Small Business Concerns & P/C Insurance Markets in Turbulent Economic Times

Small Business Insurance Webinar
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Small Business Concerns & P/C Insurance: Outline

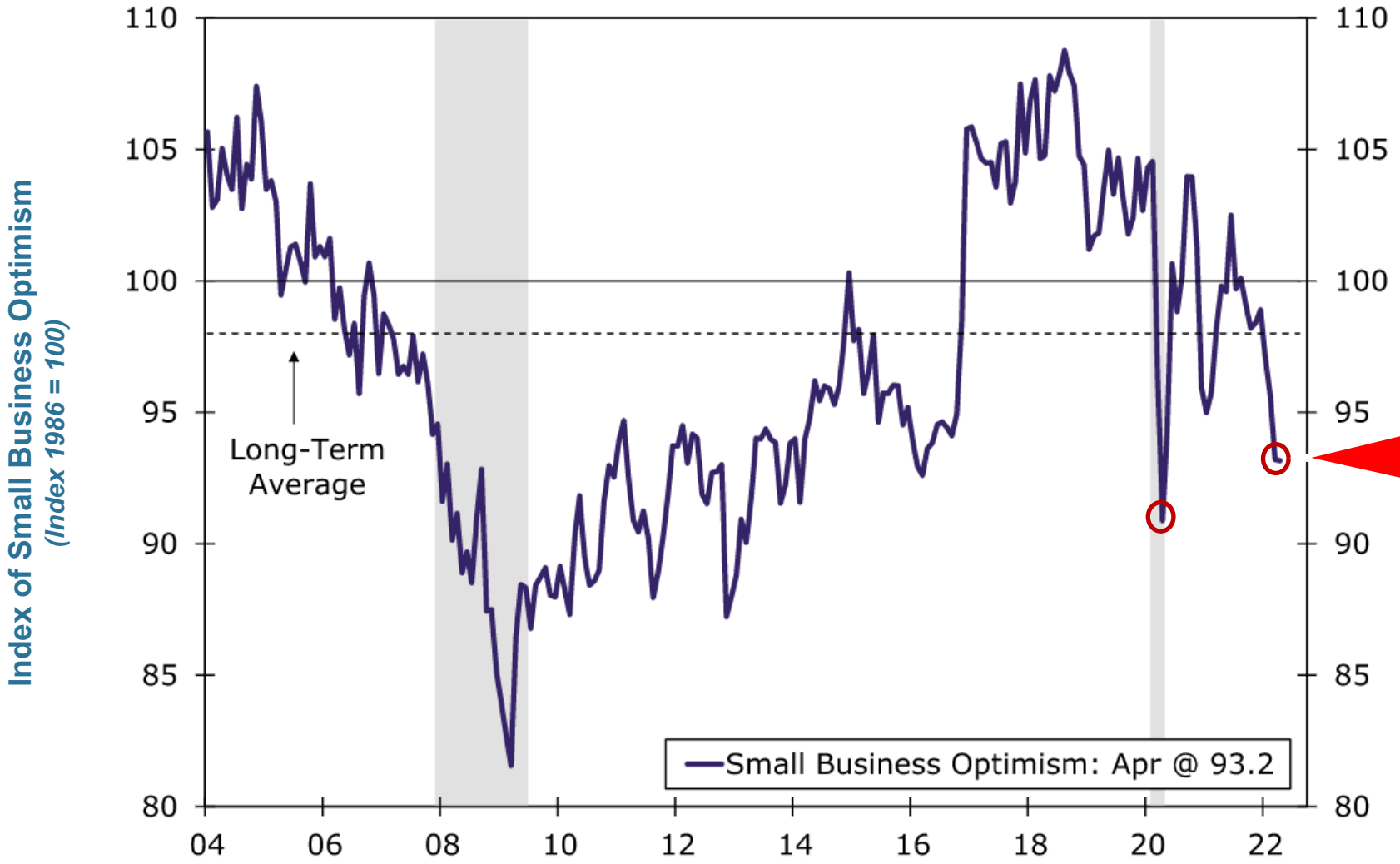
- Summary of Small Business Concerns
- Main Street America's Concerns: Economic Overview & Outlook
- Inflation
  - Impacts on claim severity and rate adequacy
- What Has Changed Since the Pandemic?
  - Business Interruption
  - Technology/Cyber Risk
- Social Inflation and Litigation Trends
- Why Rate Matters
- Summary and Q&A

Small Business Concerns

Small Businesses Have Many Concerns, but Few Simple Solutions

Insurance Can Play a Key Role in Assuring Business Continuity During Challenging Times

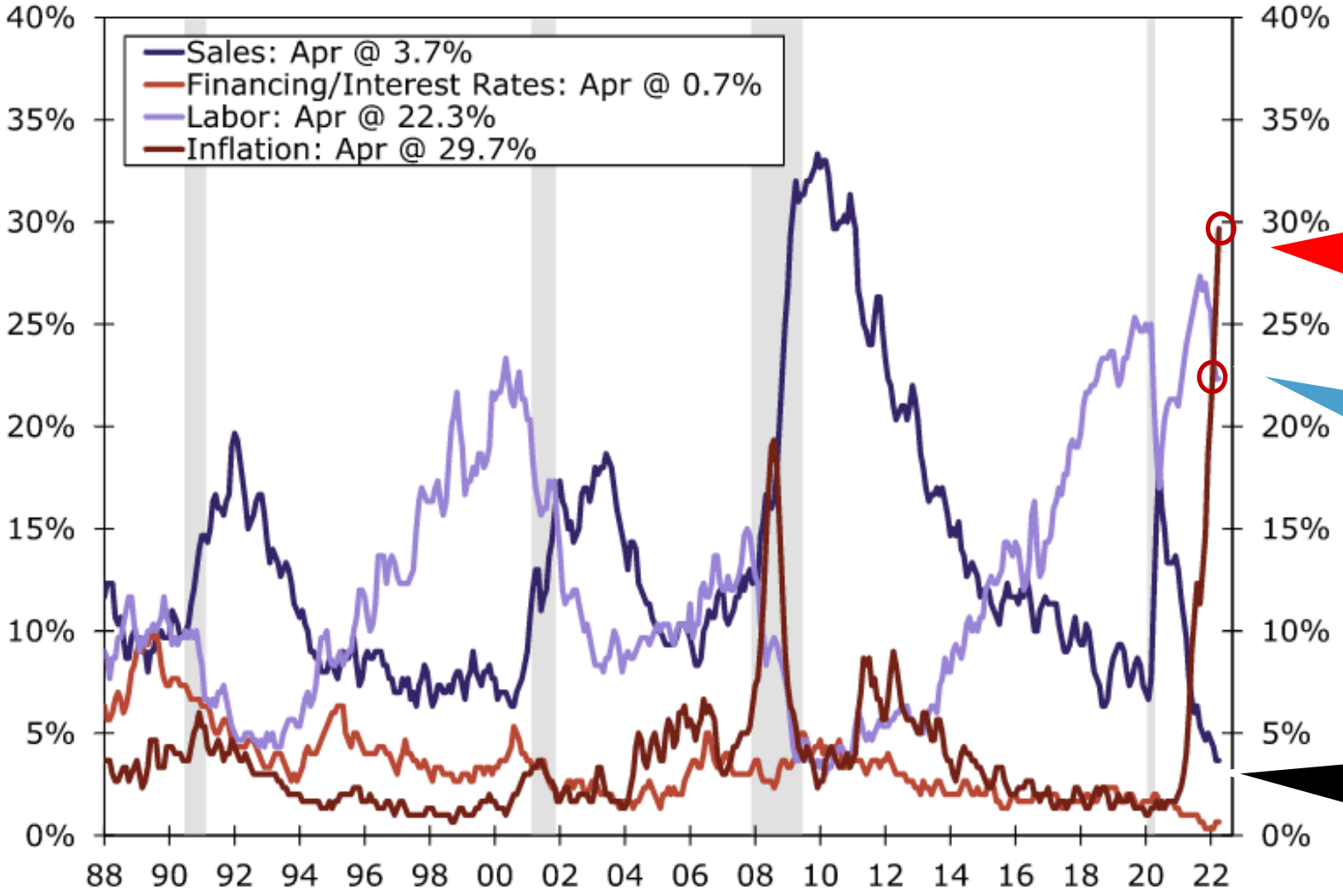
Small Business Optimism: Falling Sharply Despite Strong Demand



