OVERVIEW:
EXCESS INSURANCE MARKETS

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Executive Summary

This paper addresses the current state of the excess insurance markets vis-à-vis the commuter rail industry. Following a brief introduction to the history, structure, and operation of the excess insurance markets, the paper examines in detail the principal insurance challenge facing commuter railroads today: Lack of capacity (defined as the "availability of enough insurance to satisfy the requirements of all the insureds in a particular sector or market"). Simply put, the excess insurance markets have vastly decreased the amount of coverage they wish to dedicate to insuring commuter rail. In 2020 alone, excess market coverage for commuter railroads decreased by nearly $450,000,000. This has led to a crisis in that some commuter railroads have experienced challenges in securing the full $323 million of coverage – as set forth under the FAST Act - and in many cases the properties that were able to bridge the gap faced substantial increases in price at some levels of excess insurance.

To illustrate the dramatic inability of commuter railroads to obtain excess insurance: of 24 key excess insurers in the foreign marketplaces (London and Bermuda), 15 insurers have greatly reduced their commuter rail capacity (an average reduction of 50%) and nine have withdrawn from the marketplace altogether.

Compounding this problem, there are very few U.S. insurance carriers who wish to insure commuter railroads. Two of those carriers completely closed their commuter rail operations in the Fall of 2019.

The lack of capacity impacts myriad aspects of commuter rail operations. Many commuter railroads are contractually obligated to insure to the FAST Act's liability cap. For example, Positive Train Control vendors and providers, host railroads, and purchase of service providers all require a commuter railroad to obtain insurance coverage up to the FAST Act's liability cap. Many of these contracts provide that the commuter railroad must cease operations in the event that the commuter railroad fails to obtain the required insurance coverage.

R. John Anderson
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Overview:

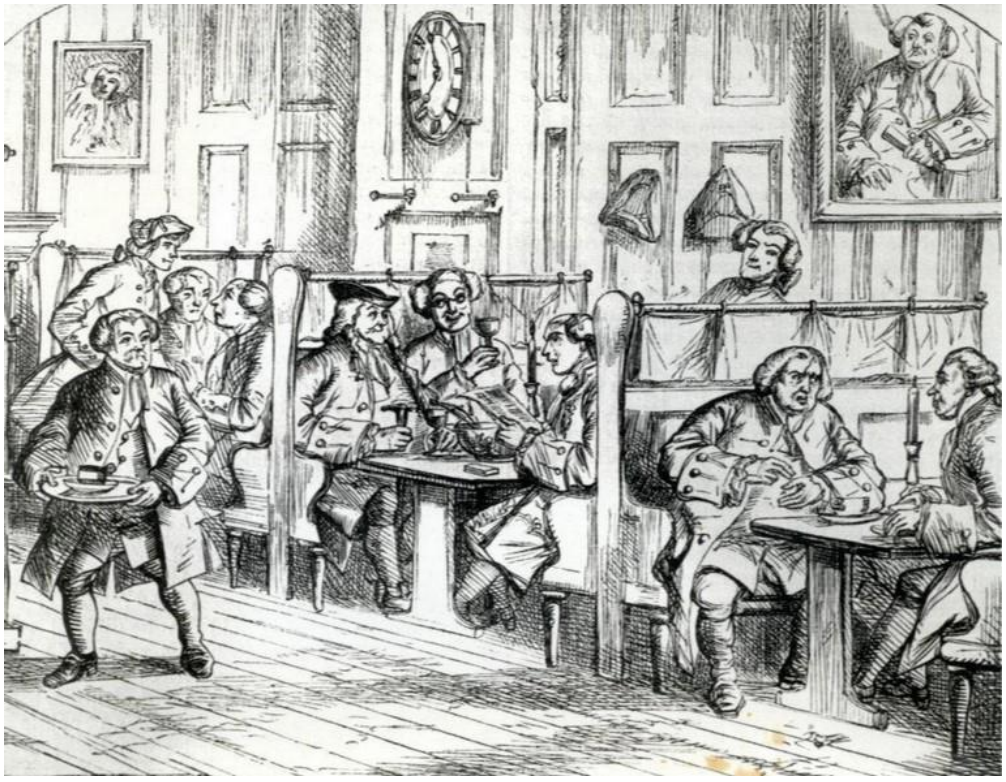
Excess Insurance Markets

I. Introduction

When we speak of insurance markets in the rail context, we are referring to the excess insurance market, that is, those layers above (or in excess of) any primary insurance or self-insured retentions. When we think of markets for rail today, we generally think of foreign markets in London and Bermuda. There are few, if any, domestic markets underwriting rail. Domestic markets are either too small to handle rail risks or are too risk averse.

