,788	A r
	Illinois National Insurance Co	MISC	$72		$70,083	A r
	Lexington Insurance Co	PROF	$3,997,669		$7,224,131	A p
3	**Nationwide Group**		**$1,662,999**	**15.3**	**$12,678,254**	
	Freedom Specialty Insurance Co	MISC	$243		$11,998	A+ r
	Nationwide Mutual Ins Co	MISC	$9,441		$11,792,529	A+ p
	Scottsdale Indemnity Co	MISC	$21,877		$36,595	A+ r
	Scottsdale Insurance Co	PROF	$1,458,582		$716,365	A+ p
	Scottsdale Surplus Lines Ins	PROF	$9,694		$16,257	A+ r
	Western Heritage Insurance Co	PROF	$163,162		$104,510	A+ r
4	**W. R. Berkley Insurance Group**		**$1,327,996**	**19.0**	**$970,380**	
	Admiral Insurance Co	PROF	$383,857		$597,621	A+ r
	Berkley Assurance Co	PROF	$34,382		$50,862	A+ r
	Berkley Regional Specialty Ins	PROF	$20,061		$51,613	A+ r
	Gemini Insurance Co	PROF	$401,368		$54,067	A+ r
	Great Divide Insurance Co	MISC	$2,452		$65,731	A+ r
	Nautilus Insurance Co	PROF	$485,877		$150,487	A+ r
5	**Zurich Financial Svcs NA Group**		**$1,232,050**	**4.7**	**$561,445**	
	Empire Fire & Marine Ins Co	MISC	$100		$48,162	A+ g
	Empire Indemnity Ins Co	PROF	$164,066		$49,249	A+ g
	Steadfast Insurance Co	PROF	$1,072,358		$430,015	A+ g
	Zurich American Ins Co of IL	MISC	-$4,474		$34,019	A+ g
6	**Markel Corporation Group**		**$1,147,678**	**39.7**	**$1,199,861**	
	Alterra Excess & Surplus Ins	PROF	$227,816		$143,087	A g
	Associated International Ins	PROF	$44,214		$97,288	A g
	Essex Insurance Co	PROF	$434,754		$385,333	A g
	Evanston Insurance Co	PROF	$440,893		$574,153	A g
7	**ACE INA Group**		**$976,441**	**11.6**	**$312,295**	
	Illinois Union Insurance Co	PROF	$446,464		$156,796	A++ g
	Westchester Surplus Lines Ins	PROF	$529,977		$155,499	A++ g
8	**Fairfax Financial (USA) Group**		**$837,129**	**30.3**	**$450,554**	
	American Safety Indemnity Co	PROF	$147,712		$96,860	A
	Crum & Forster Specialty Ins	PROF	$64,625		$46,640	A r
	First Mercury Insurance Co	PROF	$350,133		$54,805	A r
	Hudson Excess Insurance Co	PROF	$1,390		$46,944	A r
	Hudson Specialty Ins Co	PROF	$182,783		$157,662	A g
	Seneca Specialty Ins Co	PROF	$90,486		$47,643	A r
9	**CNA Insurance Cos**		**$808,262**	**9.1**	**$234,859**	
	Columbia Casualty Co	PROF	$808,262		$234,859	A g
10	**QBE Americas Group**		**$776,999**	**(23.9)**	**$214,760**	
	QBE Specialty Insurance Co	PROF	$776,999		$214,760	A p
11	**Alleghany Ins Holdings Group**		**$764,574**	**18.2**	**$307,985**	
	Capitol Specialty Ins Corp	PROF	$57,477		$52,946	A g
	Covington Specialty Ins Co	PROF	$133,544		$46,952	A+ r
	Landmark American Ins Co	PROF	$573,554		$208,086	A+ r
12	**Ironshore Insurance Group**		**$745,382**	**10.6**	**$420,877**	
	Ironshore Indemnity Inc.	MISC	$13,007		$120,540	A g
	Ironshore Specialty Ins Co	PROF	$732,375		$300,337	A g
13	**XL America Group**		**$620,013**	**36.3**	**$102,574**	
	Indian Harbor Insurance Co	PROF	$619,332		$47,368	A g
	XL Select Insurance Co	PROF	$682		$55,206	A g
14	**Berkshire Hathaway Ins Group**		**$564,508**	**38.1**	**$6,824,856**	
	General Star Indemnity Co	PROF	$151,356		$645,805	A++ g
	Mount Vernon Fire Ins Co	PROF	$102,231		$348,162	A++ g
	National Fire & Marine Ins Co	PROF	$270,274		$5,010,390	A++ g
	National Indem Co of the South	MISC	$1,717		$167,330	A++ g

