THE STATE OF THE PROPERTY INSURANCE MARKET | SPRING 2020

WHAT IT MEANS FOR INSURANCE BUYERS

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Rising premiums. Disappearing capacity. Tighter contract terms. This is the new reality for risk managers as they renew their property insurance programs. Brokers are reporting premium increases of more than 50 percent for many insureds.

The property/casualty insurance market is cyclical. A period of rising premiums and reduced capacity—a hard market—is followed by a typically longer period of falling rates and expanding capacity—a soft market. Analysts debate whether the current period of rising premiums technically qualifies as a hard market since certain key attributes are missing. Some call it a "transitioning" market instead.[1] Risk managers, brokers, and underwriters, however, aren't overly concerned about technical definitions—this passes the duck test: it looks, feels, and acts like a hard market.

For many people in the insurance ecosystem, this is their first experience of hard market conditions. While rate levels fluctuated somewhat over the past decade, the overall trend has been softening rates since 2004, the end of the last industry-wide hard market. Facing an uncharacteristically volatile market, many risk managers find it difficult to budget their insurance costs, or even to explain to senior management why premiums are rising so sharply. The pressure is on to find creative ways of keeping their total cost of risk in check.

For insurance carriers, rising rates are finally bringing relief from a prolonged period of chronically underpriced business that took a toll on the bottom line. But even though rate increases of 25 percent and more are now the norm, underwriters say more improvements are necessary to restore insurer profitability.

1. State of the Property Market - Q1 2020," AmWINS Group, Inc. 2/20/2020 https://www.amwins.com/insights/article/state-of-the-market-property

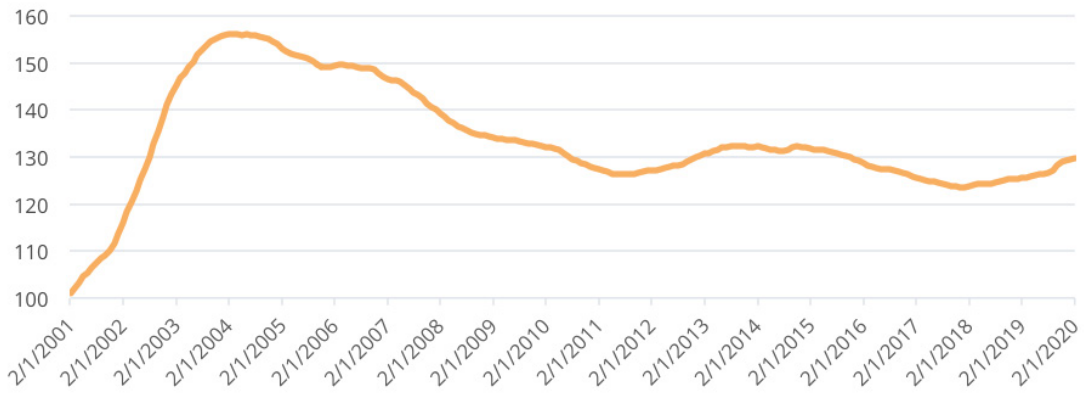
THE INSURANCE MARKET CYCLE

What goes up, must come down, according to the well-worn aphorism. But in the insurance universe, what comes down also must go up. Lather, rinse and repeat.

The cyclical nature of the insurance market was recognized at least as early as the 1920s. Over the past century, it was seen as a defining feature of the market. The last three hard markets in the United States were 1975-1978, 1984-1987, and 2001-2004. During the 2001-2004 hard market, commercial lines premiums increased, on average, 55 percent between Q4 2000 and Q2 2004, according to Advisen's ADVx® premium index. (Exhibit 1)