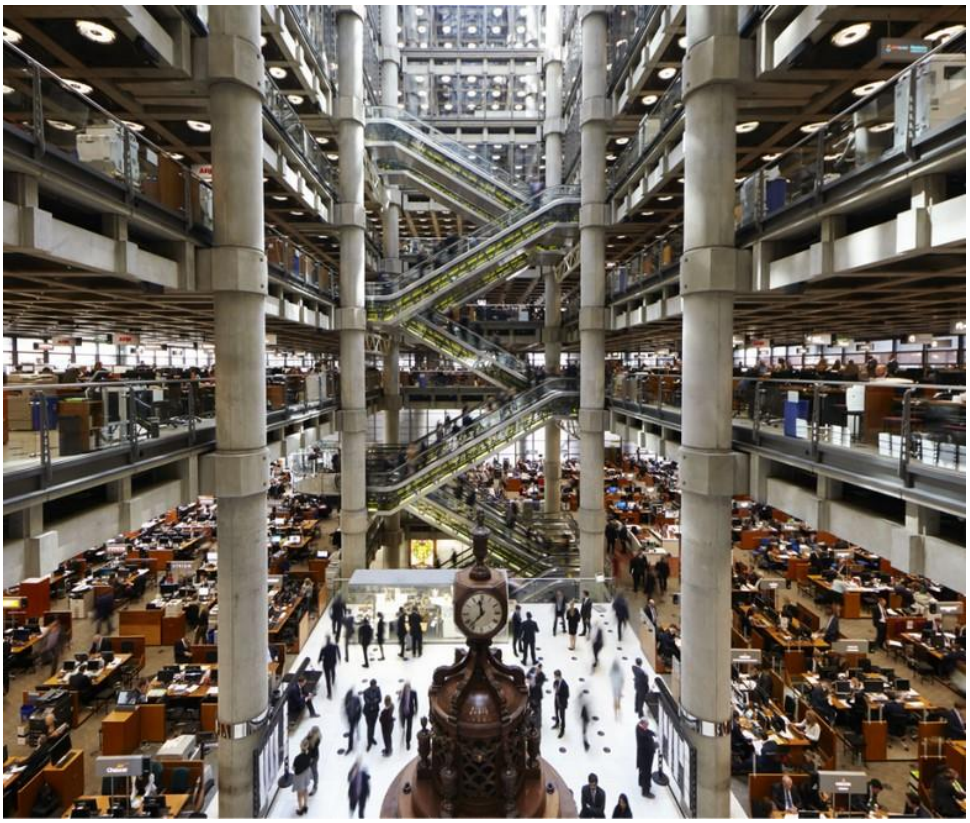
An insurance market in many ways is no different than a typical farmers' market found in cities and towns across the country. Like visitors to a farmer's market, insurance brokers literally walk from one insurer's "booth" to another, hoping to have the risks of the organizations they represent underwritten at a fair price. If no deal can be struck, the broker simply moves on to the next underwriter. At Lloyd's of London, underwriters sit in "boxes" beneath signs indicating the insurer for whom they work.

Over the last 300+ years, Lloyd's has gone from this:



[Illustration 1]

To this:



[Ill.2]

A. Lloyd's

Contrary to popular perception, Lloyd's is *not* an insurance company. It is an insurance and reinsurance *marketplace*. (Reinsurance is insurance that an insurance company purchases from another insurance company to insulate itself - at least in some part - from the risk of a major claims event. In effect, an insurance company passes on some part of its own insurance liabilities to the reinsurance company.)

The Lloyd's market has its roots in marine insurance. It was founded circa 1686 by Edward Lloyd in his London coffee house where shippers and insurers, at first by accident, came to drink coffee and exchange shipping news.