Appendix A

U.S. Surplus Lines - Top 50 Groups, 2013

Ranked by direct premiums written.
(USD Thousands)

Rank	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Current Best's Rating
	U S Underwriters Insurance Co	PROF	$28,725		$115,665	A++ g
	United States Liability Ins Co	MISC	$10,205		$537,503	A++
15	**AXIS Insurance Group**		**$547,169**	**14.9**	**$206,175**	
	AXIS Surplus Insurance Co	PROF	$547,169		$206,175	A+ g
16	**Arch Insurance Group**		**$513,786**	**14.6**	**$283,454**	
	Arch Specialty Insurance Co	PROF	$513,786		$283,454	A+
17	**Argo Group**		**$499,853**	**21.9**	**$403,706**	
	Colony Insurance Co	PROF	$495,446		$329,980	A g
	Colony National Insurance Co	PROF	$36		$46,326	A g
	Colony Specialty Insurance Co	MISC	$4,371		$27,400	A g
18	**Allied World Assurance Group**		**$466,754**	**9.3**	**$318,384**	
	Allied World Asr Co (US) Inc	PROF	$177,954		$132,643	A g
	Allied World National Assur Co	MISC	$58,537		$122,429	A g
	Darwin Select Insurance Co	PROF	$230,263		$63,312	A g
19	**Liberty Mutual Insurance Cos**		**$434,647**	**22.4**	**$91,131**	
	Liberty Surplus Ins Corp	PROF	$434,647		$91,131	A r
20	**Chubb Group of Insurance Cos**		**$421,934**	**(1.1)**	**$1,533,633**	
	Chubb Custom Insurance Co	PROF	$370,025		$173,865	A++ g
	Executive Risk Indemnity Inc	MISC	$541		$1,218,625	A++ g
	Executive Risk Specialty Ins	PROF	$51,368		$141,143	A++ g
21	**Great American P&C Ins Group**		**$393,864**	**25.2**	**$247,187**	
	American Empire Surplus Lines	PROF	$125,310		$107,613	A+ p
	Great Amer Protection Ins Co	PROF	$404		$28,244	A+ r
	Great American E&S Ins Co	PROF	$260,515		$47,298	A+ r
	Great American Fidelity Ins Co	PROF	$5,437		$47,329	A+ r
	Mid-Continent Excess & Surplus	PROF	$2,198		$16,703	A+ r
22	**Catlin US Pool**		**$384,987**	**25.9**	**$201,479**	
	Catlin Specialty Insurance Co	PROF	$384,987		$201,479	A g
23	**HCC Insurance Group**		**$353,052**	**5.0**	**$1,925,420**	
	Houston Casualty Co	PROF	$334,802		$1,909,658	A+ g
	HCC Specialty Ins Co	PROF	$18,250		$15,762	A+ r
24	**Travelers Group**		**$330,889**	**16.0**	**$1,006,521**	
	Discover Specialty Ins Co	PROF	$94		$38,855	A++ g
	Northfield Insurance Co	PROF	$115,493		$125,774	A++ g
	Northland Casualty Co	MISC	$1,278		$34,165	A++ g
	Northland Insurance Co	MISC	$3,606		$533,291	A++ g
	St. Paul Fire & Casualty Ins	PROF	$94		$15,932	A++ r
	St. Paul Surplus Lines Ins Co	PROF	$43,474		$193,578	A++ g
	Travelers Excess & Surp Lines	PROF	$166,850		$64,927	A++ g
25	**Swiss Reinsurance Group**		**$329,798**	**28.4**	**$114,984**	
	First Specialty Ins Corp	PROF	$212,752		$63,877	A+ g
	North American Capacity Ins Co	PROF	$117,046		$51,107	A+ g
26	**Aspen US Insurance Group**		**$311,023**	**24.4**	**$116,570**	
	Aspen Specialty Insurance Co	PROF	$311,023		$116,570	A g
27	**Assurant P&C Group**		**$306,676**	**(4.0)**	**$207,597**	
	Standard Guaranty Ins Co	MISC	$134,479		$150,875	A g
	Voyager Indemnity Ins Co	PROF	$172,198		$56,722	A g
28	**Starr International Group**		**$304,536**	**24.5**	**$90,561**	
	Starr Surplus Lines Ins Co	PROF	$304,536		$90,561	A g
29	**Munich-American Hldng Corp Cos**		**$276,962**	**(8.6)**	**$234,454**	
	Amer Modern Surpl Lines Ins Co	PROF	$33,606		$26,350	A+ g
	American Modern Select Ins Co	MISC	$928		$40,157	A+ g
	American Western Home Ins Co	PROF	$54,430		$61,497	A+ g
	HSB Specialty Insurance Co	PROF	$3,460		$49,713	A++ r
	Princeton Excess & Surp Lines	PROF	$184,537		$56,738	A+ g
30	**RLI Group**		**$260,468**	**9.1**	**$522,956**	
	Mt Hawley Insurance Co	PROF	$260,468		$522,956	A+ g
31	**Navigators Insurance Group**		**$254,619**	**22.6**	**$129,702**	

