COVID-19 Impact to the California SL Industry Observations

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I. Overview and Back Story:

In response to an overwhelming number of questions regarding the impact the COVID-19 ("Corona Virus") pandemic has had on the Surplus Lines Industry, specifically in California, this report highlights some observations that have been made in the short period affected by the pandemic. It is worth noting that these observations are being made during the pandemic, and the final outcome is not yet known. Section III at the end of this document summarizes the findings.

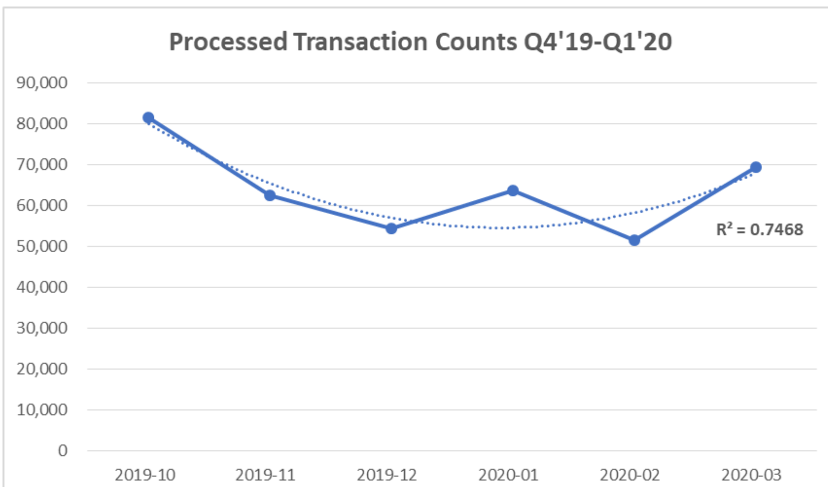
a. A number of factors related to the economic and societal impact of the pandemic have arisen over the 2-3 month period since the virus' exponential growth worldwide. These include all levels of government calling on insurers and businesses to extend payment due dates to consumers, relief and stimulus bills in the trillions of dollars, millions of workers unexpectedly unemployed, and businesses unable to resume operations due to loss of revenue.
b. Societal factors include drastic behavioral changes in the way people live their lives, shortages of essential household items, shelter-in-place orders, closures of non-essential businesses, restaurants, and public lands, prohibition of events, and general societal fears for safety and health.
c. Insurance related factors include non-renewal of small/medium sized business policies, lack of business interruption coverage for small/medium sized businesses, a high occurrence of exclusions due to "viruses", "pandemics", or other disease related causes, and lawsuits against insurers by small/medium sized businesses for lack of coverage or non-payment of claims related to losses due to the pandemic.
d. Here are some assumptions relating to the information contained herein:
    i. We can assume that most U.S. geographies imposed some level of shelter-in-place orders on or around March 15, 2020. Some localities and schools closed earlier, around March 1, 2020. This was the case for most of California.
    ii. Historical data has showed that trends in the California Surplus Lines industry tends to lag behind national and state economic shifts between 6-12 months after an event. i.e. It takes a while to move the SL "needle" in CA.
    iii. The California SLA data tends to be approximately 60 days behind the market. This is due to the regulatory 60 day grace period for filing from the policy invoice and approximately 20% of the SLA's filings are received later than that.
    iv. At this time of this report, there were 2.9M reported COVID-19 cases worldwide, with over 800,000 deaths. In the U.S., the number of reported cases was 945,000 with 53,000 deaths.

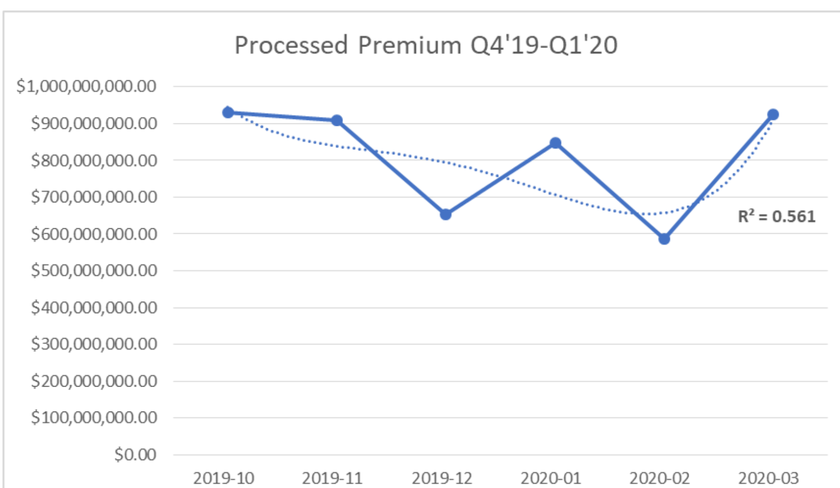
II. <u>The “Data”:</u>

While the relatively short period of time relating to this data makes high confidence statistical forecasting difficult, it can steer speculation as to the impact the pandemic may have on the SL industry in particular areas. The data observed includes Q4’2019 through April 23, 2020. A transaction is defined as a new policy, renewal, cancellations, and all types of endorsements (audits, extensions, etc.).