Small businesses are nearly as pessimistic as they were during the depths of pandemic, despite strong sales

Source: NFIB and Wells Fargo Economics.

Small Business' #1 Problem: Inflation Leads the Way*



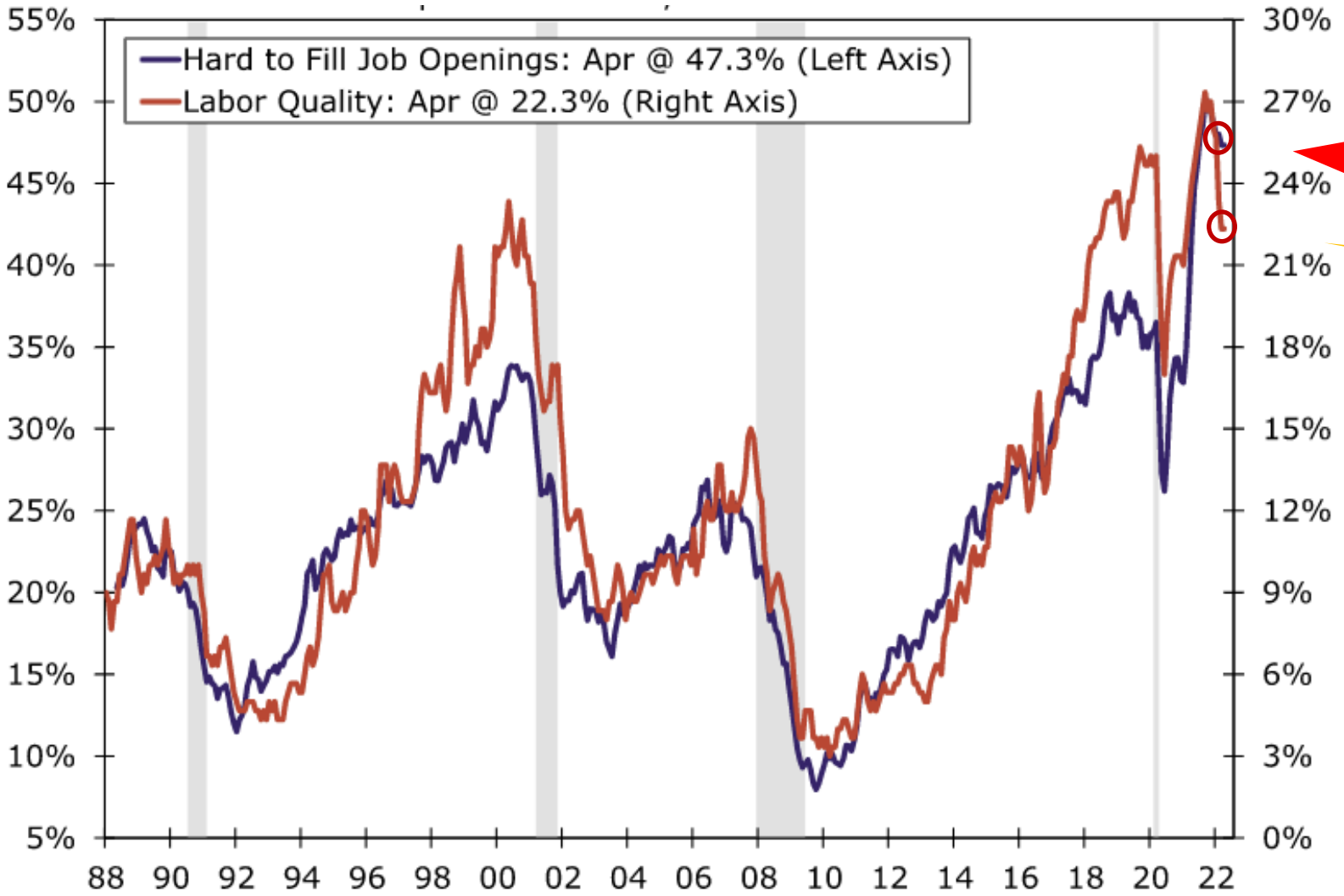
Inflation was the #1 problem for 32% of small business owners in April 2022, the highest reading since Q4:1980

Labor issues rank as the #2 issue for small business, down from #1 in 2021

Sales and Financing/Interest Rate rank as distant #3 and #4 concerns for for small business

*Not seasonally adjusted, 3-month moving average.
Source: NFIB and Wells Fargo Economics.

Small Business Labor Issues: Percent Firms Ranking Jobs Hard to Fill & Labor Quality as Top Concern