Appendix A

U.S. Surplus Lines - Top 50 Groups, 2013

Ranked by direct premiums written.
(USD Thousands)

Rank	Group Name	Type of Company	Surplus Lines DPW	Year/Year Change in DPW	Total Group PHS	Current Best's Rating
	Navigators Specialty Ins Co	PROF	$254,619		$129,702	A r
32	**Western World Insurance Group**		**$244,334**	**18.9**	**$513,476**	
	Tudor Insurance Co	PROF	$59,033		$145,752	A+ p
	Western World Insurance Co	PROF	$185,302		$367,724	A+ p
33	**State National Group**		**$235,622**	**0.0**	**$53,843**	
	United Specialty Insurance Co	PROF	$235,622		$53,843	A p
34	**IFG Companies**		**$227,340**	**(0.8)**	**$838,960**	
	Burlington Insurance Co	PROF	$199,269		$177,968	A g
	First Financial Insurance Co	PROF	$25,506		$393,471	A
	Guilford Insurance Co	PROF	$2,565		$267,522	A g
35	**White Mountains Insurance Grp**		**$221,729**	**8.0**	**$158,126**	
	Homeland Ins Co of NY	PROF	$194,703		$107,893	A r
	Homeland Insurance Co DE	PROF	$27,026		$50,234	A r
36	**Franklin Holdings Group**		**$192,394**	**21.3**	**$176,197**	
	James River Casualty Co	PROF	$5,204		$15,569	A- g
	James River Insurance Co	PROF	$187,190		$160,628	A- g
37	**Endurance Specialty Group**		**$192,178**	**(21.1)**	**$92,821**	
	Endurance American Spec Ins Co	PROF	$192,178		$92,821	A g
38	**State Auto Insurance Cos**		**$179,560**	**29.3**	**$95,859**	
	Rockhill Insurance Co	PROF	$179,560		$95,859	A r
39	**Everest Re U.S. Group**		**$177,149**	**10.6**	**$75,024**	
	Everest Indemnity Insurance Co	PROF	$176,731		$54,581	A+ g
	Everest Security Insurance Co	MISC	$418		$20,443	A+ g
40	**HIIG Group**		**$162,806**	**0.0**	**$204,235**	
	Houston Specialty Insurance Co	PROF	$112,944		$187,750	A-
	Oklahoma Specialty Ins Co	PROF	$49,862		$16,486	A- r
41	**Global Indemnity Group**		**$159,468**	**15.9**	**$316,024**	
	Penn-America Insurance Co	PROF	$65,271		$80,400	A g
	Penn-Patriot Insurance Co	PROF	$1,865		$4,682	A g
	Penn-Star Insurance Co	PROF	$37,930		$23,953	A g
	United National Insurance Co	PROF	$53,221		$196,343	A g
	United National Specialty Ins	MISC	$1,181		$10,646	A g
42	**GeoVera U.S. Insurance Group**		**$148,346**	**8.7**	**$22,307**	
	GeoVera Specialty Insurance Co	PROF	$148,346		$22,307	A g
43	**Maxum Specialty Insurance Grp**		**$144,110**	**14.0**	**$106,019**	
	Maxum Indemnity Co	PROF	$144,110		$106,019	A- p
44	**IAT Insurance Group**		**$142,825**	**28.5**	**$276,229**	
	Acceptance Casualty Ins Co	PROF	$7,267		$49,759	A- g
	Acceptance Indemnity Ins Co	PROF	$90,583		$124,078	A- g
	Wilshire Insurance Co	MISC	$44,976		$102,392	A- g
45	**SCOR U S Group**		**$136,751**	**0.0**	**$51,063**	
	General Security Indem Co AZ	PROF	$136,751		$51,063	A r
46	**Cincinnati Insurance Cos**		**$136,406**	**22.4**	**$228,385**	
	Cincinnati Specialty Undrs Ins	PROF	$136,406		$228,385	A
47	**Allianz of America Cos**		**$133,000**	**(37.5)**	**$1,135,665**	
	Allianz Global Risks US Ins Co	MISC	$77		$867,289	A+ g
	Allianz Underwriters Ins Co	PROF	$6,717		$66,203	A+ g
	Fireman's Fund Ins Co of OH	PROF	-$289		$48,005	A r
	Interstate Fire & Casualty Co	PROF	$126,496		$154,168	A r
48	**Selective Insurance Group**		**$128,998**	**0.0**	**$62,286**	
	Mesa Underwriters Spec Ins Co	PROF	$128,998		$62,286	A p
49	**Kinsale Insurance Co**		**$124,154**	**0.0**	**$81,407**	
	Kinsale Insurance Co	PROF	$124,154		$81,407	A-
50	**Meadowbrook Insurance Group**		**$116,396**	**(50.2)**	**$282,616**	
	Century Surety Co	PROF	$105,918		$178,629	B++ p
	ProCentury Insurance Co	MISC	$713		$46,050	B++ p
	Savers Property & Cas Ins Co	MISC	$9,764		$57,937	B++ p