Structurally, Lloyd's operates as a partially-mutualized marketplace within which multiple financial backers, grouped into "syndicates," come together to pool and spread the risk. Today, these underwriters are a collection of both corporations and private individuals. Prior to the mid-1990s, the backers were all wealthy individuals, among them Admiral Lord Nelson and Winston Churchill. In 2019, 93 syndicates collectively wrote £35.9B of gross premiums across 200 specialty lines on risks placed by 335 brokers. Approximately 50% of those premiums came from North America.

Lloyd's has never failed to pay a claim in its 330+ year history. Past claims have included the 1906 San Francisco Earthquake, the sinking of the Titanic, the Exxon Valdez, Deepwater Horizon, and 9/11.

As the world's largest insurance market, Lloyd's must be accessible for commuter railroads to obtain the billions of dollars in excess insurance coverage the industry needs. In addition, it is increasingly necessary to access the world's second largest excess insurance market, Bermuda, to fully obtain the required coverage. Such extensive coverage is simply not available in the United States.

B. Excess Insurance "Towers"

For the reasons discussed below, there is no single insurance company that is willing to fully insure a commuter rail agency for a potentially catastrophic event. Consequently, excess insurance "towers" are built from the bottom (highest risk coupled with the highest premiums) to the top (lowest risk with the lowest premiums). Each insurance company develops an "appetite" for varying degrees of risk. This, of course, limits the amount of insurance available. Some companies will insure only at the lowest levels of the tower (the so-called "working layers") while others are interested only in the uppermost (and therefore "safest") levels of the tower.

The tower layers themselves are further subdivided and consist of numerous insurance companies each commiting to a share of the coverage in that layer. This framework further spreads the risk. It is not uncommon for ten or more insurance companies to participate in a particular layer with each company committing to providing a portion of the coverage (typically from $2.5M to $10M). Though increasingly rare, some companies, if the layer is small enough, will commit to covering the entire layer, usually in an amount not greater than $20M to $25M.

The tower illustrated below demonstrates commuter rail's reliance on foreign markets, particularly Lloyds's. Here, of the 22 participating insurers filling 35 slots on the tower, 28 slots were covered by London insurers (and of those, 18 were from Lloyd's and ten from other London carriers), seven were from Bermuda, and only one from the U.S. In this tower, the commuter rail agency has elected to hold a $15 Million deductible or self-insured retention.

Placement		Carrier			Limit
$77,500,000 xs $160,000,000					
London		Lloyd's:			
			Apollo		10M
			Canopius		7.5M
			Aspen		5M
			Axa XL		7.5M
			Misc		7.5M
London			Argo Re		10M

London			Markel		5M
Bermuda			OCIL		20M
Bermuda			Sompo		5M

$25,000,000 xs $135,000,000					
Bermuda			Axa XL		25M

$35,000,000 xs $100,000,000					
London		Lloyd's			
			CV Starr		10M
			Hamilton Re		5M
			Apollo		5M
			Misc		5M
London			Markel		5M
London			Argo		5M

$50,000,000 xs $50,000,000					
London		Lloyd's			
			Aspen		15M
			Canopius		10M
			Aegis		3.5M
			Misc		3.69M
US			Liberty		2.9M
Bermuda			Ascot		2.5M
Bermuda			AWAC		2.5M
Bermuda			Argo		2.5M
London			Lexington		2.41M

$10,000,000 xs $40,000,000					
London			Axa XL Dublin		5M
London			Lexington		5M

$10,000,000 xs $30,000,000					
Bermuda			Queens Island		1.089M

$5,000,000 xs $25,000,000					
London		Lloyd's			
			Canopius		2.25M
			Convex		2.25M
London			Argo		.5M

$10,000,000 xs $15,000,000					
London		Lloyd's			
			Aegis		5M
			Misc		1.5M
London			Argo		2M
London			Axa XL Dublin		1.5M

[Fig.1]

II. The Excess Insurance Market

A. Current Market Conditions

The insurance industry is highly cyclical. A "soft" market cycle is defined by lower insurance premiums, a broader appetite to assume risks and coverages, increased capacity (the availability of high limits), and greater underwriting flexibility. On the other hand, a "hard" market is characterized by higher insurance premiums, diminished capacity, more conservative underwriting, and fewer carriers writing certain coverage lines or insuring certain specific industries.