Exhibit 1

ADVx® – Composite



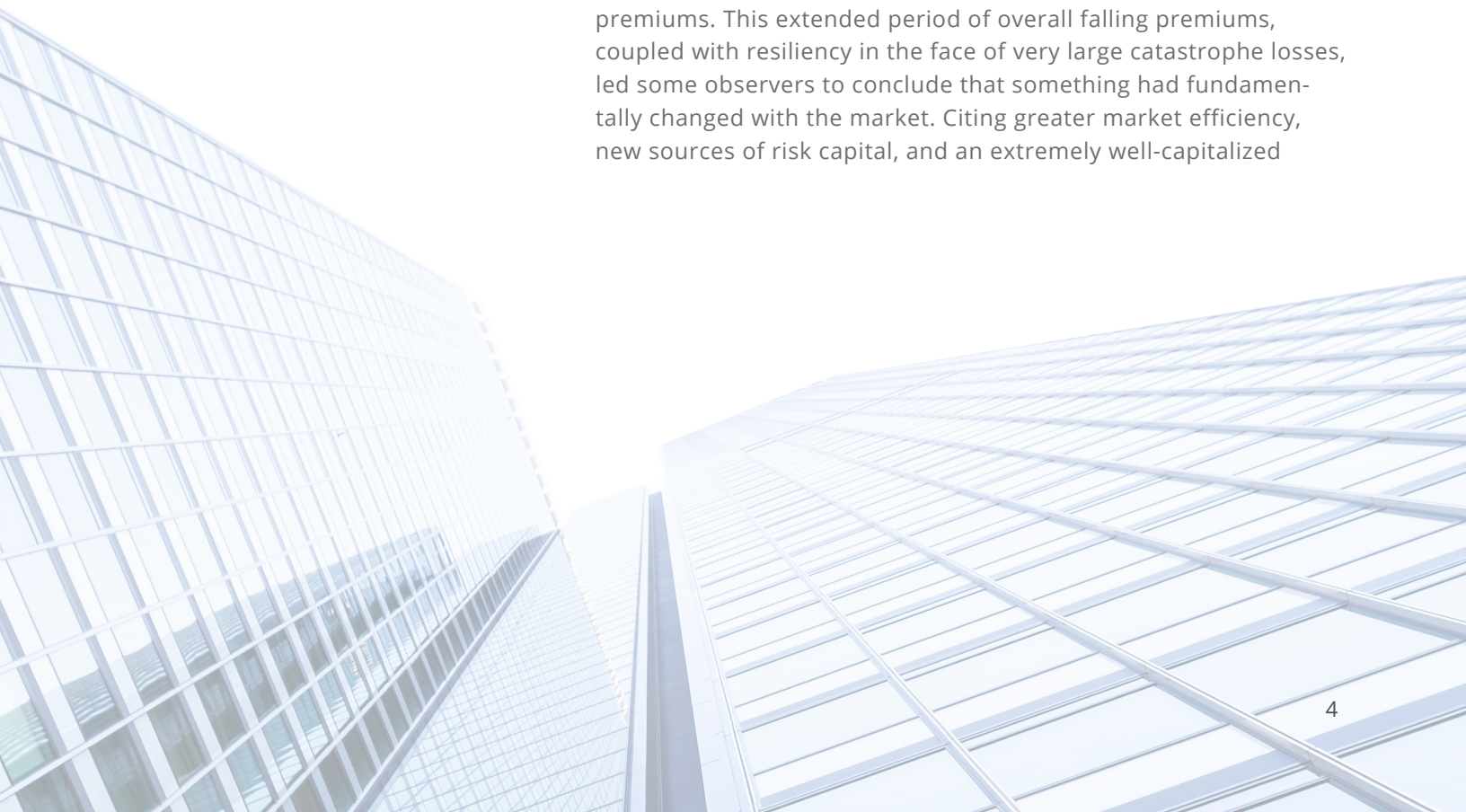
“During soft markets, premium rates fall as insurance carriers compete to increase market share.

During soft markets, premium rates fall as insurance carriers compete to increase market share. Underwriters also tend to be more willing to offer broader coverage and to relax underwriting standards. Lower rates for more expansive coverage eventually takes a toll, and insurer profitability suffers. When the pain becomes too great, underwriters begin demanding higher premiums. This response usually follows decisions by some carriers to reduce capacity or even withdraw altogether from some lines, classes, or territories. When underwriters discover that they can demand, and get, higher premiums, rates rise sharply.

Market cycles generally affect the entire property & casualty insurance market, though not all lines of business experience rate changes to the same degree. During the 2001-2004 hard market, for example, the average commercial property premium quickly shot up 80 percent as compared to the 2000 level, while the average general liability premium more gradually rose 45 percent.

Rates can also rise in an otherwise softening market in response to events specific to individual lines of business. In property, large natural catastrophes can trigger higher rates for brief periods. Property rates, for example, surged in 2006 in response to $57 billion in insured losses from Hurricanes Katrina, Rita, and Wilma in 2005, before resuming their downward trajectory in 2007.

The average commercial lines renewal premiums declined between Q2 2004 and Q4 2017, despite several years of large natural catastrophe losses that momentarily triggered higher property premiums. This extended period of overall falling premiums, coupled with resiliency in the face of very large catastrophe losses, led some observers to conclude that something had fundamentally changed with the market. Citing greater market efficiency, new sources of risk capital, and an extremely well-capitalized

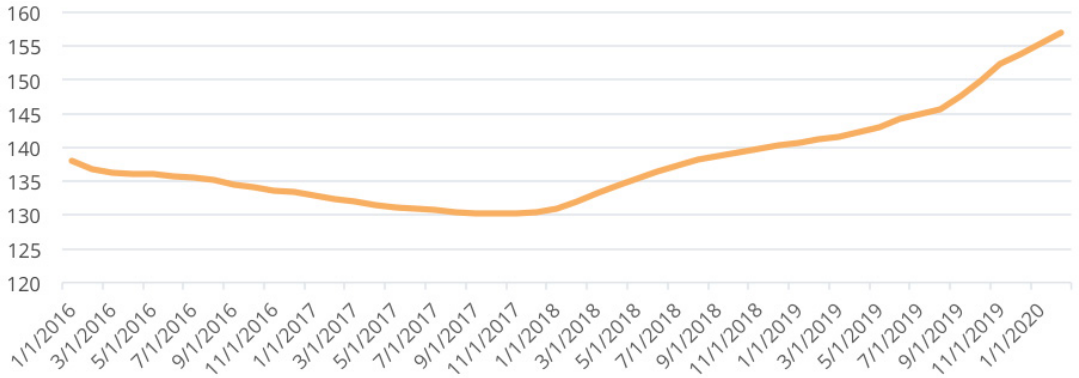


property/casualty insurance industry, some analysts questioned whether market cycles were a thing of the past.[2]

Property premiums began to rebound in Q4 2017, the final quarter of a record-setting year for natural catastrophes, and continued to trend upward in 2018. (Exhibit 2) Some observers concluded that the market was experiencing a short-term correction like that seen in 2006 in response to hurricane losses, rather than the beginning of a more sustained hard market. Property rates, however, continued to rise and were joined by other lines of business such as D&O and excess casualty. The duration and magnitude of rate increases, as well as the number of lines of business now experiencing increases, suggests that the insurance market cycle is alive and well and that the hard phase of the cycle is underway.