a. Overall California SL transactions have stayed consistent with historical seasonality across the time period, despite a weak February, 2020, Q1’2020 showed an increase over Q4’2019. Strong October’19 and March’20 influences the trend lines, and Q1’20 showed strong collective growth. See below:

Q4'19		Q1'20	
Registered Txns	**Reg. Premium**	**Registered Txns**	**Reg. Premium**
196,923	**$2,530,247,957**	**219,475**	**$2,920,628,937**
	Growth Percent:	**11%**	**15%**

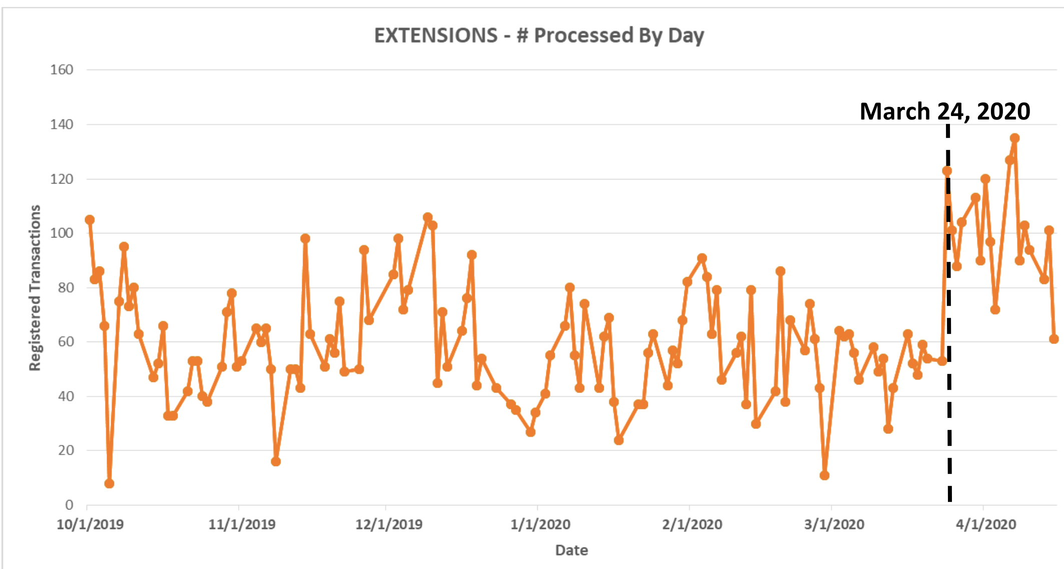


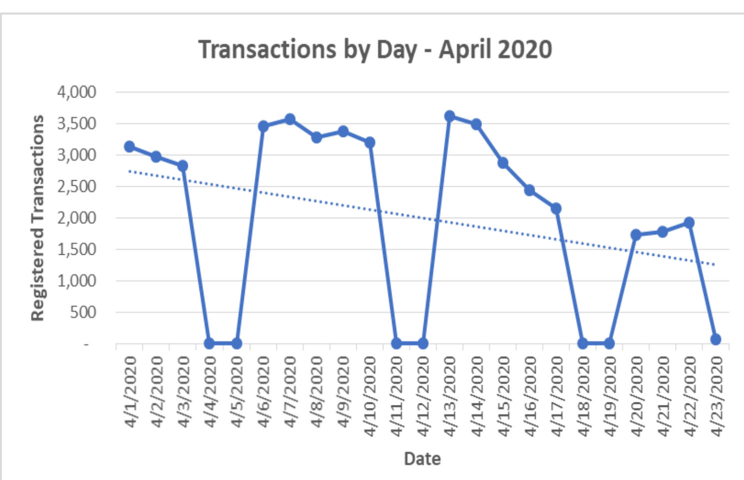


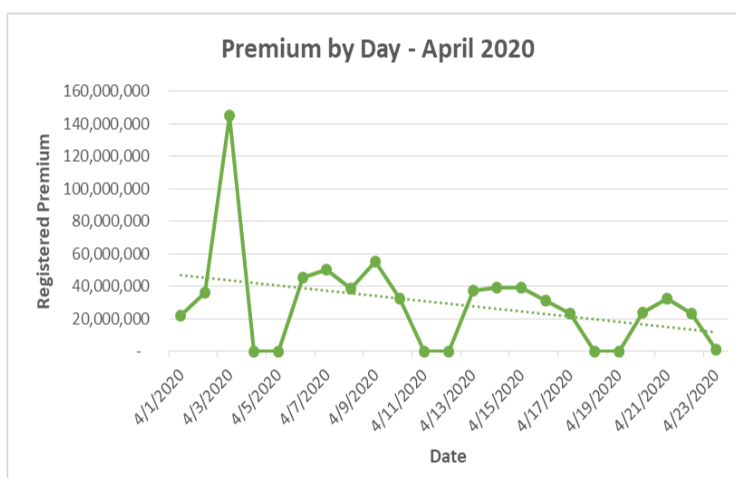
*NOTE: Approximately 10% of October 2019 numbers include older policies from backlog.

b. Transactions by Type (new business, renewals, endorsements, etc.) behaved consistently with the overall trends in Q4'19 and Q1'20. This behavior spilled into the first week of April, 2020 and then transitioned into a significant decline overall. There are two observations to be made here:
