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Texas Surplus Lines Insurer Financial Update

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A product of annually evaluating each surplus lines insurer eligible in Texas is the accumulation of data elements for each and the creation of a 'composite' financial picture of the insurer market compared to prior years. As we have done since 2000, the exhibit on page 2 compares various financial data and ratios over a five-year period. (Note that a one page summary of selected financial data for each eligible insurer is available at slsot.org under "Company Information".)

There are three distinct risk-bearing entities in the Texas surplus lines market. Foreign (U.S.) insurers make up 74% of eligible insurers [139], Alien (Non-U.S.) insurers are 26% of eligible insurers [47] and Underwriters at Lloyd's, London [70 Syndicates]. Premium processed by the Surplus Lines Stamping Office of Texas (SLSOT) for these entities in 2007 was as follows: Foreign insurers $1.848 billion, 75%; Alien insurers $147.1 million, 6% and Lloyd's $437.0 million, 19%. As of September 30, 2008 the three types of entities maintained the same percentages as in 2007. The top ten individual insurers (including Lloyd's) reported 55% of the total premium processed by the SLSOT in 2007 with this percent declining to 53% as of September 30, 2008. When compiling premium by insurers within an insurance group the top ten insurance groups wrote 64% of the premium processed by the SLSOT in 2007 increasing to 66% as of September 30, 2008.

In a year when everyone acknowledges there were soft market conditions and admitted insurers continued 'taking back' business, premium processed by the SLSOT in 2007 was up $156 million or 4.37%. The small increase in 2007 is indicative of the softening market when compared to the 17.2% increase in 2006. Premium processed as of September 30, 2008 was $2.432 billion or 11.2% lower than at the same time in 2007. Looking forward the 2008 average premium per policy of $7,416 at September 30, 2008 was down from $8,312 at the end of 2007 or -10.7% and items processed were off 3.3%, again evidencing a softening market.

Gross premium for these insurers declined in 2007, in aggregate 10% and average 18%. Net premium on the other hand increased 24% aggregate and 13% average. Comments in many insurers' Management's Discussion and Analysis and Annual Statements indicate insurers are increasing their net retentions in an effort to reduce reinsurance costs and also because reinsurers are requiring insurers to assume more of the burden. The leverage ratio of gross premium to surplus fell to 71% and the net premium to surplus ratio declined to 50% compared to 84% and 55% respectively in 2006.

Operating results in 2007 for surplus lines insurers were very good. Underwriting gains, reported by 72% of the eligible insurers, in aggregate were $4.0 billion, an average of $21.5 million, for a 12% and 3% increase respectively. The combined ratio deteriorated to 92%, a 4% increase over 2006. Net income after tax was earned by 88% of these insurers, in aggregate $10.1 billion and on average $54.3 million for an increase of 61% and 47% respectively. Evidence suggests that the lower number of catastrophic events and better than expected reserve development allowed some reserves to be reduced. Investment income on the whole was good although our outlook is for this component of net income to decline in 2008 and worsen in 2009. Return on policyholder surplus was 13.0% compared to 10.5% in 2006. Positive operating cash flow was reported

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by 79% of the Foreign insurers compared to 86% in 2006.

Aggregate capital and surplus of 186 eligible insurers was $102.7 billion compared to $96.3 billion in 2006, although there was a decline in average capital and surplus. There are several components to this aggregate increase in capital and surplus: the net addition of twelve well-capitalized newly eligible insurers, net income and changes to asset values, offset by unrealized capital losses and dividends paid. The average capital and surplus of these insurers declined $10.2 million or 2% and was $546.2 million at the end of 2007 compared to $556.4 million in 2006. Only 76% of eligible insurers increased capital and surplus in 2007 compared to 91% in 2006.

The insurer evaluation process produces a Priority Rating for each insurer so resources can be allocated to the most deserving insurers. During the 2008 evaluation process seventeen insurers or 9% were upgraded and fourteen insurers or 7% were downgraded. Currently, 21 insurers (11%) are Priority 1, 44 insurers (23%) are Priority 2 and 123 insurers (66%) are Priority 3. A.M. Best ratings for currently eligible insurers that are rated reflect 100% are in the Secure range and no insurers are in the Vulnerable range. Eighteen insurers were not rated due to company request, rating procedure inapplicable, not formally followed or insufficient operating experience. Most of the insurers not rated were Alien insurers not formally followed or newly formed insurers. During the 2008 evaluation season there were an unusually large number of new submissions for eligibility, especially considering the soft market conditions. Twelve insurers sought initial eligibility in 2008, the most new submissions since 12 applied in 2002.