Exhibit 2

ADVx® – Property (Large Account)



2. "Fitch: Are we seeing the end to the traditional reinsurance cycle?? Business Insurance February 20, 2019 https://www.insurancebusinessmag.com/us/news/breaking-news/fitch-are-we-seeing-the-end-to-the-traditional-reinsurance-cycle-159521.aspx; "It's Official: The Insurance Cycle Is Dead, Willis Towers Watson Says," Carrier Management April 20, 2018 https://www.carriermanagement.com/news/2018/04/20/178159.htm

DRIVERS OF THE HARD PROPERTY MARKET

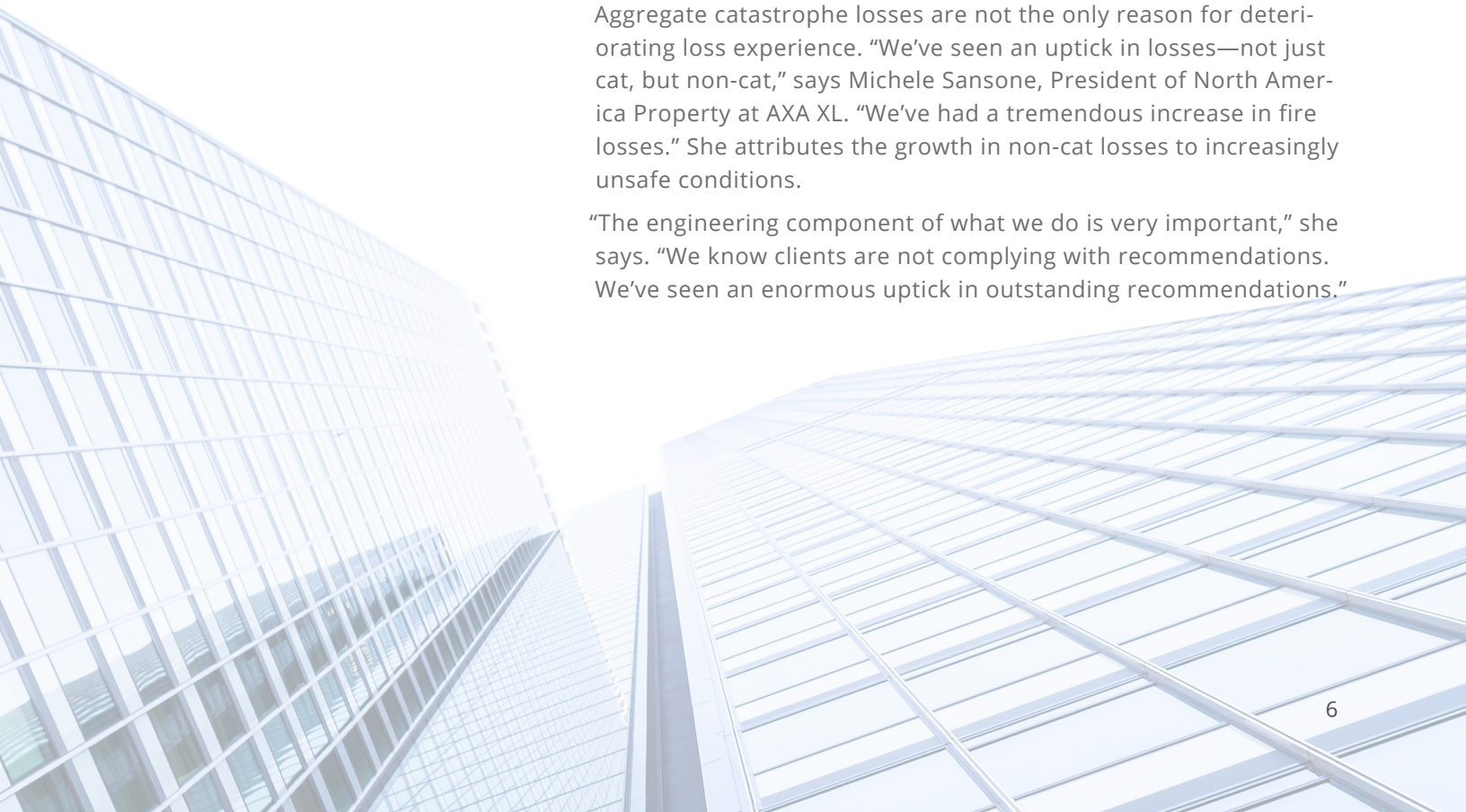
> **“An aggregation of natural catastrophe losses spanning several years contributed to deteriorating property insurance results and was a catalyst for rate hikes.**

An aggregation of natural catastrophe losses spanning several years contributed to deteriorating property insurance results and was a catalyst for rate hikes. In 2017, insurers posted a record-breaking $135 billion in catastrophe losses, according to Munich Re. Adverse results were substantially driven by losses from Hurricanes Harvey, Irma, and Maria. That was followed by insured losses of $86 billion in 2018 and a more typical, but still elevated, $52 billion in 2019.

Higher insured catastrophe losses are, in part, a result of an increase in the frequency of loss events. The number of hydrological and meteorological disasters especially increased over the past 30 years, according to Munich Re data. Additionally, higher concentrations of values in catastrophe-prone regions contribute to more costly events and higher insured losses. “Look where insurers are growing fastest, where they are becoming heavily concentrated. And then look where these events are occurring,” observes Jordan Foley, Chief Strategy Officer of Athenium Analytics. “Miami is a prototypical example, where practically every highrise that goes up is right along the waterfront. Another example is wildfire in Southern California. There are more and more neighborhoods in the foothills where wildfires tend to spread.”

Aggregate catastrophe losses are not the only reason for deteriorating loss experience. “We’ve seen an uptick in losses—not just cat, but non-cat,” says Michele Sansone, President of North America Property at AXA XL. “We’ve had a tremendous increase in fire losses.” She attributes the growth in non-cat losses to increasingly unsafe conditions.