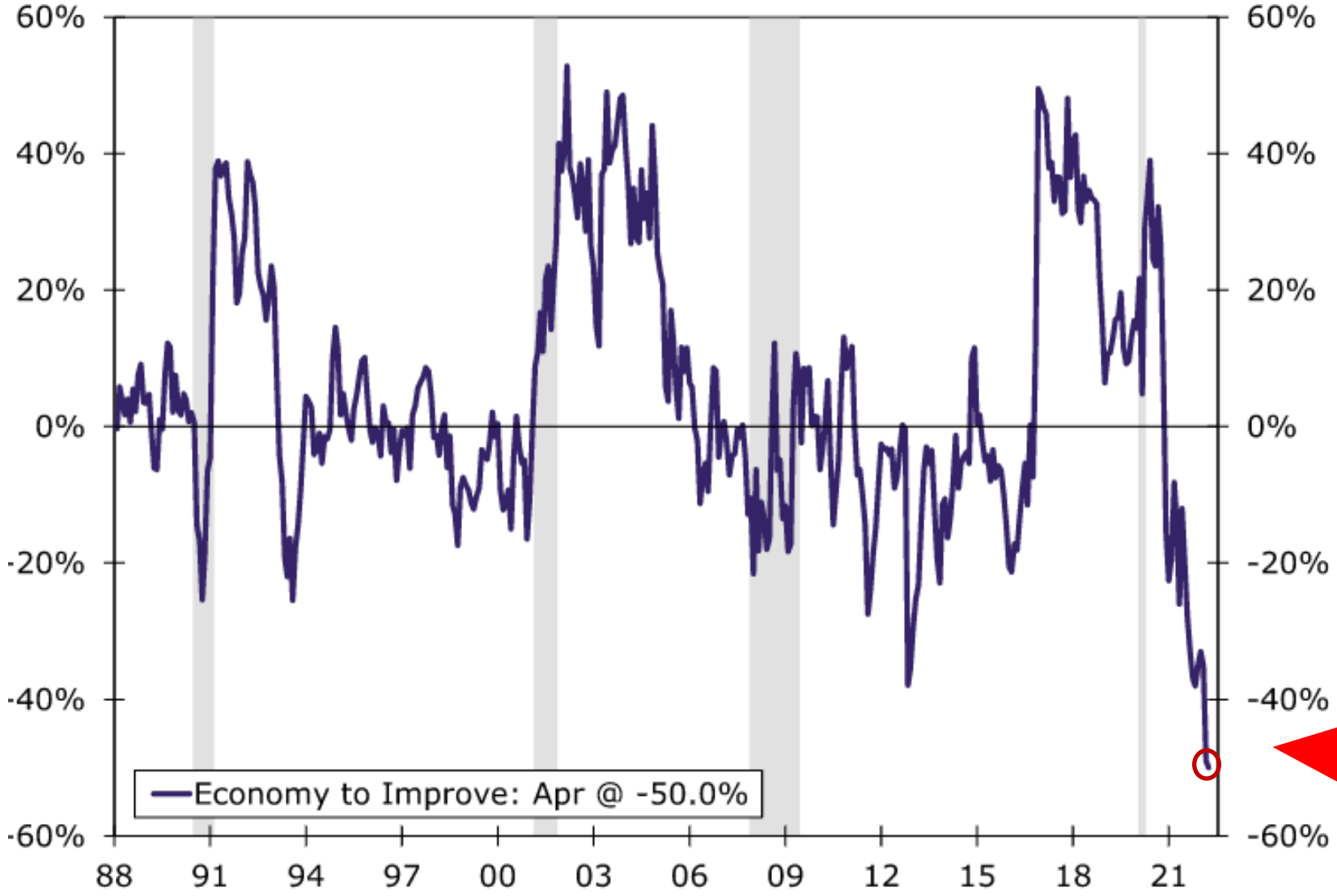


47.3% of small businesses report difficulty filling open positions (double the historical average of 23%)

22.3% of small businesses report labor quality as their #1 labor concern

Source: NFIB and Wells Fargo Economics.

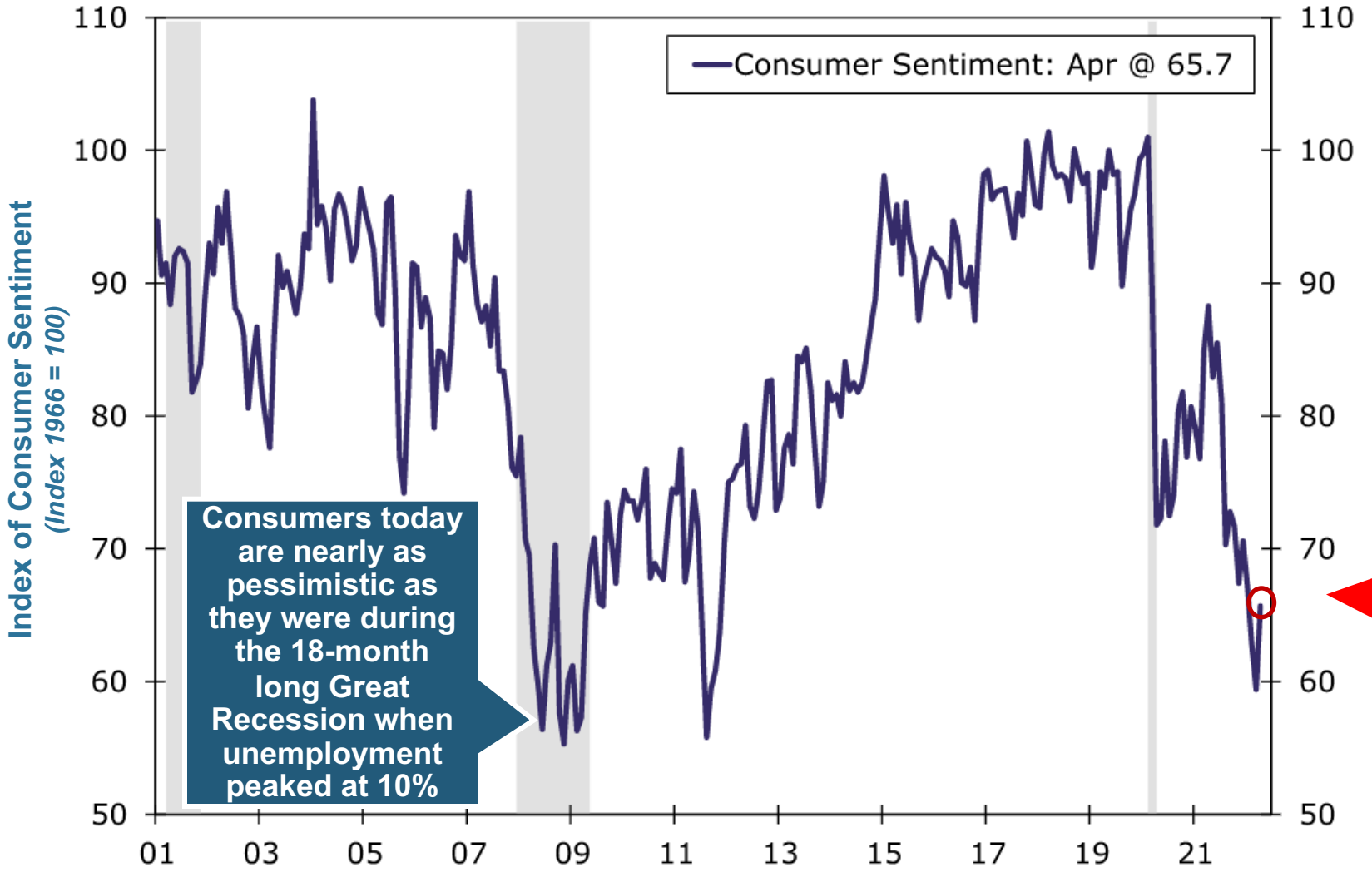
Net Percent of Small Businesses Expecting Economy to Improve Over Next 6 Months *(% better minus % worse)*



A large majority of small small business owners expect the economy to worsen over the next 6 months (% better - % worse = -50%→lowest reading in 48-year history of the survey back to 1974)

Source: NFIB and Wells Fargo Economics; Yardeni Research: https://www.yardeni.com/pub/ecoindsmbus.pdf.