Source: A.M. Best data & research

Appendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits, 2007-2012

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2009	2010	2011	2012	2013
Acceptance Casualty Insurance Co				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
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
Alterra Excess & Surplus Ins	X	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	X	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
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
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
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
Chartis Select Insurance Co	X	X	X		
Chartis Specialty Insurance Co	X	X	X	X	
Chubb Custom Insurance Co	X	X	X	X	X
CIM Insurance Corporation		X	X	X	X
Cincinnati Specialty Undrs Ins	X	X	X	X	X
Clarendon America Insurance Co	X	X	X		
Colony Insurance Co	X	X	X	X	X
Colony National Insurance Co	X	X	X	X	X
Columbia Casualty Co	X	X	X	X	X
Companion Specialty Ins Co	X	X	X	X	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
Darwin Select Insurance Co	X	X	X	X	X
Discover Specialty Insurance Co	X	X	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
Fireman's Fund Ins Co of OH	X	X	X	X	X
First Financial Insurance Co	X	X	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	X	X			
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
Great American E&S Insurance Co	X	X	X	X	X
Great American Fidelity Insurance Co	X	X	X	X	X
GuideOneNational Insurance Co					X
Guilford Insurance Co	X	X	X	X	X
Gulf Underwriters Insurance Co	X	X		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
Houston Casualty Co	X	X	X	X	X
Houston Specialty Insurance Co	X	X	X	X	X
HSB Specialty insurance Co					X
Hudson Excess Insurance Co					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
Landmark American Ins Co	X	X	X	X	X
Landmark Insurance Co	X	X	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	X
Maxum Indemnity Co	X	X	X	X	X
Medical Security Insurance Co					X
Merchants National Ins Co	X	X	X	X	X
Mesa Underwriters Spec Ins Co				X	X
Mid-Continent Excess & Surplus				X	X
Montpelier US Insurance Co	X	X			
MSA Insurance Co	X	X	X	X	X
MSI Preferred Insurance Co	X	X	X	X	
Mt Hawley Insurance Co	X	X	X	X	X
Mt Vernon Fire Insurance Co	X	X	X	X	X
NAMIC Insurance Co, Inc	X	X	X	X	X
National Fire & Marine Ins Co	X	X	X	X	X
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