“The engineering component of what we do is very important,” she says. “We know clients are not complying with recommendations. We’ve seen an enormous uptick in outstanding recommendations.”



> **Another contributor to poor loss experience is underreported values**

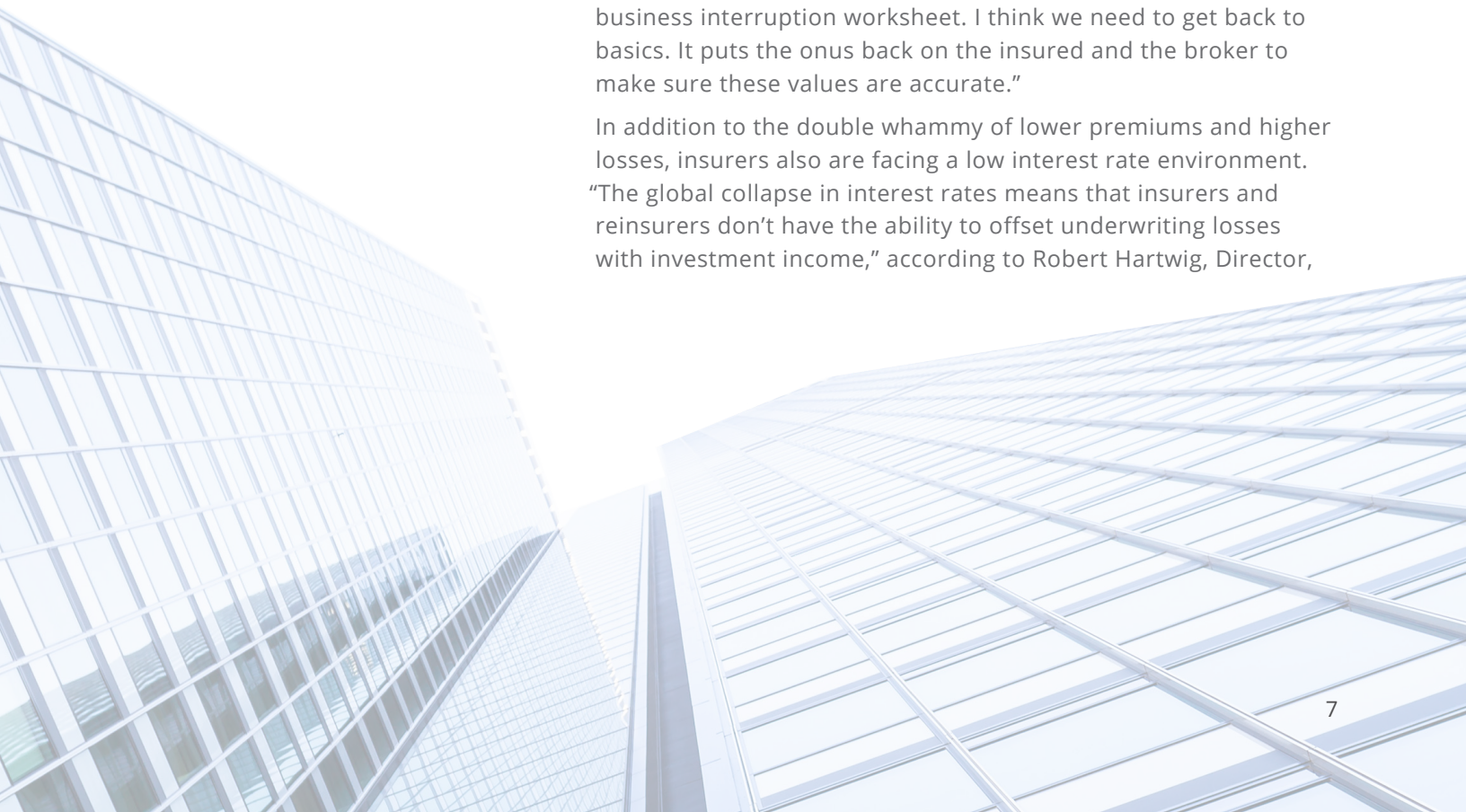
"The soft market definitely does not drive good behavior and recommendation compliance," agrees Scott Ewing, Senior Vice President—Americas Engineering Leader at AXA XL Risk Consulting. Both Ewing and Sansone emphasize that not all clients are lax in maintaining safety standards, but "if someone is just looking for the lowest premium, they probably are less inclined to take our recommendations seriously," according to Ewing.

Another contributor to poor loss experience is underreported values, which Sansone says has become an issue in recent years. "I don't know why they are underreporting, but it's a big problem," she says. "Even when you get a rate increase, you're still behind. We put up big limits. We invest a lot of the company's capital on these insureds. We expect some basic things, and one is reporting the right values."

"We do loss expectancies on all the risks we engineer," adds Ewing. "Underwriting uses that loss expectancy to set their line, to buy facultative reinsurance, and other things. Underreported values can severely impact those. We may think we have $50 million exposed, but if it is a 50 percent value, we have $100 million exposed. It can be a big shock."

Sansone says that underwriters use a variety of tools to estimate values, but that they often don't know that an insured is underreporting until there is a claim. "That's not how you want to find out someone is underreporting," she explained. "It wasn't long after 9/11 that we were asking for signed statements of values and the business interruption worksheet. I think we need to get back to basics. It puts the onus back on the insured and the broker to make sure these values are accurate."

