ALIRT INSURANCE RESEARCH

Independent Analysis of Insurance Company Risk Trends

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Fronting Insurers On the Move

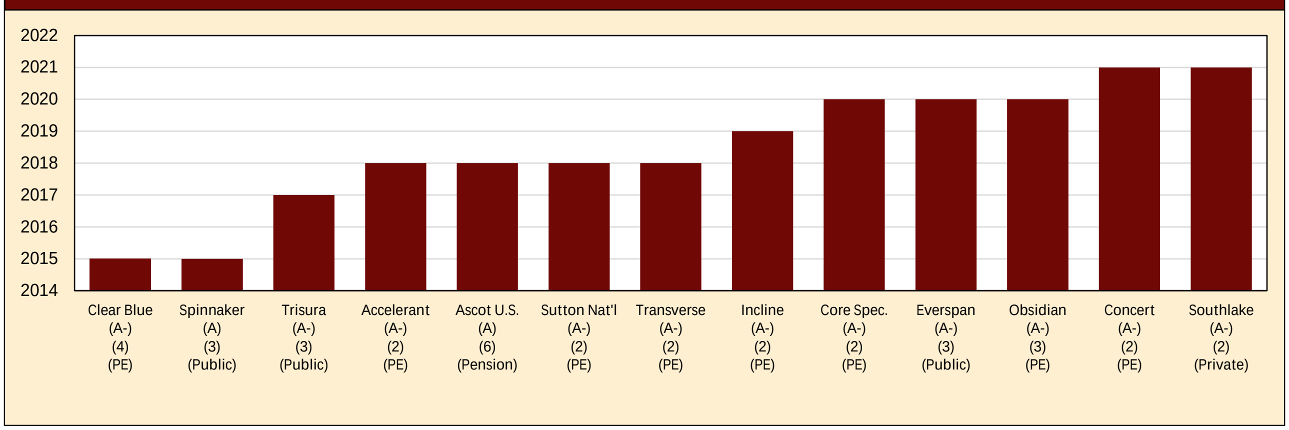
Introduction

At a recent TMPAA conference, ALIRT Insurance Research presented on the rapid growth of the fronting model in the U.S. property & casualty market over the past several years. Our clients have increasingly asked about these new entrants, so we provide some insights here.

For those unfamiliar with the term, "fronting" is a reinsurance arrangement between a regulated primary ("issuing") insurer and a reinsuring entity, often an offshore unauthorized (re)insurer, captive or unrated (or poorly rated) U.S. insurer. The fronting arrangement allows entities that cannot underwrite property & casualty risks in the U.S. – either legally or due to inadequate ratings – to access the market. MGAs and their reinsurance partners are often involved in such fronting arrangements.

The fronting company may either cede all of the risk it underwrites ("pure front") or retain some of the risk ("hybrid front"). For this it receives a fronting fee representing a percentage of the gross business written, traditionally 5-8%. Some hybrid fronts have become more active in overseeing/designing MGA programs or even owning them; some may even provide platforms to facilitate programs. These are often called "active "or "platform" fronts.