Consumer Sentiment: Near 20-Year Low Despite Strong Jobs Markets



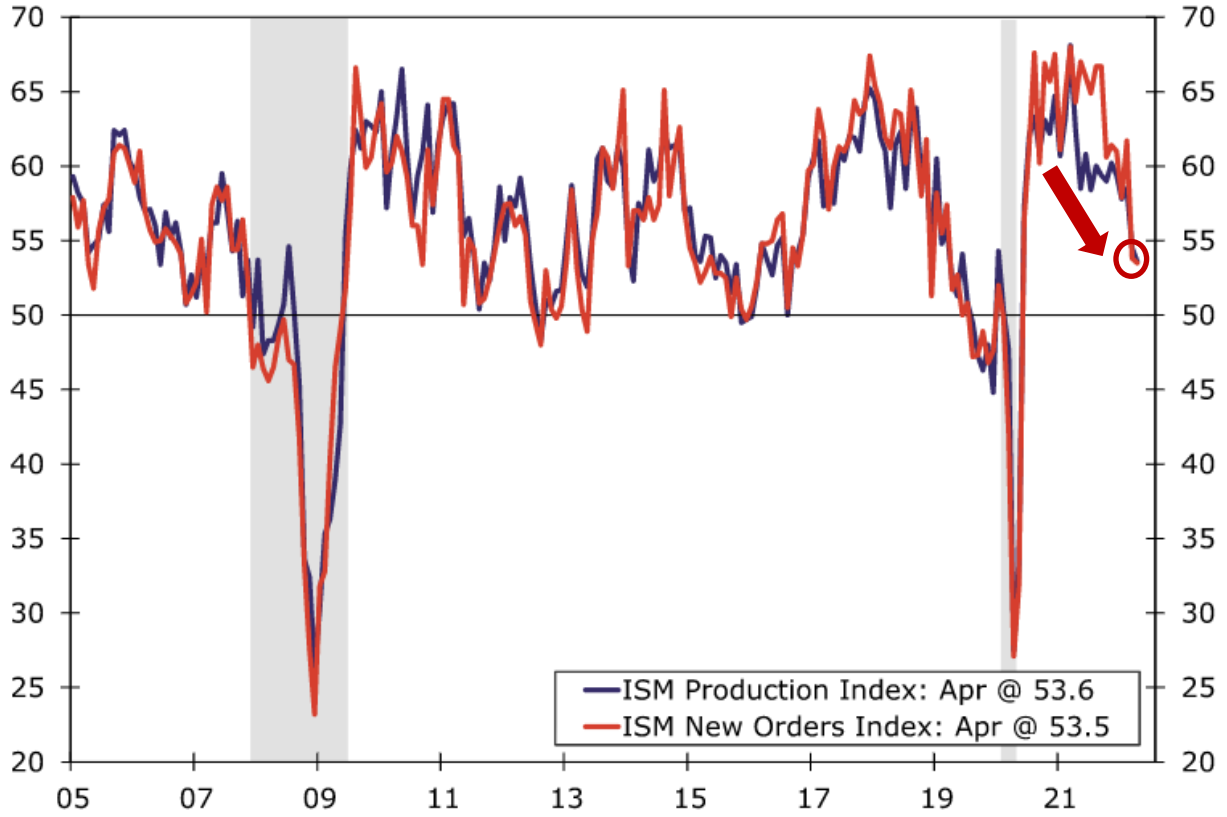
Despite unemployment rates that are among the lowest in 50+ years and the "end" of the COVID pandemic, consumers are *GRUMPY*

Source: University of Michigan and Wells Fargo Economics.

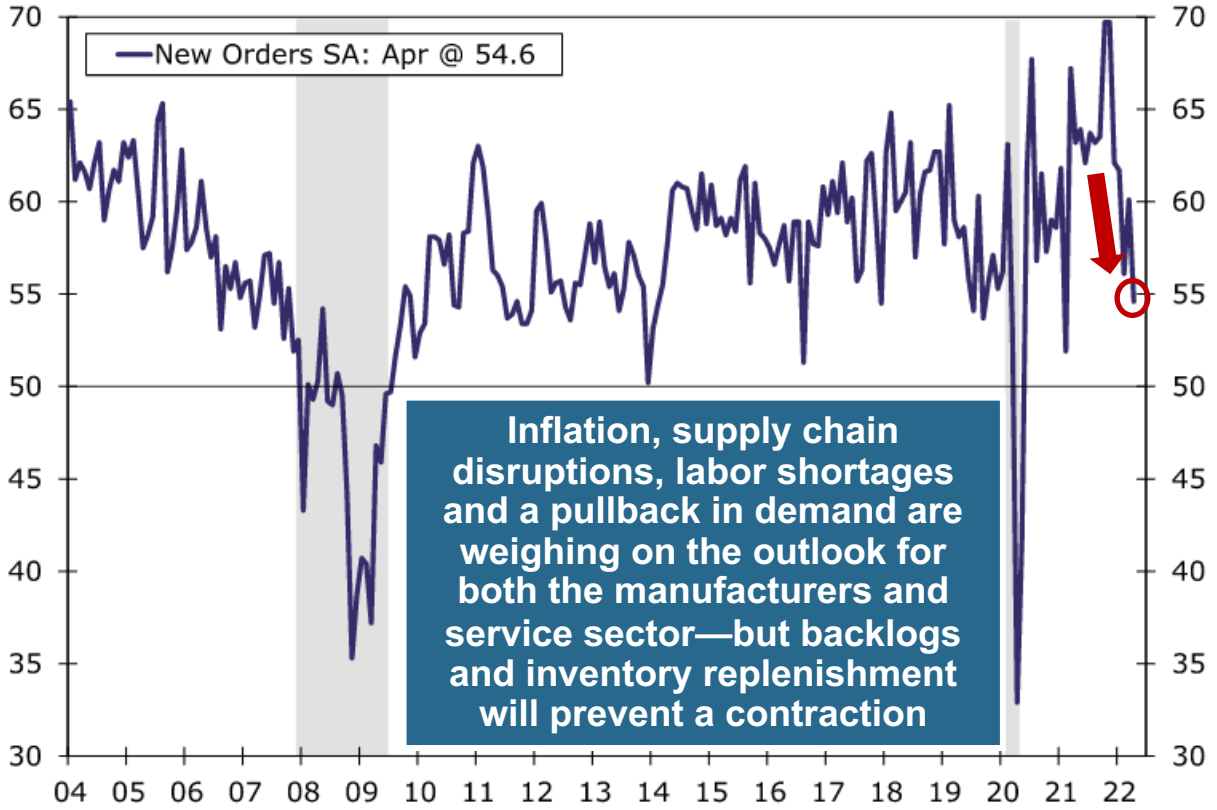
Manufacturing and Services Sectors Are Still Expanding, but at a Slower Pace—*Clear Deceleration in Demand*