In addition to the double whammy of lower premiums and higher losses, insurers also are facing a low interest rate environment. "The global collapse in interest rates means that insurers and reinsurers don't have the ability to offset underwriting losses with investment income," according to Robert Hartwig, Director,



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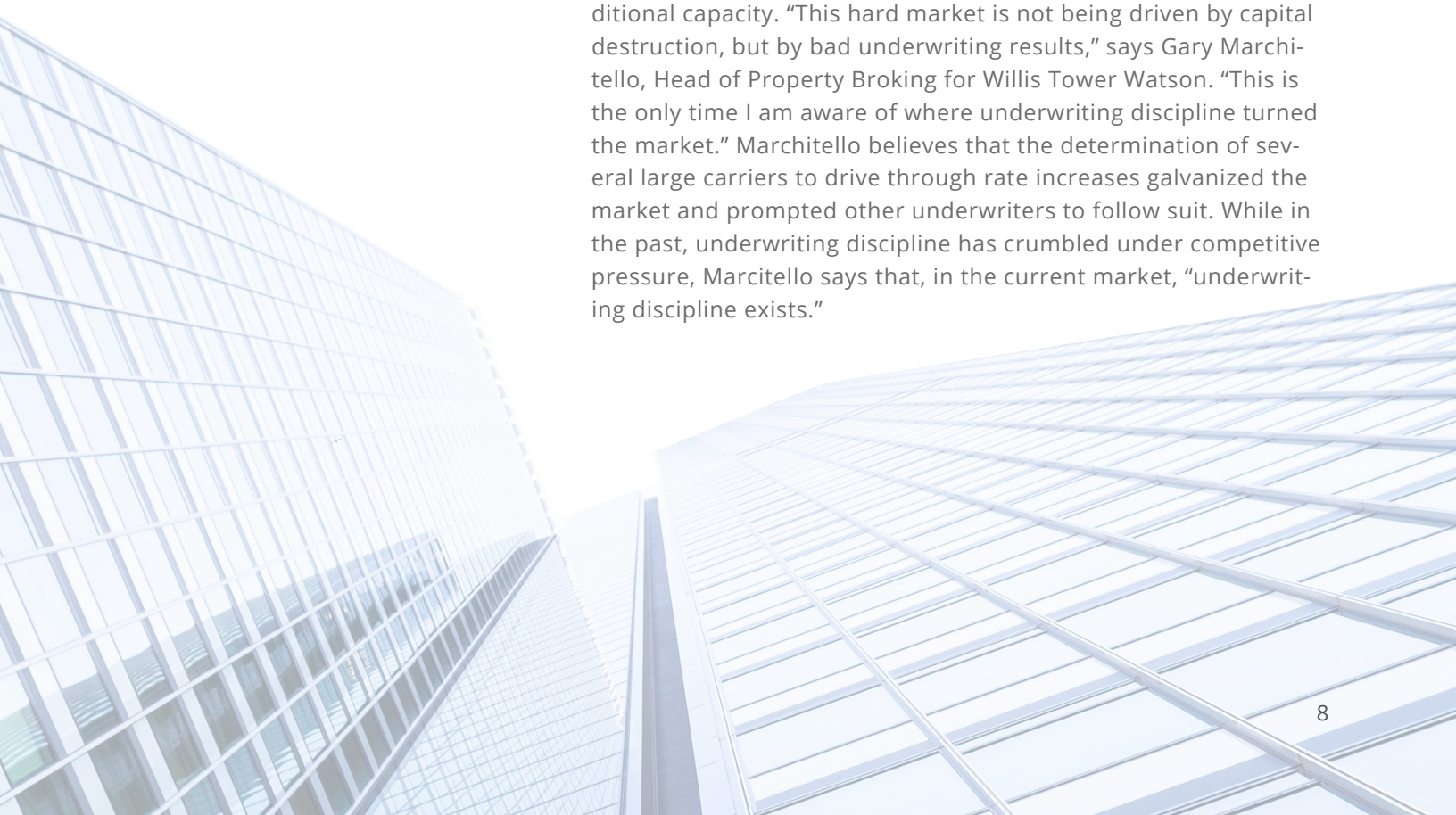
Risk and Uncertainty Management Center and Clinical Associate Professor at the Darla Moore School of Business of the University of South Carolina. He notes that before the 1970s, in a generally lower interest rate environment, "the industry ran underwriting profits two-thirds of the time." He sees lower interest rates—and therefore lower investment income—as an "enormous disciplinary force this generation of underwriters is rediscovering."

The present hard market, while perhaps justifiable by eroding rate levels coupled with higher losses, caught many experts by surprise. The property/casualty insurance industry overall is exceptionally well-capitalized, with policyholders' surplus—a proxy for "supply" in the insurance supply/demand equation—hovering at record highs. The property segment of the industry is especially well-capitalized because of cat bonds, reinsurance sidecars, and other forms of insurance-linked securities (ILS) that supplement the capital that sits on insurers' and reinsurers' balance sheets. The conventional wisdom among analysts and informed observers was that this excessive pool of money would continue to fuel competition, and would quickly squelch any attempt to drive through rate increases. According to this theory, the market will turn only when enough capital is destroyed to change the balance of the insurance supply/demand equation.

The current hard market, however, is taking place in an environment where the insurance industry remains highly capitalized, and the ILS market continues to provide billions of dollars of additional capacity. "This hard market is not being driven by capital destruction, but by bad underwriting results," says Gary Marchitello, Head of Property Broking for Willis Tower Watson. "This is the only time I am aware of where underwriting discipline turned the market." Marchitello believes that the determination of several large carriers to drive through rate increases galvanized the market and prompted other underwriters to follow suit. While in the past, underwriting discipline has crumbled under competitive pressure, Marcitello says that, in the current market, "underwriting discipline exists."