Fronting Insurance Groups - Entrants Over the Last Decade

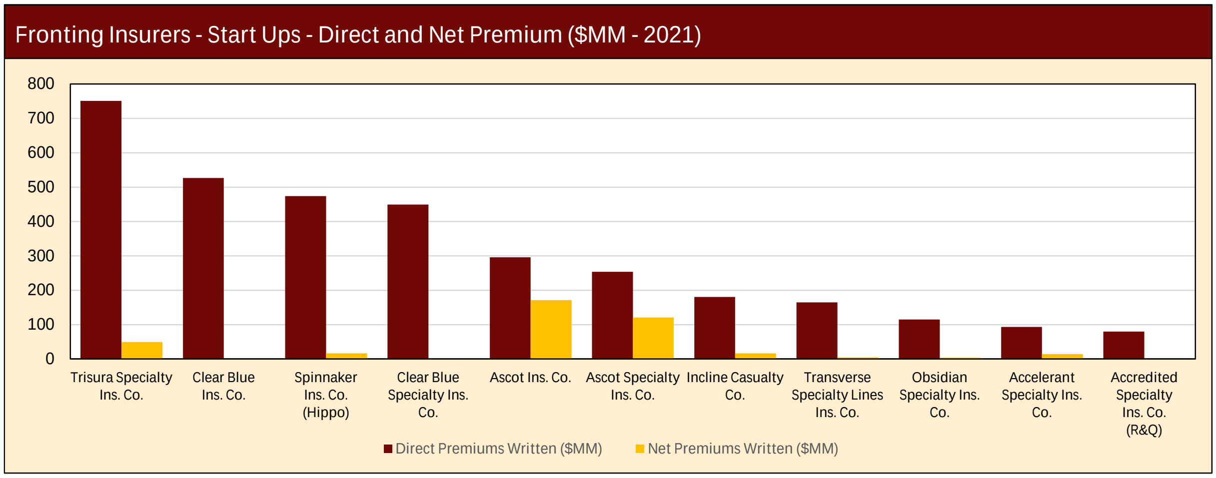


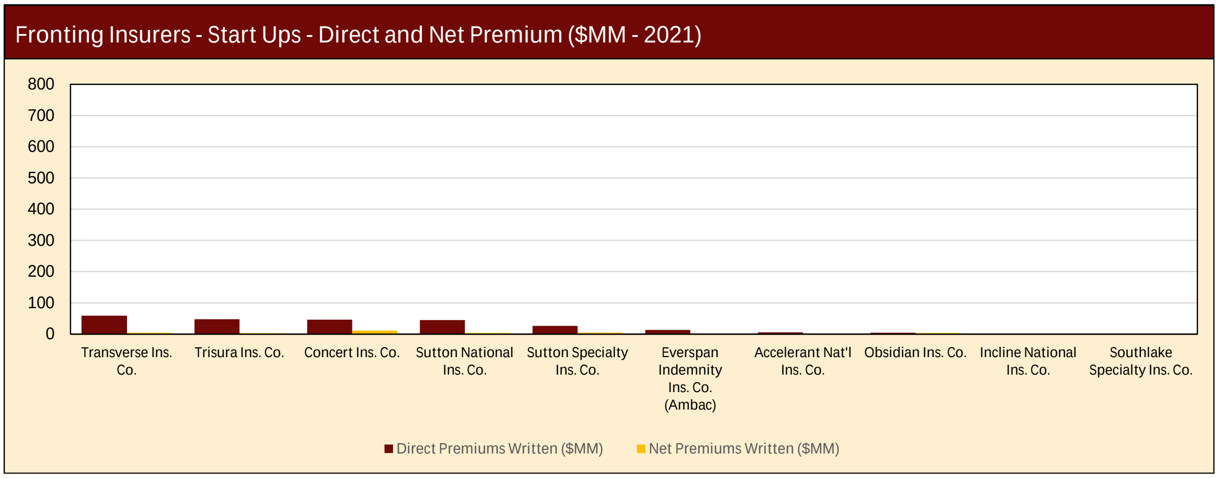
The above chart shows the 13 insurance groups with fronting operations that were established over the past decade. These involve both de novo insurers and acquisitions, almost always with admitted and E&S capabilities.

While the number of new entrants is sizeable, the direct premium written by this cohort remains small. On the following page, we show the 2021 direct premium generated by this new class of fronting carriers[1]. It equaled just $3.6 billion, or less than 0.5% of the total industry direct premium amount. The vast majority of this direct premium was ceded, indicating that most of this cohort is presently acting as "pure fronts," though many cite an appetite to retain more fronted risk (10-20%) as they grow.

We note that a number of these carriers reported little to no direct or net premium in 2021, due largely to being in a start-up mode.

[1] We include the premium figures for multiple insurers within one group. As indicated, a fronting operation often has access to both admitted and excess and surplus line capacity.