Appendix B

U.S. Domestic Professional Surplus Lines – Entrances & Exits, 2007-2012

X denotes domestic professional surplus companies, defined as companies with direct premium from surplus lines business greater than 50% of total premium.

Company Name	2009	2010	2011	2012	2013
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
Nutmeg Insurance Co	X	X	X		
Oklahoma Specialty Ins Co					X
Old Guard Insurance Co		X	X	X	
Old Republic Union Ins Co	X	X	X	X	X
Omega US Insurance Inc	X	X	X		
Pacific Insurance Co, Ltd	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	X	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	X	X	
Protective Specialty Ins Co			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	X	X		
Sagamore Insurance Co			X	X	
Savers Property & Casualty Ins Co				X	
Scottsdale Insurance Co	X	X	X	X	X

Company Name	2009	2010	2011	2012	2013
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
Specialty Surplus Insurance Co		X			
St. Paul Fire & Casualty Ins	X	X	X	X	X
St. Paul Surplus Lines Ins Co	X	X	X	X	X
Standard Guaranty Ins Co	X	X	X	X	
Starr Surplus Lines Ins Co		X	X	X	X
Steadfast Insurance Co	X	X	X	X	X
TDC Specialty Insurance Co					X
TM Specialty Insurance Co	X	X	X	X	
Tokio Marine Specialty Ins Co				X	X
Torus Specialty Insurance Co	X	X	X	X	X
Traders & General Ins Co	X	X	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 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	X	X
Valiant Specialty Insurance Co	X	X	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 research

Appendix C
U.S. State Survey: Regulated & Unregulated Alien Lists

State	Regulated Alien List Maintained	Unregulated Alien List Maintained	Alien Insolvencies Tracked	Fraud Unit
Alabama	No	No	No	Yes
Alaska	Yes**	No	No	Yes
Arizona	No**	No	No	No
Arkansas	Yes**	No	No	Yes
California	Yes**	No	No	Yes
Colorado	Yes	No	No	Yes
Connecticut	No	No	No	Yes
Delaware	Yes	No	No	No
Dist of Columbia	No	No	No	No
Florida†	Yes (1)	Yes (2)	No (3)	Yes (4)
Georgia	Yes**	No	No	Yes
Hawaii	Yes**	No	No	No
Idaho	Yes*	No	Yes	Yes
Illinois†	No	Yes	No	Yes
Indiana	Yes*	No	No	No
Iowa	Yes*	No	No	No
Kansas†	Yes*	No	No	Yes
Kentucky	Yes*	No	No	Yes
Louisiana	Yes	No	No	Yes
Maine	Yes	No	No	No
Maryland	Yes*	No	No	No
Massachusetts	Yes**	No	No	Yes
Michigan (5)†	Yes	No	No	No
Minnesota†	Yes	No	No	Yes
Mississippi	Yes**	No	No (2)	Yes
Missouri	Yes*	No	No	Yes
Montana	No	Yes	No	Yes
Nebraska	No	No	No	Yes
Nevada	Yes**	No	No	Yes
New Hampshire	Yes**	No	No	No
New Jersey†	No*	No	No	No
New Mexico†	Yes*	No	No	No
New York	No	No	Yes	Yes
North Carolina	Yes (6)	No(6)	No	Yes
North Dakota	Yes**	No	No	Yes
Ohio	Yes**	Yes	No	No
Oklahoma	Yes	No	No	No
Oregon	No	No	No	No
Pennsylvania	No***	No	Yes	Yes
Rhode Island	Yes**	No	No	No
South Carolina	Yes*	No	No	No
South Dakota	No	No	No	Yes
Tennessee	No	No	No	No
Texas	Yes	No	Yes	Yes
Utah	Yes	No	Yes	Yes
Vermont†	No	No	No	No
Virginia	No	No	No	No
Washington	No	No	No	Yes
West Virginia	Yes*	No	No	Yes
Wisconsin	No	No	No	No
Wyoming	Yes**	No	No	No