MANAGING THROUGH
THE HARD MARKET

> **“Higher premiums are unavoidable, even for loss-free accounts.**

Higher premiums are unavoidable, even for loss-free accounts. “We’re seeing an uptick of about two points per month” on property renewals, says Marchitello. “On average, property accounts are renewing 25 percent higher this year.”

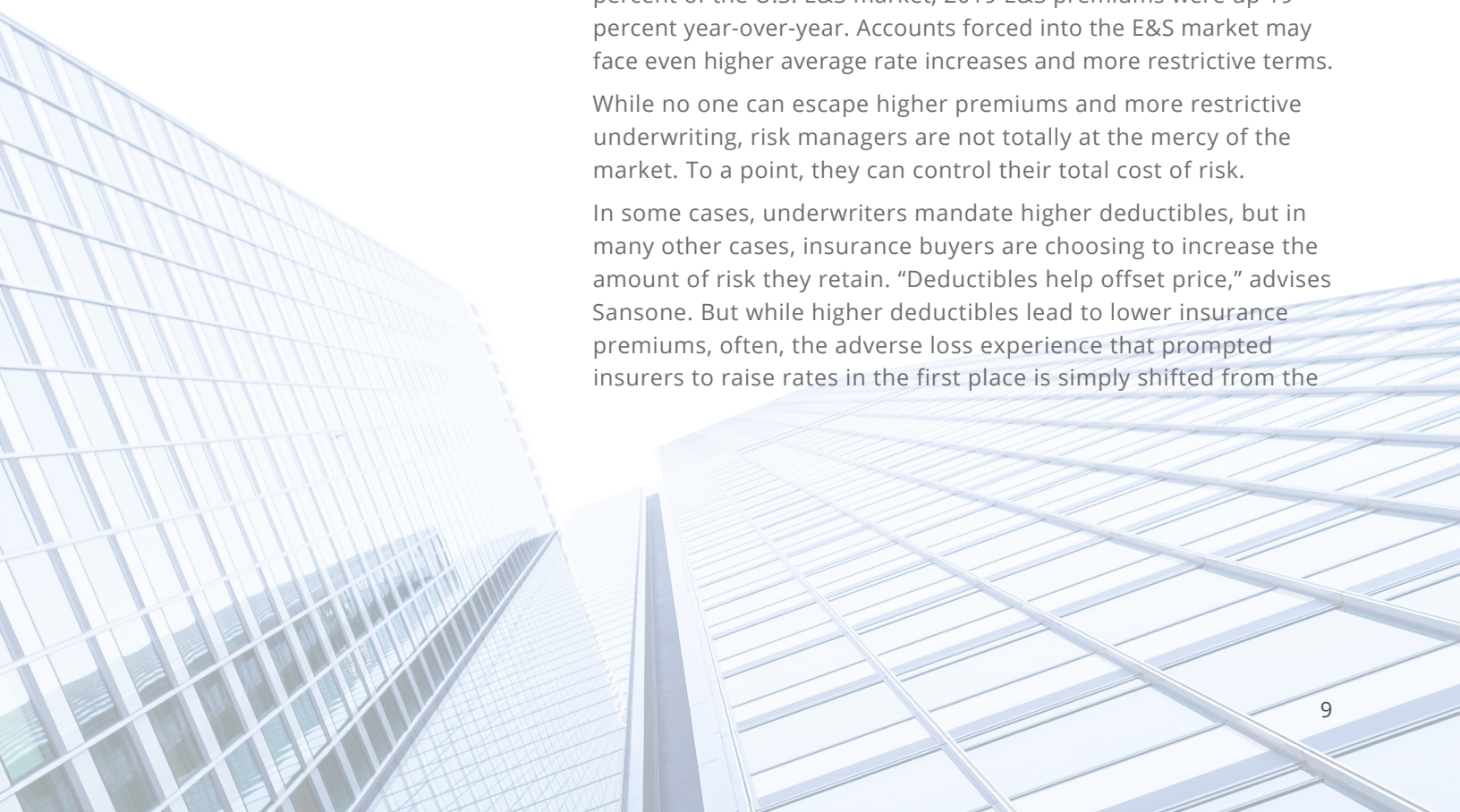
Marchitello warns, however, against the “tyranny of averages” since focusing on average rate changes obscures much of what is going on in the market. “Some accounts are seeing very low increases or, rarely, even flat renewals,” he said. “But you also see 50 percent, 100 percent, or in an extreme case, a 300 percent increase.”

In addition to higher premiums, insurance buyers are facing greater underwriting scrutiny and often more restrictive coverage terms. Marchitello notes that industry sectors receiving the greatest underwriting attention include car dealers, paper/wood products, chemicals, life sciences, food & beverage, manufacturing, senior living, habitational, waste management and hospitality.

As standard lines carriers become more cautious in how they deploy their capacity, more business is flowing into the surplus lines market. Data collected by the Surplus Lines Stamping Office of Texas shows that for 15 state stamping offices, representing 64 percent of the U.S. E&S market, 2019 E&S premiums were up 19 percent year-over-year. Accounts forced into the E&S market may face even higher average rate increases and more restrictive terms.

While no one can escape higher premiums and more restrictive underwriting, risk managers are not totally at the mercy of the market. To a point, they can control their total cost of risk.