(Index Value > 50 Indicates Expansion)

Manufacturing: Production vs. New Orders

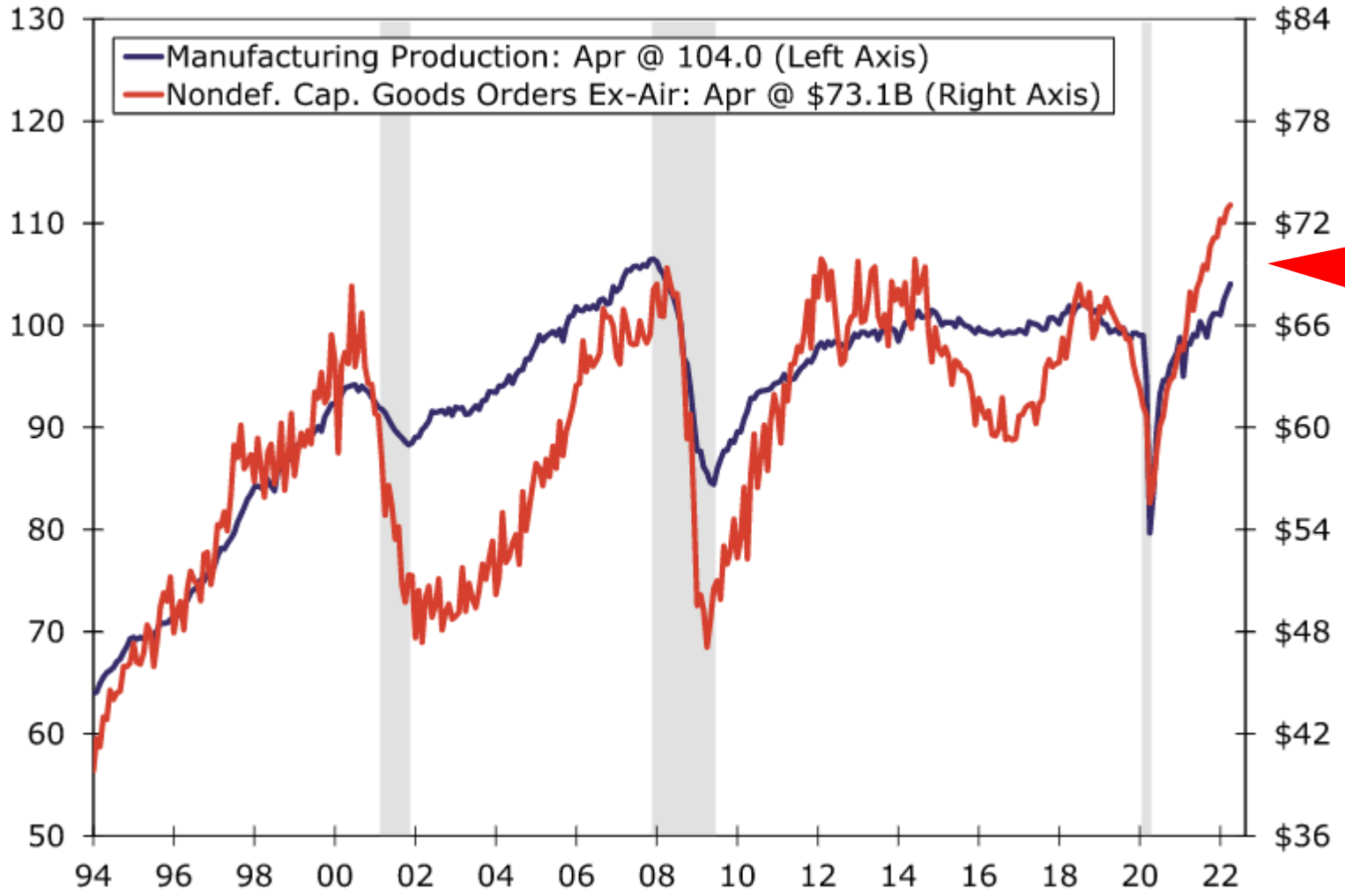


Services: New Orders



Sources: Institute for Supply Management and Wells Fargo Economics.

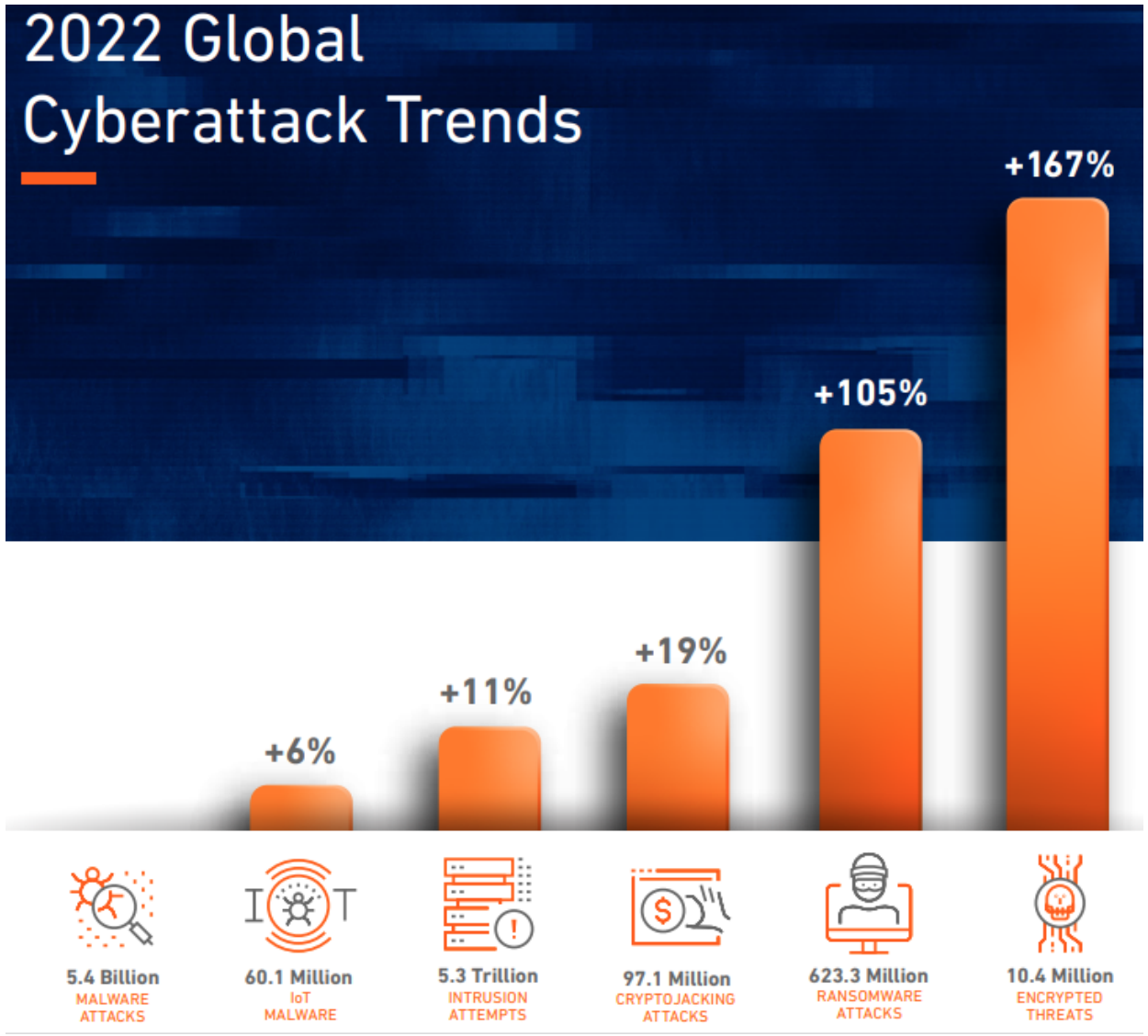
Manufacturing Production vs. Nondefense Capital Goods Spending, Jan. 1994 – Apr. 2022