Trends evidenced by the composite financial data, premium statistics and published trade publications indicate a soft market continues although seemingly stabilized. The health of the risk-bearing entities eligible in Texas is good and better than the P&C market as a whole. Surplus lines premium for commercial lines business was 18.3% of total commercial lines business in Texas for 2007 and 18.5% in 2006. On a nationwide basis A.M. Best's *U.S. Surplus Lines-Market Review* shows commercial lines business written in the surplus lines market was 14.0% and 14.4% for the same respective periods. The statistical trends indicate a slight flight to quality (or at least to larger-sized companies or groups) with the top ten insurance groups commanding 66% of the market. In Texas, no eligible surplus lines insurers have become impaired over the past four years. *(continued Financial, page 3...)*

Texas Surplus Lines Insurer Composite Financial Information

Calendar Year 2007-2003 Comprised on Currently Eligible Insurers

	2007	2006	2005	2004	2003
Capital & Surplus	102,692,104,822	96,255,165,279	75,403,523,298	65,448,080,153	55,849,152,951
Average	546,234,600	556,388,239	448,830,496	391,904,672	334,426,066
Median	92,426,439	86,819,000	79,990,451	64,323,256	57,339,000
Underwriting Gain (Loss)	4,006,155,437	3,571,040,220	1,196,354,228	(590,055,784)	923,880,897
Average	21,538,470	20,883,276	7,121,156	(3,907,654)	5,532,221
Median	1,969,636	1,835,687	450,642	751,623	0
Net Income After Tax	10,146,951,413	6,294,992,030	7,952,450,619	5,622,573,701	5,072,091,271
Average	54,261,772	36,812,819	47,336,016	33,668,106	30,371,804
Median	5,697,642	5,877,948	4,299,424	3,825,700	2,853,996
Return on Policyholder Surplus	13.0%	10.5%	9.3%	9.3%	10.4%
Gross Premium	72,764,196,877	81,066,459,165	69,551,987,565	69,867,100,778	69,968,959,001
Average	395,457,592	479,683,190	413,999,926	418,365,873	418,975,802
Net Premium	51,322,190,259	41,542,047,622	35,325,177,586	35,467,692,764	34,276,556,365
Average	278,924,947	245,810,933	210,268,914	212,381,394	205,248,841
Gross Premium to Surplus Ratio	71%	84%	92%	107%	125%
Net Premium to Surplus Ratio	50%	55%	47%	54%	61%
SLSOT Premium Processed**	3,724,220,192	2,998,384,870	2,879,629,825	2,800,896,916	2,645,125,725
Average	21,527,284	20,536,883	19,070,396	16,975,133	16,128,815
Combined Ratio	92%	88%	94%	97%	91%
	Number of Insurers				
Insurers Included	187	175	169	167	166
Foreign (U.S.)	139	130	124	124	124
Alien (Non-U.S.)	47	44	44	42	41
Underwriters at Lloyd's (Syndicates)	70	63	60	57	64
New Submissions for Eligibility	12	8	8	4	6
Priority Rating Changes Upgrades	17 / 9%	27 / 16%	39 / 23%	32 / 19%	24 / 14%
Priority Rating Changes Downgrades	14 / 7%	7 / 4%	14 / 8%	9 / 5%	14 / 8%
Increased capital & surplus	143 / 76%	157 / 91%	135 / 80%	142 / 85%	148 / 89%
Underwriting gains	136 / 72%	124 / 72%	108 / 64%	79 / 47%	94 / 57%
Net income	164 / 88%	151 / 87%	150 / 89%	144 / 86%	146 / 88%
Positive Op. Cash (U.S. insurers)	112 / 79%	110 / 86%	91 / 72%	101 / 81%	107 / 87%

*Exclusive of Underwriters @LLoyd's ** will not equal total premium process by the SLSOT

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Our expectation for 2008's final result and projections for 2009 are less favorable than we see in trade publications. Insurers making up the surplus lines market have strengthened their balance sheets over the past few years and this should allow them to succeed. Our concern is that the soft market remains, investment income will no doubt be down and we expect unrealized capital losses to be significant. The table below represents the degree to which U.S. insurers eligible in Texas have invested in mortgage backed securities. The evidence gathered during insurer evaluations in 2008 reflect very few mortgage backed security investments that were written down due to 'other than temporary declines' (OTTD) but this was at December 31, 2007 and our expectation is for OTTD to be much greater on 2008 Annual Statements.

U.S. Insurers Currently Eligible in Texas-Mortgage Backed Securities

Total Investment	$5,604,140,942
Number of insurers with this type investment	107
Investment total as a % of their invested assets	19.2%
Investment total as a % of Capital and Surplus	28.5%

Of the 107 U.S. insurers with mortgage backed security investments, nine insurers had 40% or more of their invested assets in this type of investment. Mortgage backed securities, as a percent of invested assets for these insurers was 19.2% and was 28.5% of their capital and surplus. Sixteen insurers had mortgage backed security investments equivalent to 75% or more of capital and surplus, with eight of these over 100%.