In some cases, underwriters mandate higher deductibles, but in many other cases, insurance buyers are choosing to increase the amount of risk they retain. “Deductibles help offset price,” advises Sansone. But while higher deductibles lead to lower insurance premiums, often, the adverse loss experience that prompted insurers to raise rates in the first place is simply shifted from the



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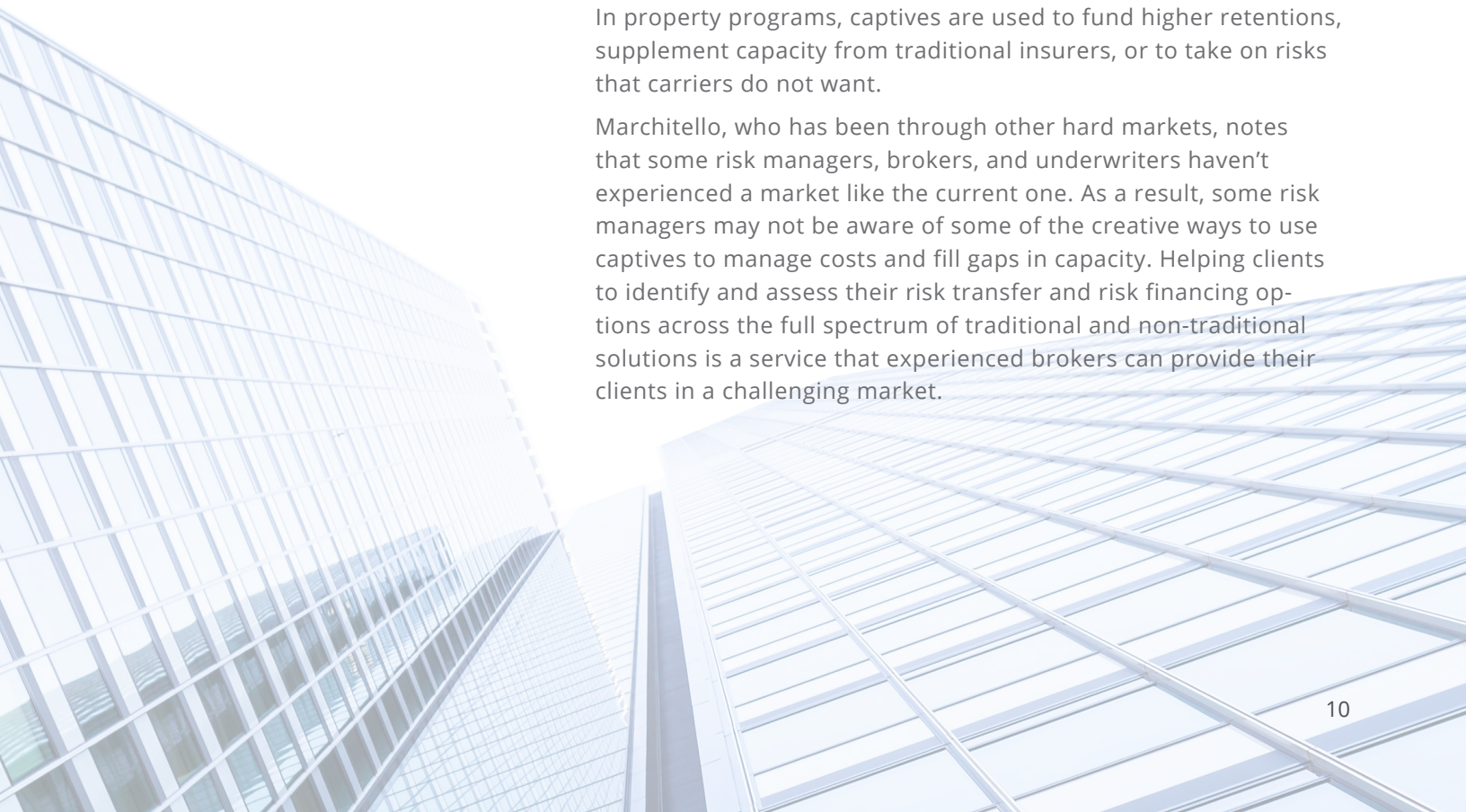
insurer to the policyholder through higher retained losses. Insureds often must aggressively step up their property loss control game to maximize the benefit of a higher deductible. "With the hardening market, we are getting a lot more client requests to discuss our recommendations with them and to come up with plans to help them meet the recommendations," says Ewing

Marchitello agrees that, if customers want to reduce their cost of risk, it is important to have a loss improvement plan and to take care of recommendations. He also recommends developing a business continuity plan. In addition to lowering potential losses, "it is important to demonstrate to underwriters that you are working to improve your risk."

Even good accounts are seeing higher premiums, but Marchitello notes that "there is a huge distinction between best-in-class risks and all the rest." Sansone agrees that underwriters give more favorable treatment to the best risks, but she warns that even outstanding accounts may need to pay more. "It depends on how underpriced their risk is. If they have been getting reductions on top of reductions and they are very far from the technical rate, that could be a problem."

Another strategy risk managers are employing to manage total cost of risk amid rising insurance costs and tightening terms and conditions is to shift property exposures to captive insurers. Often, companies already have a captive, but only now, prompted by a hardening market, are they seeking to make the best use of it. In property programs, captives are used to fund higher retentions, supplement capacity from traditional insurers, or to take on risks that carriers do not want.

Marchitello, who has been through other hard markets, notes that some risk managers, brokers, and underwriters haven't experienced a market like the current one. As a result, some risk managers may not be aware of some of the creative ways to use captives to manage costs and fill gaps in capacity. Helping clients to identify and assess their risk transfer and risk financing options across the full spectrum of traditional and non-traditional solutions is a service that experienced brokers can provide their clients in a challenging market.