Maufacturing production now exceeds pre-COVID levels and nondefense capital goods orders (ex-aircraft) have reached a new record high

Source: Federal Reserve Board, US Dept. of Commerce and Wells Fargo Economics.

Cyber Attack Trend Summary



Ransomware attacks and Encrypted threats more than doubled last year

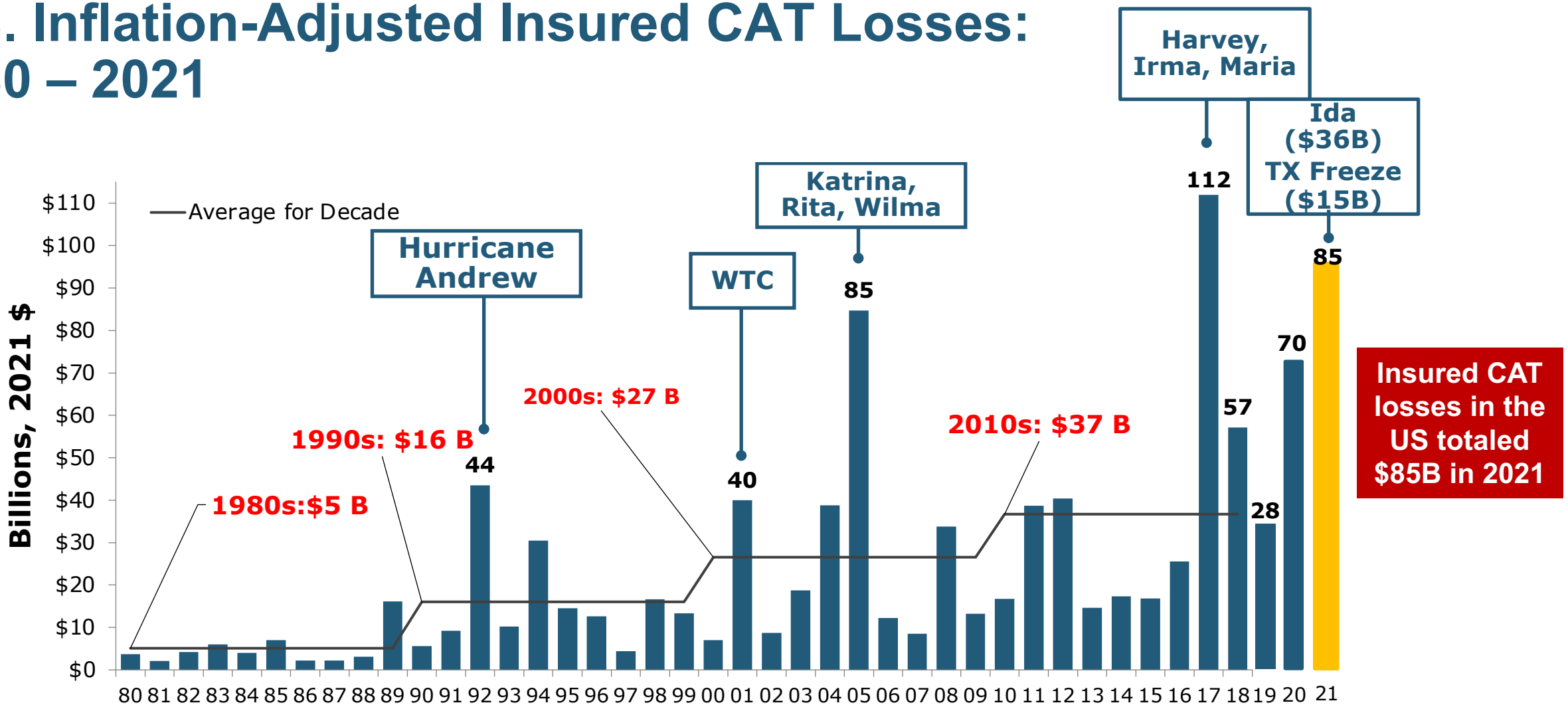
What Are Encrypted Threats?

In simple terms, TLS (Transport Layer Security) is used to create an encrypted tunnel for securing data over an internet connection. While TLS provides legitimate security benefits for web sessions and internet communications, cybercriminals increasingly use this encryption protocol to hide malware, ransomware, zero-day attacks and more.

Traditional security controls, such as legacy firewalls, lack the capability or processing power to detect, inspect and mitigate cyberattacks sent via HTTPs traffic, making this a highly successful avenue for hackers to deploy and execute malware.

Sources: 2022 SonicWall Cyber Threat Report, accessed at: https://www.sonicwall.com/medialibrary/en/white-paper/2022-sonicwall-cyber-threat-report.pdf;
Risk and Uncertainty Management Center, Univ. of South Carolina.