It has always been difficult to project future results, but particularly so for year-end 2008 and into 2009. There is a confluence of factors weighing against better results ahead: credit and equity market turmoil, pricing levels, investment return, underwriting discipline, the influence of London and Bermuda on the market, the effect of federal loans to AIG and catastrophe events as yet unknown.

SLSOT Mini-Seminars Available On-Line 24/7

SLSOT's 2008 Educational Seminars are now available on-line at www.slsot.org. This year's seminars are segmented into five short presentations that target specific areas. There are four presentations pertaining to the EFS and one for those still filing paper documents. The EFS presentations address topics such as selecting the appropriate coverage and class codes, basic assistance for new EFS users, and understanding the purpose and procedures of our data validation program. The presentation for paper filers addresses specific tag codes and how to resolve them. We believe these shorter presentations will allow you to focus on the subject relative to your individual needs.

Ballinger Elected to NAPSLO Foundation Board

In September, Stamping Office Executive Director Phil Ballinger was elected to the Derek Hughes/ NAPSLO Educational Foundation Board of Directors. The Foundation is involved in a number of education programs supporting the surplus lines industry, including creation of the Associate in Surplus Lines Insurance (ASLI) professional designation, funding for the AM Best Annual Review of the Surplus Lines Market, sponsorship of significant insurance research projects, and awarding of college scholarships.

E F S Quick Tips

• If you have a typo on an EFS entry, it is necessary to reverse the transaction and re-enter it with the correct information. Never enter an "endorsement" that doesn't exist just to correct an EFS typo.

• If you are uncertain of the correct coverage or class codes, please contact the EFS Help Desk for assistance. Coverage Code 9050 (Property-Package) should never be combined with 9015 (Property-Fire/Allied Lines).

• When transactions are submitted through the EFS, it is not necessary to also submit paper copies of those items.

Helpful Hints - Paper Filing of Policies

• When filing a tag correction on a premium-bearing endorsement, be sure to show the premium on the Transmittal & Verification Slip.

• When responding to a tag memo, please do not submit another copy of the policy. This causes confusion and can lead to duplication of premium. Be sure you read the entire tag text for complete instructions.

Financial Analysis Sweeps Annual Salsa/Queso Contest

The 8th Annual SLSOT Salsa & Queso Contest was held on Halloween. Sandy Barnhart, Analyst I, retained her title from last year winning top honors and bragging rights for Best Salsa. This is her 4th win overall. Brian Wilds, Director, also took his 4th overall win with Best Queso. Employees are encouraged to sample all the entries and vote for their favorite in each category. The winners received $25 cash prizes in addition to custody of the famous sombreros to display proudly in their offices until next year's competition.

Comparison of SLSOT Premium Processed by Line of Business

Annual Statement by Line of Business	Premium through 10/31/08	Premium through 10/31/07	Percent Change
1 Fire (incl. allied lines)	$568,584,725	$683,133,108	-16.77%
2 Allied lines	$39,449,335	$32,654,980	20.81%
3 Farmowners multiple peril	$905,431	$1,040,855	-13.01%
4 Homeowners multiple peril	$63,197,458	$73,051,251	-13.49%
5 Commercial multiple peril	$152,367,429	$161,937,894	-5.91%
8 Ocean marine	$3,946,091	$8,116,909	-51.38%
9 Inland marine	$64,622,597	$66,513,953	-2.84%
11 Medical malpractice	$45,263,049	$51,280,714	-11.73%
12 Earthquake	$1,357,760	$324,651	318.22%
13 Group accident & health	$78,075,602	$69,545,800	12.27%
15 All other A&H	$2,764,106	$1,935,751	42.79%
17 Other liability	$1,295,580,520	$1,453,199,066	-10.85%
18 Products liability	$22,526,836	$29,823,208	-24.47%
19.2 Other priv pass auto lia	$8,144	$2,599	213.35%
19.4 Other comm. auto liab	$74,261,332	$106,101,994	-30.01%
21.1 Priv pass auto physical	$1,305,707	$1,392,085	-6.20%
21.2 Comm auto phys.damage	$45,312,665	$55,528,810	-18.40%
22 Aircraft (all perils)	$14,415,236	$7,529,050	91.46%
23 Fidelity	$1,501,561	$946,732	58.60%
24 Surety	$1,020,724	$135,852	651.35%
26 Burglary & theft	$973,807	$1,056,402	-7.82%
27 Boiler & machinery	$1,513,942	$699,895	116.31%
28 Credit	$202,487,128	$239,510,650	-15.46%
31 Aggregate/other business	$281,890	$148,578	89.73%
TOTAL	$2,681,723,075	$3,045,610,787	-11.95%

Note: Due to rounding figures may not total

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We invite readers to suggest topics for articles that may be of interest to others.