After 15+ years of a soft market, the insurance industry has been experiencing a hardening of the market for the past few years. The effects of the current market are being seen across most lines of insurance and the majority of industries. Insurance experts predict that the hard market will continue throughout 2021 and beyond.

This exponentially hardening market is primarily due to increased "social inflation" which can be described as the rising costs of insurance claims resulting from factors such as increasing litigation, broader definitions of liability, more plaintiff-friendly legal decisions, and larger compensatory jury awards. Taken together, these have created a vast imbalance in underwriting financials—a balance which the markets feel must be corrected for their own survival.

B. Premiums in a Hard Market

During 2020, we saw some of the largest percentage rate increases, predominantly at the high excess level. As noted above, high settlements and verdicts have created a large imbalance, along with social inflation, in underwriting financials. This in turn caused the markets to increase their premiums to "level" their losses.

1. Social Inflation

The International Risk Management Institute (IRMI) has stated that there is no single, common definition of "social inflation." However, it has been described in a variety of ways. Several characteristics have been identified.

The first characteristic is the notion that the rising costs of insurance claims are being fueled by societal trends, for example, significant jury awards ("nuclear verdicts") against corporations.

The second characteristic is that these awards and settlements contain at least some, if not all, of the following constructs:

a. More liberal treatment of claims;

b. Lack of willingness to impose liability caps;

c. Third-party litigation funding;

d. Erosion of trust in corporate America;

e. Changing views of social responsibility and the righting of wrongs, for example, increased pursuit of sexual harassment/abuse claims (#MeToo movement);

f. Populism (defined as a political approach that strives to appeal to people who feel that their concerns are disregarded by established elite groups); and

g. Society's desensitization to large jury verdicts and settlements.

Some experts add the following to the social inflation mix:

h. Increasing active shooter and, in general, stand-alone terrorism related incidents;

i. Increasing auto claims in both frequency and severity due to a decrease in oil prices, increased cell phone and marijuana/drug use while driving, and an increase in overall technological distractions in vehicles;

j. Increase in both frequency and severity of wildfires and other climate-related events.

And still other commentators explain rate increases as being driven by:

k. Liability exposure for transit systems with large bus/coach fleets;

l. Historical underpricing of premiums;

m. Deterioration of reserves; and

n. Lack of capital investment by investors to develop new insurance carriers.

2. Large Loss History

In addition to social inflation, recently there have been an inordinate number of large losses impacting many excess market sectors:

1.	Wildfires: Allegedly caused by power and distribution lines, conductors, and failure of power pole (2017/2018)	**$12B-$24B**
2.	Traumatic Brain Injuries related sports injuries (2016)	**$1B**
3.	Hospitality: Hotel active shooter killing 58 (2018)	**$800M**
4.	Sexual Abuse: University sports physician (2018)	**$500M**
5.	Class Action: Chemical exposure (2017)	**$671M**
6.	Class Action: Agrichemical exposure (various dates)	**$10B**
7.	Talc Litigation: (2018/2019) (alleging bodily injury over a period of time)	**$5B**
8.	Opioid Litigation: (various dates)	**$48B**+
9.	2 Class Actions: Product liability (2018 and 2019)	**$2B and $4.69B**
10.	Medical Malpractice: Wrongful death/medical device (2018)	**$348M**
11.	Medical Device: 17 defective metal hips (various dates)	**$941M**
12.	Product Liability: Engine defect (2019)	**$758M**
13.	Gas explosion: Gas leak with one death and 25 injured (2018)	**$790M**

These losses alone, all of which occurred in the United States, total approximately **$100B** and do not yet account for recent hurricanes, Midwest floods, winter storms, summer demonstrations, and Covid.

It is noteworthy that commuter rail, which has invested billions in advanced safety technology over the last decade, has an excellent loss history and does not appear on this list. Nevertheless, while commuter rail, as part of the excess liability insurance market, benefits from sharing risk with extensive coverage and low premiums in a soft market, it also suffers the shared consequences of shrinking coverage and exceedingly high premiums in a hard market fueled by social inflation and large losses.