The fronting model is by no means new, and we have seen fronting activity ebb and flow over our 30 years in business. We believe that the current class of fronting specialist is part of a broader movement towards specialty commercial insurance over the past decade, accelerating with the recent firming/hard market. Access to private equity and cheap debt has spurred a number of these start-ups as has A.M. Best's willingness to assign critical A- ratings for new fronting insurers, with initial capital levels and experienced managements proving key.

The fronting model has enjoyed greatest traction within the program/MGA community given exits or the dialing back of traditional insurer appetite for a number of lines of business. As management for Trisura, one of the larger of the new fronting specialists, stated in its 2021 Managing Discussion and Analysis:

> "*It is our belief that conditions are favorable for our continued growth … From our business activity to date, program administrators welcome our new capacity as there is currently a lack of carriers and the products and arrangements currently offered to them by the existing market do not always meet the needs of their business and clients.*"
>
> *"We continue to believe there is a strong supply of highly rated international reinsurers keen to gain exposure to this business, allowing the Company to cede risk on its policies to these reinsurers on commercially favorable terms. This has been supported by our experience in the market through 2021."*

Analytical Considerations

The financial analysis of a fronting insurer is similar to that of any P&C insurer, though there are some special considerations given the unique nature of the fronting model. The following four are important ones:

1. **<u>Is the fronting company part of an intercompany pooling arrangement</u>**? A group intercompany pooling arrangement traditionally provides an insurer with greater geographical and business diversification of risk. In some instances, such an arrangement significantly dilutes the exposure to loss in the fronted book of business. Alternatively, if business written by other members of the pool performs poorly, it can have a financially deleterious impact on the fronting specialist which has assumed a share of the group's overall book of business.

2. **<u>How much risk is the fronting insurer assuming</u>**? If it is ceding all of its business to a reinsurer, the primary risk will be the credit exposure to that counterparty; if it is assuming some risk, it will bear both reinsurer credit risk as well as potential loss exposure to improperly underwritten business.

3. **<u>What does the reinsurance portfolio look like</u>**? Key risks here are concentration with just one or perhaps a few reinsurers, whether they are affiliated reinsurers (which would concentrate the underwriting risk within the group), and whether reinsurer partners are authorized to assume business in the U.S. or is "unauthorized." If unauthorized, the reinsurer will generally be required to post collateral. The quality and sufficiency of collateral is critical to ensure reimbursement of claims payments.

4. Lastly, and of great importance, **<u>how well is the fronting company vetting the programs it is underwriting?</u>** While this information is not available in the financial filings themselves, credit considerations should include the existence of underwriting and claims paying controls and the types and frequency of audits, among other risk management tools.

<u>Conclusion</u>

The fronting model is currently enjoying a renaissance as program managers/managing general agents seek additional sources of capacity in the current firming/hard market. The withdrawal by a number of traditional insurance groups from unprofitable lines of business has hastened the opportunity for these unique carriers. This, along with the appetite of private equity and reinsurers to participate in more specialty placements has added additional momentum to their emergence.

As analysts we are agnostic about the growth of these new fronting carriers. As with any start-up, outside capital support is often needed for a number of years until the business ages, premiums are earned into income statements, and scale is achieved. Because much of the fronted business is currently written by specialty wholesale brokers (i.e. program administrators or other managing general agents), the ability of a fronting insurer to carefully vet programs up front and maintain on-going oversight of underwriting and claims for each is critical to future success.

As stated before, the fronting model is not new and has faced challenges in the past when fronting insurers neglected this critical oversight, underwriting and operating losses grew, and the reinsurance support behind the programs faltered. In such a scenario, a fronting insurer can quickly find itself in financial trouble.

We conclude by reminding readers that ***the fronting company – as the insurer named on the declarations page of the insurance policy – retains legal responsibility to pay claims even if the reinsuring entity becomes insolvent or refuses to pay.*** For this reason, it is extremely important to track the financial wherewithal of this entity, even if it is ceding most or all of the direct premium written.

To this end, ALIRT will continue to monitor on a quarterly basis the growth and financial viability of this new and interesting cohort of fronting insurers.

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