U.S. Inflation-Adjusted Insured CAT Losses: 1980 – 2021



Insured CAT losses in the US totaled $85B in 2021

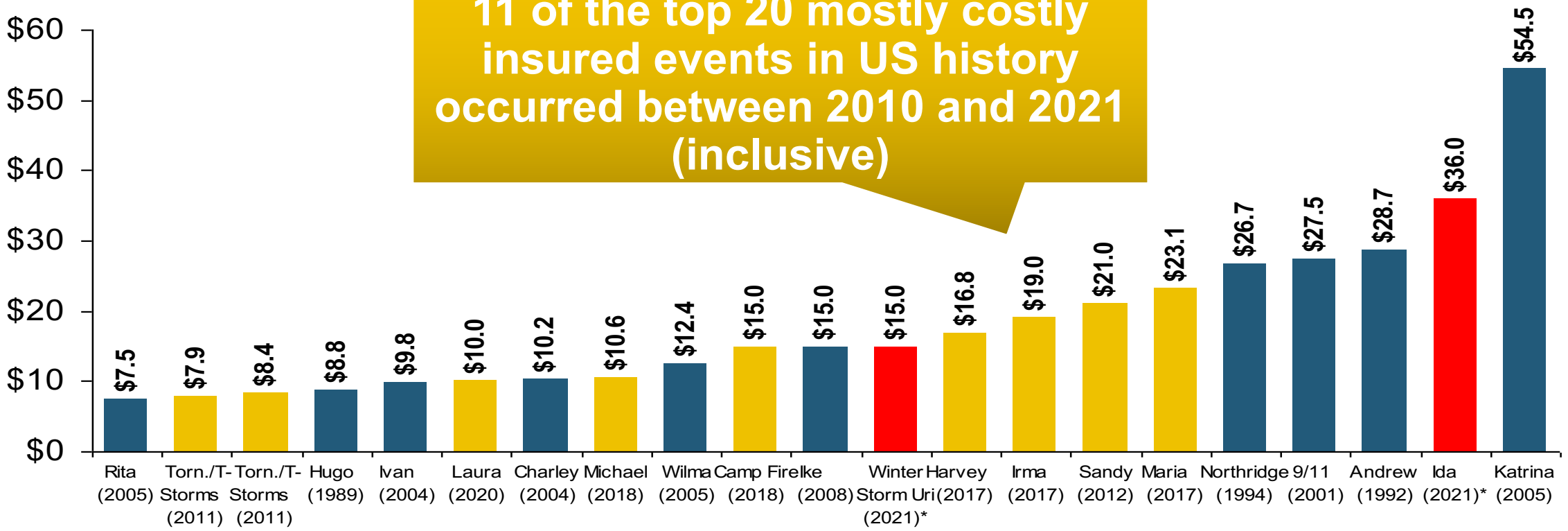
Average Insured Loss per Year*
1980-2021: $23.8 Billion
2012-2021: $44.1 Billion

The 2020s are off to an ominous start with $76B in average annual insured losses

*Stated in 2021 dollars.
Sources: Property Claims Service, a Verisk Analytics business (1980-2019); 2020 and 2021 figures from Munich Re; Insurance Information Institute; University of South Carolina, Risk & Uncertainty Management Center.

Top 21 Most Costly Disasters in U.S. History—Katrina Still Ranks #1

(Insured Losses, 2020 Dollars, $ Billions)



17 of the 20 Most Expensive Insurance Events in US History Have Occurred Since 2004

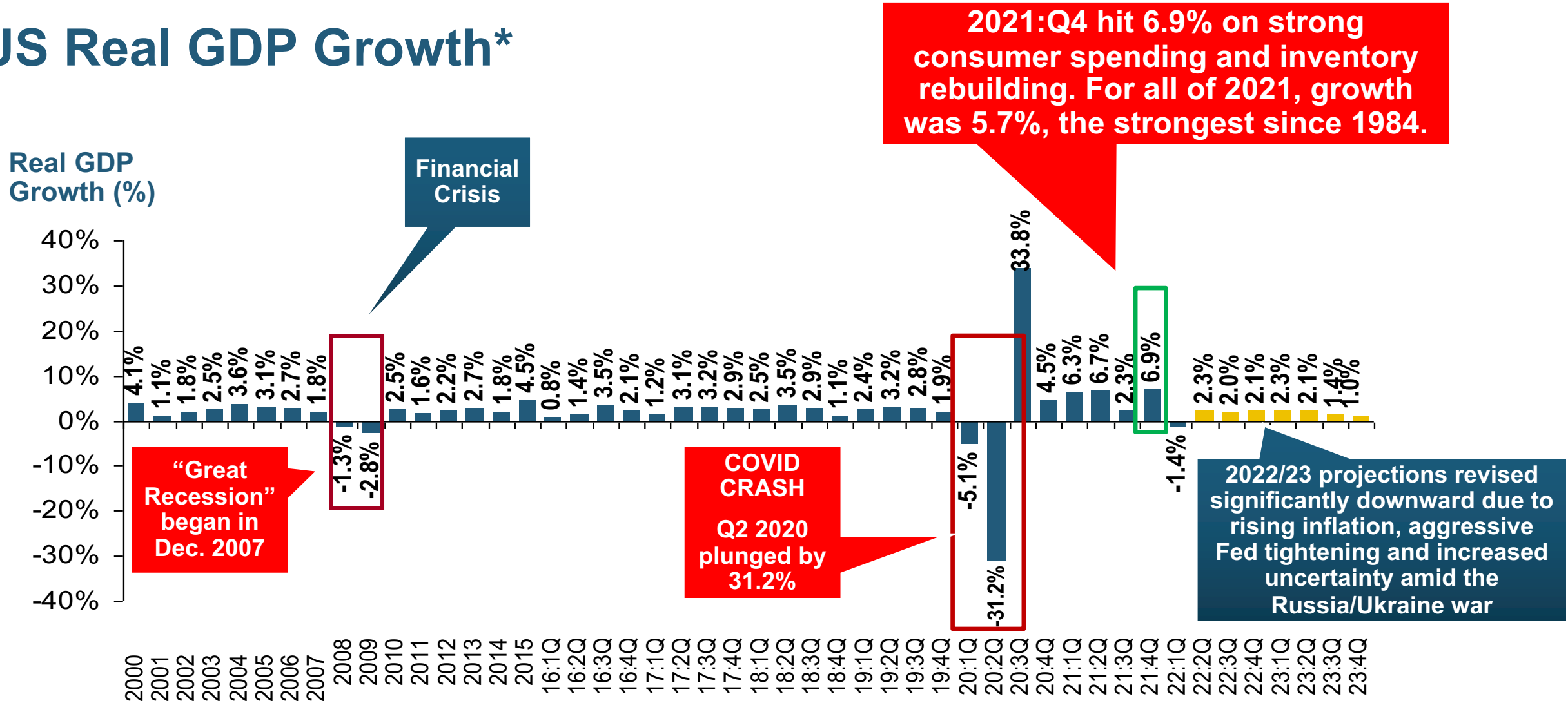
*Estimated (in 2021 dollars)

Sources: PCS, RMS, Aon, Karen Clark & Co; USC Center for Risk and Uncertainty Management adjustments to 2020 dollars using the CPI.