3. Recent Rate Trends

A number of rate trends in the current market climate have been identified as a result of social inflations and large loss history:

1. Rate increases of **20%-50% to 300%** (*not a typo*) for all large risk classes (of which commuter rail is a part) even with minimal or no adverse loss history;

2. Observation of rate changes reveal:

   a. Most Fortune 5000 companies have seen approximately 50% increases in premium while distressed Fortune 500 companies have experienced 100% increases;

   b. The worst changes occurred in excess auto with large fleet exposure seeing rate increases of 100% to 300%;

   c. Even non-loss accounts with no auto exposure have seen increases of approximately 25%;

   d. Many excess towers have seen price inversion, where premiums for the upper layers of the tower are more expensive than lower layers.

The following chart illustrates the premium history for layers $50M xs $50M and $85M xs $15M of a sample commuter agency:

Layer		2017	2018	2019		2020
$50 xs $50		$1,444,000	$1,444,000	$1,653,000		$3,000,000
$85 xs $15		$5,338,528	$5,338,528	$5,645,752		$9,139,000

[Fig.2]

III. Underwriting Capacity

A. Basic Concepts

Even more problematic for commuter rail than exponentially rising premiums is the issue of **"capacity"** or, simply put, the availability of enough insurance to satisfy the requirements of all the insureds in a particular sector or market.

From the perspective of the excess liability markets, underwriting capacity is the maximum amount of liability that an insurance company agrees to assume from its underwriting activities. It represents an

insurer's ability to retain risk. It is important for an insurance company to calculate and maintain its underwriting capacity so it will be able to pay claims when needed.

An insurance company's potential for profitability depends on its "appetite" for risk. The more risk it assumes by underwriting certain types of insurance policies (or by increasing the number of policies it writes), the more premiums it can collect and invest. However, the more risk an insurer accepts through the issuance of a large number of policies or accepting larger risks, the more the possibility exists that it may become unprofitable or worse, insolvent.

For any business, striking the correct balance is essential to maintaining financial health. An insurer's underwriting capacity (the determined maximum amount of acceptable risk) is a critical component of its operations.

The goal of good underwriting is to generate premiums that exceed the insurer's losses and expenses. Several ways to do that, as we are seeing now, include underwriting policies that cover less volatile risks (as commuter rail is perceived to be), increase premiums, and decrease capacity.

B. Capacity for Commuter Rail

In general, capacity for lead excess insurers who underwrite commuter rail has greatly decreased. Non-lead excess insurers have decreased their capacity as well. London and Bermuda markets continue to monitor the amount of capacity they deploy. As a result of the current hard market, further capacity withdrawal is expected over the next few years.

The following chart depicts the reduction in capacity by some key commuter rail insurers (in millions);

Insurer	Former Capacity	Current Capacity	Delta
AIG	150	75	-75
Apollo	50	15	-35
Argo Re	75	25	-50
Aspen	50	25	-25
AxaXL	150	50	-100
Canopius	25	20	-5
CV Starr	25	15	-10
Liberty	75	50	-25
Liberty Specialty	100	25	-75
Munich	50	25	-25
Sompo	50	25	-25
StarStone	25	0	-25

Swiss Re		50		0		-50
						-435

[Fig.3]

In addition, the following insurers have announced reductions in capacity:

1. Convex-London
2. Hamilton Re
3. Hiscox
4. Markel

At least seven insurers have completely withdrawn from the rail market:

5. Axa XL-Dublin, closed operations as of December 31, 2020 for U.S. business
6. AWAC
7. Ascot Bermuda
8. Swiss Re-U.S. (closed operations November, 2019)
9. Zurich-U.S., (closed operations September, 2019)
10. Aspen-Dublin
11. Arch-U.S. (closed operations January, 2020)

C. Capacity and Limitations on Rail Passenger Liability: The FAST ACT

The detrimental effect of decreased insurance capacity in commuter rail becomes readily apparent when one considers lack of capacity in relation to the FAST Act.

1. Background

Limitations (or caps) on rail passenger liability first appeared in December 1997, as part of Title 49, U.S.C. Section 28103. This cap was incorporated into Section 11415 of the Fixing America's Surface Transportation ("FAST Act"), a comprehensive five-year surface transportation bill, published on December 4, 2015. At that time, the cap was increased from $200M (the original cap in 1997) to $294.3M. The cap was also indexed to inflation to be adjusted every five years.