† Indicates state's response is as of August 2013. These states have not responded as of Aug. 15, 2014.
* Uses the "white list" from the International Insurers Department of the National Association of Insurance Commissioners (NAIC).
** Uses the "Quarterly Listing of Alien Insurers" from the international Insurers Department of the NAIC to qualify aliens for the ADOI "List of Qualified Unauthorized Surplus lines Insurers."
*** The Pennsylvania Insurance Department maintains a listing of all eligible surplus lines insurers including alien insurers.
(1) The Florida Office of Insurance Regualtion maintains a current listing of all surplus lines insurers including aliens.
(2) The Florida Office of Insurance Regulation maintains a list of Federally Authorized insurers that claim federal exemption (IID list).
(3) An alien insurer insolvency is not tracked once it has become insolvent or disappeared
(4) There is a unit for unlicensed/unapproved entities that is operated out of the Market Conduct section of the Florida Office of Insurance Regulation. There is no routine monitoring of unregulated alien insurers.
(5) The Michigan Office of Financial and Insurance regulation maintains a current listing of all eligible unauthorized surplus lines including aliens.
(6) The North Carolina Department of Insurance maintains a current listing of all surplus lines carriers that have applied and been approved for registration, including aliens.
Source: A.M. Best Co., as of Aug. 31, 2013.

Appendix D

U.S. State Survey: Capital & Surplus Requirements for Surplus Lines Companies

State	Domestic Company Minimum Surplus	Alien Company Minimum Surplus	Pending Revisions
Alabama	$5,000,000	$2,500,000 (1) & 15,000,000	No
Alaska	15,000,000	15,000,000 & 2,500,000 (1)	No
Arizona	15,000,000	15,000,000 (8)/ 5,400,000 (1)	No
Arkansas	20,000,000	N/A	No
California	45,000,000 (2)	(8)	No
Colorado	15,000,000	5,400,000	No
Connecticut	15,000,000	15,000,000	No
Delaware	15,000,000	15,000,000	No
Dist of Columbia	300,000	300,000	No
Florida†	15,000,000	15,000,000 (3)	No
Georgia	4,500,000	10,000,000/ 10,000,000 (1)	No
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	6,000,000	5,400,000 (3)	No
Louisiana	15,000,000	15,000,000 (8)	No
Maine	4,500,000	Listed with NAIC International Insurers Department (9)	No
Maryland	15,000,000	N/A	No
Massachusetts	20,000,000	20,000,000	Yes
Michigan†	7,500,000	15,000,000 (10)	Yes (5)
Minnesota†	15,000,000	15,000,000	No
Mississippi	1,500,000	15,000,000 & 5,400,000 (3)	No
Missouri	15,000,000	15,000,000	Yes
Montana	15,000,000	15,000,000	Yes
Nebraska	15,000,000	(8)	No
Nevada	15,000,000	5400000/ 100,000,000 (4)	Yes
New Hampshire	15,000,000	n/a	No
New Jersey†	15,000,000(6)	15,000,000(6)	No
New Mexico†	15,000,000(5)	15,000,000(5)	N/A
New York	45,000,000	45,000,000 (9)	No
North Carolina	15,000,000	15000000(11)	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/ 5,400,000 (3)	No (6)
Pennsylvania	15000000/ 4500000	(8) 4500000	No
Rhode Island	15,000,000	15,000,000	No
South Carolina	15,000,000	15,000,000	No
South Dakota	500,000	500,000	No
Tennessee	15,000,000/ 15,000,000	Listed with NAIC International Insurers Department	No
Texas	15,000,000	(8)	No
Utah	2,500,000 (1)	50,000,000/ 50,000,000 (2)	No
Vermont†	15,000,000	15,000,000	No
Virginia	1,000,000/ 3,000,000	Deemed Approval (7)	No
Washington	15,000,000	(9)	No
West Virginia	15,000,000	15,000,000	No
Wisconsin	N/A	N/A	No
Wyoming	15,000,000	15,000,000(9)	No