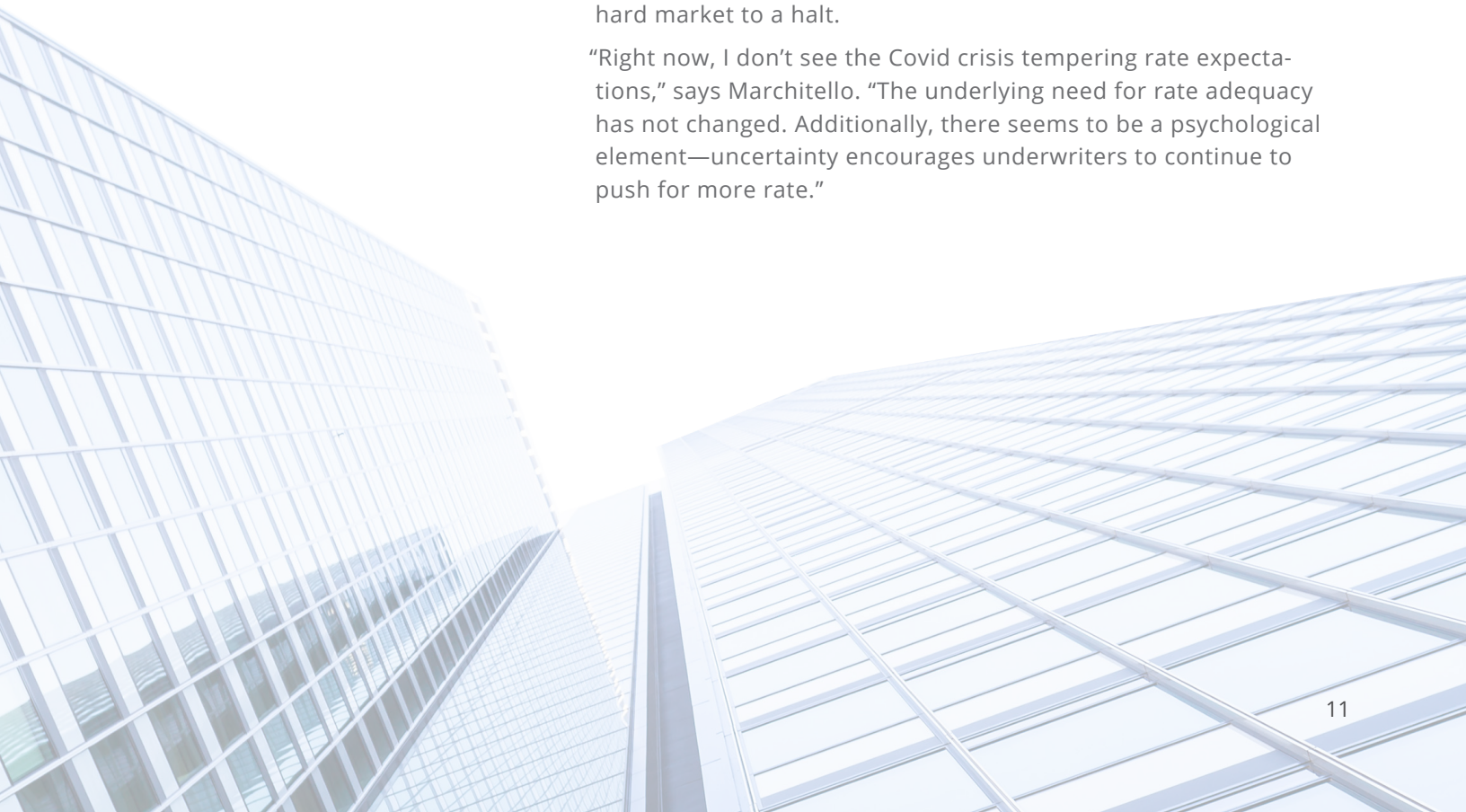
WHAT'S AHEAD

Rates have increased materially, but insurers insist that more increases are necessary to bring the property insurance ROE back to an appropriate level. "I think we have a long way to go to get back where we need to be," according to Sansone. While COVID-19 and an impending recession have introduced uncertainty into the market, many analysts believe that rates will continue to rise at least through 2020.

In late March, as this report is being written, COVID-19 infections are increasing at an exponential rate as record-shattering unemployment insurance claims illuminate the economic damage that will result from efforts to contain the pandemic. Insurers are only starting to come to grips with the potential impact of the coronavirus and the looming recession on exposures, the competitive landscape, and the ability of customers to pay premiums on a timely basis.

Some potential outcomes—such as a sharp increase in vacant properties and a decrease in maintenance and loss control activities—suggest that property loss experience could worsen, which would add further fuel to the hard market blaze. On the other hand, as companies go out of business, insurers will compete to write a smaller pool of viable accounts, which could bring the hard market to a halt.

"Right now, I don't see the Covid crisis tempering rate expectations," says Marchitello. "The underlying need for rate adequacy has not changed. Additionally, there seems to be a psychological element—uncertainty encourages underwriters to continue to push for more rate."



> **Rates have increased materially, but insurers insist that more increases are necessary**

Bob Hartwig, however, sees parallels with the Great Recession of 2008-2011, when the economic downturn resulted in several years of negative written premium growth for the insurance industry.

"It is possible that, if the global economy becomes unhinged, you will see an easing in the hard market. Carriers will compete to preserve market share in a lower growth environment," Hartwig said.

The depth and duration of the looming recession are still unknown. Many analysts expect a V-shape recession—a sharp downturn and a rapid recovery—in which case it will likely not have a lasting impact on the property insurance market. If it looks more like the Great Recession of 2008, which had a sluggish recovery, the dynamics of the market could change materially. ■