The index methodology ensures that the aggregate allowable awards to all rail passengers, against all defendants, for all claims, including punitive damages, arising from a single accident or incident is based on current dollars adjusted for inflation.

On February 22, 2021, the U.S. Transportation Secretary issued a notice that the statutory adjustment to the rail passenger transportation liability cap under section 11415 of the FAST Act would go into effect 30 days after February 25, 2021 (the day the Secretary's notice was published in the Federal Register). Thus, on March 27, 2021, the liability cap was raised from $294.3M to $322.9M.

2. Impact

The increase in the liability cap affects the insurance programs of nearly all commuter railroads. Importantly, the excess market's decreased capacity impacts the ability of commuter railroads to fully insure to the liability cap.

Even in states with tort caps, many commuter railroads are contractually bound to insure third-parties up to the FAST Act's liability cap. For example, trackage agreements with host freight railroads, purchase of service agreements, and contracts with positive train control (PTC) vendors usually require coverage to the liability cap. Many of these third-party contracts state that failure to maintain this coverage as required could lead to immediate termination of the contracts, at the discretion of the vendor, host railroad, or service provider.

In effect, failure to obtain the required insurance may result in third-parties shutting down commuter service until the coverage is obtained or some other type of financial guarantee is provided to the third-party.

Referring to the sample tower illustrated above (Fig. 1), of the 22 participating insurers, 17 have reduced their capacity. Five of those 17 have ceased underwriting commuter rail altogether. In 2021, with the loss of capacity illustrated above, the railroad depicted will have to replace approximately $48.5M in coverage *plus* seek an additional $27M with the FAST Act increase. Thus, from 2020 to 2021, this railroad alone must procure a total of nearly $70M in additional coverage in a contracting market.

Thus, while the intention of the FAST Act in capping liability for all rail passengers per incident favors providers of passenger rail, procuring $27M of additional insurance coverage has produced unintended consequences by placing commuter railroads into possibly precarious positions vis-à-vis host railroads, purchase of service carriers, and PTC service providers.

IV. Continued and Future Trends

The following are "highlights" of the state of the markets in London and Bermuda:

1. "Market Momentum" suggests that excess market conditions seen in 2019 and 2020 are continuing in 2021;

2. Excess insurers are strictly adhering to minimum premiums which are being increased by at least $5,000 per million dollars of coverage;

3. Carriers in London, Bermuda and the U.S. are combining their capacity so that instead of, for example, all three offices having $25M in capacity each, all three offices must now *share* $25M);

4. Carriers are continuing to reduce their capacity or, in the alternative, are not deploying all available capacity;

5. Reinsurance markets are also increasing premiums and reducing capacity;

6. Attachment points (the point at which a carrier must contribute to payment of a loss) are being carefully scrutinized;

7. Carriers continue to consider commuter rail a "high risk" insurance placement: despite its excellent loss record and safety investments: of particular concern is sharing track with other railroads;

8. Continued lack of discounting even with continued reduction in ridership throughout the pandemic; and

9. Increased self-insured retentions.

Most commentators agree that the excess market changes that insureds experienced in 2019 and 2020 will continue throughout 2021. Perhaps most problematic is the realization that the last few years are not an aberrant "bump" in the road. Further, these changes are not merely part of a soft/hard market cycle which must be endured until another soft cycle begins. Rather, the recent patterns seen in the excess market have more than likely established a *new baseline* with respect to capacity and premiums. As such, there will not be a "return to normal." Consequently, commuter railroads must explore alternative means to risk management.

A common strategy to manage financial risk in the investment world is the concept of a diversified "portfolio" whereby investors weather the ups and downs of various markets and across industries by placing within their portfolio an array of investments (cash, stocks, bonds, mutual funds, money markets, gold, collectibles and art). The goal, of course, is to have sufficient diversification to provide financial stability as markets fluctuate.

Given the current state of the excess insurance market, commuter railroads should explore diversifying their own risk management "portfolios." In most cases, insurance will always play a role. Beyond insurance, however, other alternatives, for example, captive insurance, increasing self-retention, and insurance pools would diversify the risk of relying on foreign excess markets, as would a federal backstop to the insurance market to guarantee coverage for commuter railroads. Importantly, developing strategies to convince U.S. insurers to rejoin the excess markets is certainly a key component to regain stability and control of the excess insurance markets.