† Indicates state's response is as of August 2013. These states have not responded as of Aug. 15, 2014.
(1) Trust Fund
(2) Minimum surplus phase-in period for US- domiciled nonadmitted insurer currently on the California list of eligible surplus lines Insurers that did not meet the $45 million minimum capital and surplus requirements as of Jan. 1, 2011: the insurer must have capital and surplus of 45 million by Dec. 31, 2013.
(3) In addition, alien carriers required to maintain $5.4 million trust fund in the United States.
(4) Lloyd's
(5) Due to Dodd-Frank.
(6) This law became effective Jan. 1, 2012.
(7) Insurers appearing on the Quarterly Listing of Alien Insurers maintained by the International Insurers Department of the NAIC deemed approved in Virginia.
(8) Alien company must be listed on the Quarterly Listing of Alien Insurers maintained by the International Insurance Department of the NAIC.
(9) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes. As of Jan. 1, 2013, new alien insurers require $45 million.
(10) Due to Dodd-Frank; NAIC Quarterly Listing of Alien Insurers is used for verification purposes.
(11) For those alien surplus lines carriers 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.
Source: A.M. Best Co., as of Aug. 31, 2014.

Appendix E

U.S. State Survey: Stamping Office & Multistate Taxation of Surplus Lines Transactions

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
Alabama	No	6.00%	No	No	Yes	No
Alaska	No	2.70%	1.00%	No	Yes	Insured Reports
Arizona	Yes	3.00%	0.20%	No	No	No
Arkansas	No	4.00%	No	Yes	Yes	Yes
California	Yes	3.00%	0.20%	No	Yes (1)	Yes (1)
Colorado	No	3.00%	No	Yes	Yes	Yes
Connecticut	No	4.00%	No	No	Yes	Yes
Delaware	No	2.00%	No	No	Yes	Insured Reports
Dist of Columbia	No	2.00%	No	Yes	Yes	No
Florida	Yes	5.00%	0.175%	Yes(3)	Yes	Yes
Georgia	No	4.00%	No	No (8)	Yes	Insured Reports
Hawaii	No	4.68%	No	Yes	Yes	Insured Reports
Idaho	Yes	1.50%	0.25%	NO	NO	No
Illinois†	Yes	3.50%	0.10%	Yes	No	No
Indiana	No	2.50%	No	No	Yes	Yes
Iowa	No	1.00%	No	No	Yes	No
Kansas†	No	6.00%	No	No	No	No
Kentucky	No	3.00%	No	Yes	No	Yes
Louisiana	No	5.00%	No	Yes	Yes	Insured Reports
Maine	No	3.00%	No	No	Yes	Yes
Maryland	No	3.00%	No	N/A	Yes	Insured Reports
Massachusetts	No	4.00%	No	Yes	No	No
Michigan†	No	2.00%*	No	No	No	Yes - Insured Reports
Minnesota	Yes	3.00%	0.06%	N/A	No	No
Mississippi	Yes	4.00%	0.25%	Yes	Yes	Yes
Missouri	No	5.00%	No	No	Yes	Yes
Montana***	No	2.75%	0.00%	Yes	No	No
Nebraska	No	3% (9)	No	No	No	No
Nevada	Yes	3.50%	0.40%	No	Yes	Yes
New Hampshire	No	3.00%	No	Yes(9)	Yes	Yes
New Jersey†	No	5.00%	No	No*	Yes (1)	No
New Mexico†	No	3.003%	N/A	N/A	No	No
New York	Yes	3.60%	0.20%	No (4)	Yes	Yes (2)
North Carolina	No	5.00%	No	No	Yes	Insured Reports
North Dakota	No	1.75%	No	Yes (5)	Yes	No
Ohio	No	5.00%	No	No	Yes	No
Oklahoma	No	6.00%	No	Yes	No	Insured Reports
Oregon	Yes	2.3% (6)	$15.00	No	Yes	No
Pennsylvania	Yes	3.00%	$25.00	No	Yes	Insured Reports
Rhode Island(10)	No	2.00%	No	Yes	No	No
South Carolina	No	4.00%	No	No	No	No
South Dakota	No	2.5% - 3.0%	No	Yes	Yes	Yes
Tennessee	No	5.00%	No	Yes	No	No
Texas	Yes	4.85%	0.06%	NO	Yes	Insured Reports
Utah	Yes	4.25%	0.25%	Yes	Yes	No
Vermont†	No	3.00%	No	N/A	Yes	Yes
Virginia	No	2.25%	No	No	No	No
Washington	Yes	2.00%	0.10%	No	Yes	Yes
West Virginia	No	4.55%	No	No	No	No