   i. There was a sharp increase in *extension* endorsements on March 24, 2020. It is believed that this is primarily due to legislation requiring extended grace periods for payments and prohibition of cancellation of certain types of insurance during the pandemic.
   ii. There was a sharp decrease in the second week of April, 2020 for all transactions. This decrease amounted to approximately 30% less transactions per day than the 12-month daily average. Given the recent nature of this trend, it's unclear as to how long it will last.

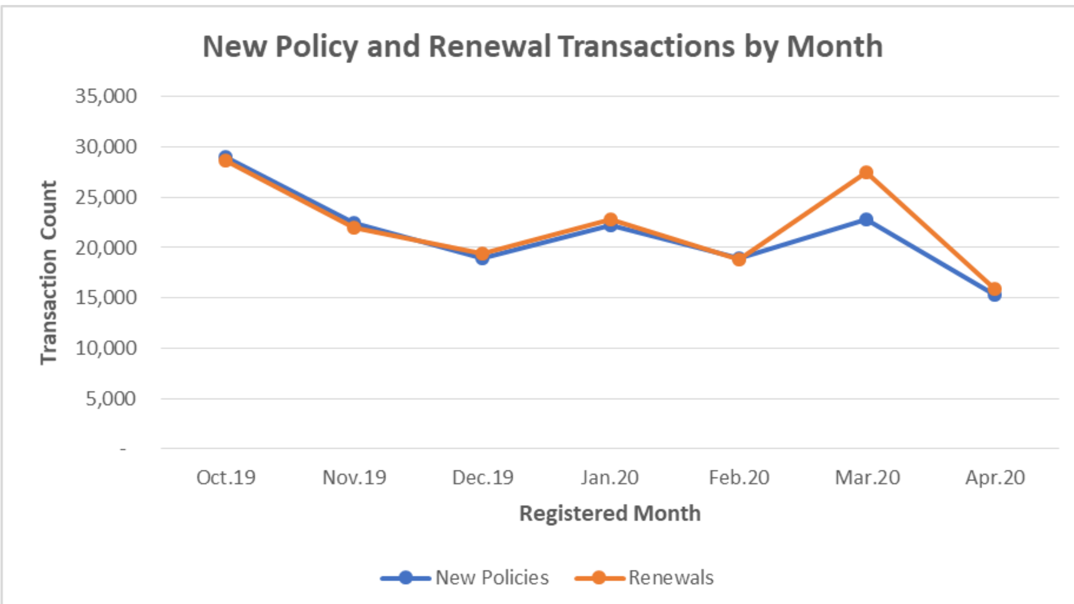
Q4'19 Monthly Avg.		Q1'20 Monthly Avg.		April, 2020 (estimated)	
Transactions	Premium	Transactions	Premium	Transactions	Premium
65,641	$843,415,986	73,158	$973,542,979	59,401	$875,259,202.45
	PERCENT CHANGE:	11%	15%	-19%	-10%