Appendix E

U.S. State Survey: Stamping Office & Multistate Taxation of Surplus Lines Transactions

State	Stamping Office	Premium Tax	Stamping Fee	Tax Allocated	Procurement Tax Applies	Procurement Monitored
Wisconsin	No	3.00%	No	No	Yes (7)	No
Wyoming	No	3.00%	No	Yes	Yes	Yes

† Indicates state's response is as of August 2013. These states have not responded as of Aug. 15, 2014.
(1) Not by DOI; handled by state franchise tax board.
(2) Not by DOI; handled by Department of Revenue Services/Taxation
(3) Florida has joined the tax sharing agreement of NIMA. Since 7/1/2012 all Florida homestate policies get filed at the NIMA Clearinghouse and other NIMA participants will get their portion of the allocated premium. Non-participating state's premium will be retained by the home state.
(4) New York as of July 21,2011 no tax allocation. Additionally , where NY is the "home state of the insured" and the policy covers risks located both inside and outside the US , only the portion of the premium attributable to the risk inside the US is subject to 100% tax.
(5) Tax payable is sum of 1.75% on portion of gross premiums allocated to North Dakota plus other states' applicable tax rates & fees applicable on portion of premiums allocated to other states.(NDCC 26.1-44-03.1)
(6) This amount includes .3% collected for Oregon Fire Marshall's office.
(7) Tax now 3% on ocean marine business.
(8) Effective 7/1/12, multi-state allocation does not apply. Pay 4% on entire premium when Georgia is the home state.
(9) Tax payable is sum of 3% on portion of gross premiums allocated to Nebraska plus other state's applicable tax rates applicable on the portion of premiums allocated to other states
(10) Premium taxes are handled by the Division of Taxation
* Plus 0.5% regulatory fee in Michigan
*** Assesses a 1% stamping fee on paper filings and a 1/2% (0.005) stamping fee on electronically filed policies. No longer necessary for Montana
****Effective 01/01/2012, Montana's stamping fee is 0.00% for electronically filed polices and endorsements and paper filings have a 0.25% stamping fee
Source: A.M. Best Co., as of Aug. 31, 2013.

Contributors

David Blades, Oldwick
Carol Demyanovich, Oldwick
Laura McArdle, Oldwick
Kenneth Monahan, Oldwick
Daniel Ryan, Oldwick
Henry Witmer, Oldwick

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A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, NJ 08858
Phone: +1 (908) 439-2200

WASHINGTON OFFICE
830 National Press Building
529 14th Street N.W., Washington, DC 20045
Phone: +1 (202) 347-3090

A.M. BEST AMÉRICA LATINA, S.A. de C.V.
Paseo de la Reforma 412
Piso 23
Mexico City, Mexico
Phone: +52-55-5208-1264

A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400

DUBAI OFFICE (MENA, SOUTH & CENTRAL ASIA)
Office 102, Tower 2
Currency House, DIFC
PO Box 506617, Dubai, UAE
Phone: +971 43 752 780

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A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, NJ 08858
Phone: +1 (908) 439-2200

WASHINGTON OFFICE
830 National Press Building
529 14th Street N.W., Washington, DC 20045
Phone: +1 (202) 347-3090

A.M. BEST AMÉRICA LATINA, S.A. DE C.V.
Paseo de la Reforma 412
Piso 23
Col. Juárez, México, DF
Phone: +52-55-5208-1264

A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400

A.M. BEST MENA, SOUTH & CENTRAL ASIA
Office 102, Tower 2
Currency House, DIFC
PO Box 506617, Dubai, UAE
Phone: +971 43 752 780