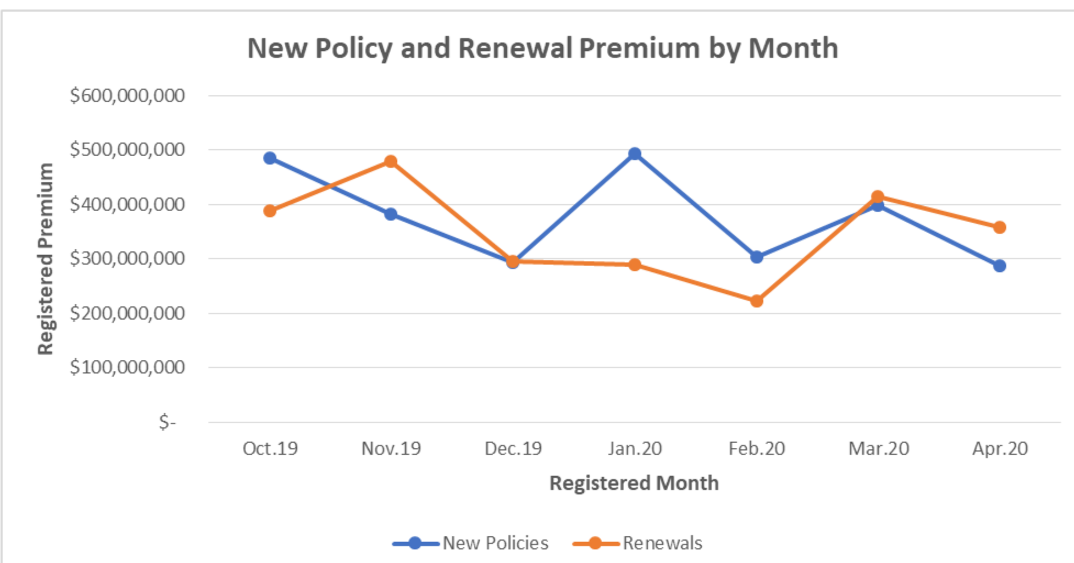






c. New Policies vs. Renewals. The contribution of new policies and renewals to all California Surplus Lines transactions is approximately 80% over the last 10 years. Transaction counts for both types are nearly the same (i.e. ≈40% of the market for each); however, trends have indicated that new business premium is higher in a strong economy and lower than renewals during a weaker economy. These trends began to change near the latter part of 2019 and showing signs of changing as a result of pandemic related events. One could speculate that in the near term (remainder of 2019), the California SL market would continue to decline in new business with renewals taking the majority of the transaction types. This could be expected to invert in 2021 as admitted risks in Management Liability, Professional Liability, Cyber Risk, D&O, EPL and similar business coverages move to the surplus lines market.





III. Conclusion

This unprecedented World event makes it difficult to confidently predict what the medium and long term affects to the economy will be and balance of world power will ultimately end up, one could be led to conclude the following changes to the Surplus Lines Industry based on the nascent information obtained to date.

a. The overall SL market will most likely behave consistently with general economy as it has in the past, staying somewhat economy agnostic and lagging behind national economic changes by 3-6 months.
b. Given the timing of the pandemic and long societal recovery, we may continue to see a declining market in terms of both SL business activity and total premium through the end of 2020. We may expect the average premium to increase for coverages such as Management Liability, Professional Liability, Cyber Risk, D&O, EPL and similar business coverages; however, the industry may not immediately benefit from this. This will be compounded by an especially contentious election period in Q4'20.
c. We should also see a significant shift of traditionally admitted risks to the SL market for small/medium sized businesses. This will be hard to prove due to lack of visibility of detailed information from the admitted market; however, a symptom of this trend would be visible increases in new policies beginning in Q4'20 with positive momentum going into 2021.

The current situation is extremely fluid at this time. There are no known cures or vaccines for the COVID-19 virus, and existing treatments produce mixed results. The impact of this situation on the SL market will partially be dependent upon how it is handled by SL insurers, brokers, underwriters, and ultimately the insureds. Positive news about surplus lines insurers paying out claims to small and medium sized businesses and unfavorable news for the admitted market could be a small silver lining for the SL industry.

UPDATE April 1, 2021:

At the end of 2020, we compared our California "pre-pandemic" models to actual results in 2020. We observed a 23% increase in premium and 8% increase in filed policies. Our early models indicated a 29% percent increase in premium and 5% increase in policies. One conclusion to make here is that the affects of the pandemic may have *reduced* total premium in 2020 in California by 6%, but increased policy activity by 3% (mostly due to pandemic-related endorsements). While it is "water under the bridge" it's interesting to note that a 6% loss in an $11B+ market is not immaterial.

In California, we observed a strong recovery and increase in certain industries, particularly Municipalities, Online Retail, and Hospitality. Industries still down, but on the rise, include Arts & Entertainment, Oil, Mining, and Gas, and Transportation/Warehousing. Early models indicate another strong growth year for Surplus Lines Insurance in California in 2021.