Small Businesses: Main Street America's Concerns

Businesses Are Grappling With Many Issues Today—COVID Was Just the Beginning

US Real GDP Growth*



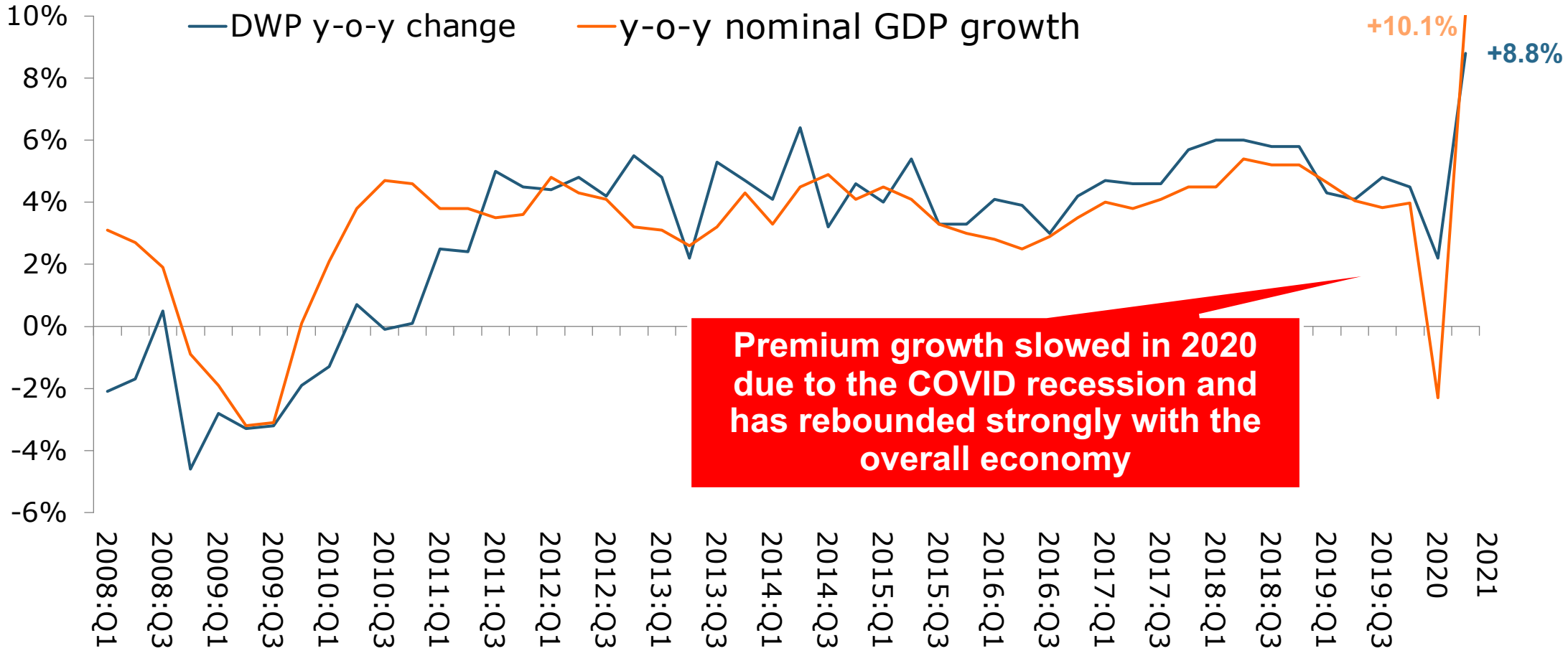
GDP Recovered to Q4 2019 Level in Q1 2021. Demand for Insurance Increased Materially in 2021/22—Particularly in Economically Sensitive Commercial Lines Such as WC

* Estimates/Forecasts from Wells Fargo Securities.

Source: US Department of Commerce, Wells Fargo Securities 5/22; Center for Risk and Uncertainty Management, University of South Carolina.

The Economy Drives P/C Insurance Industry Premiums: 2006:Q1–2021*

Direct Premium Growth (All P/C Lines) vs. Nominal GDP: Quarterly Y-o-Y Pct. Change

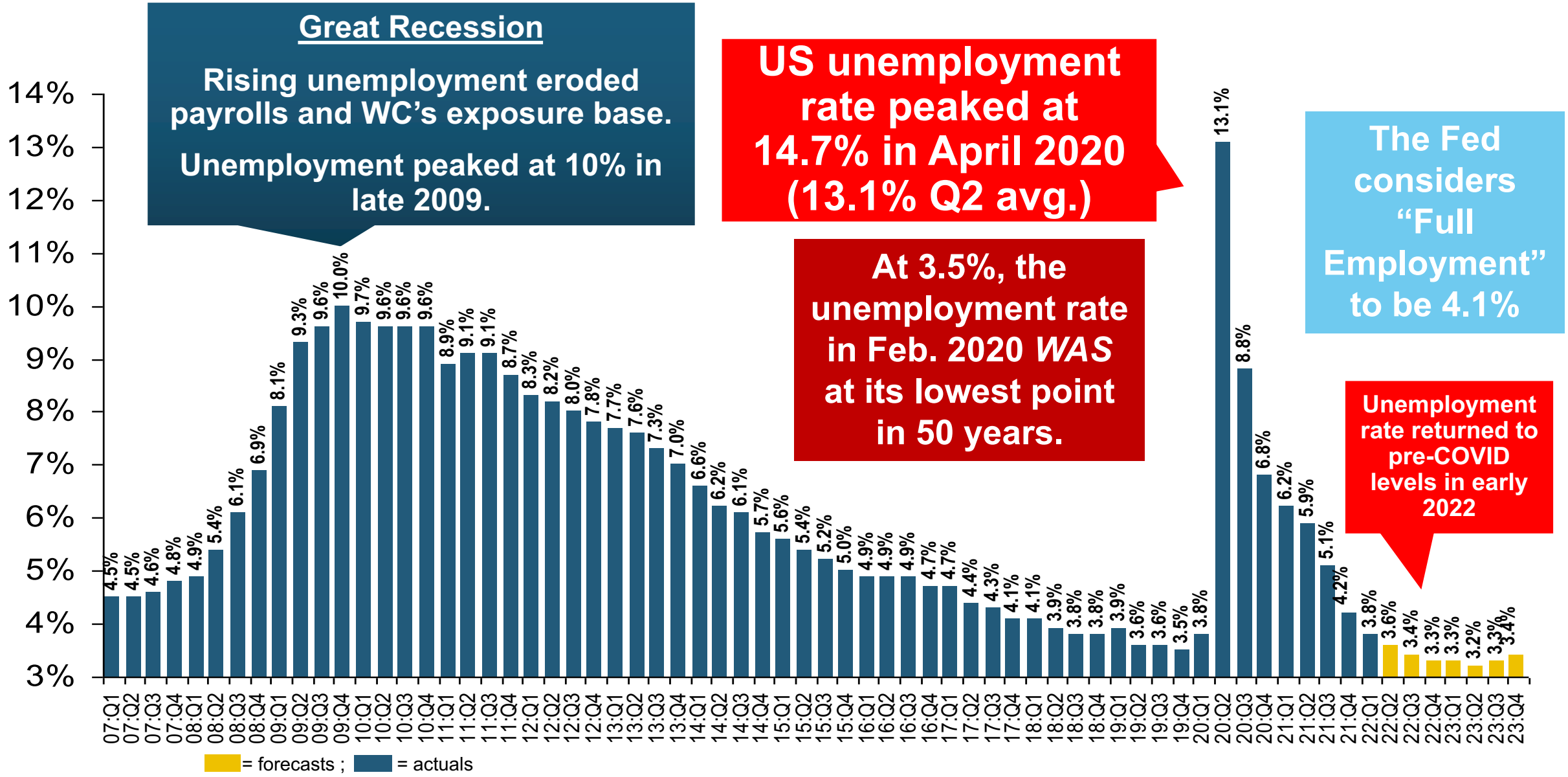


Premium growth slowed in 2020 due to the COVID recession and has rebounded strongly with the overall economy

Direct written premiums track nominal GDP fairly tightly over time, suggesting the P/C insurance industry's growth prospects inextricably linked to economic performance.

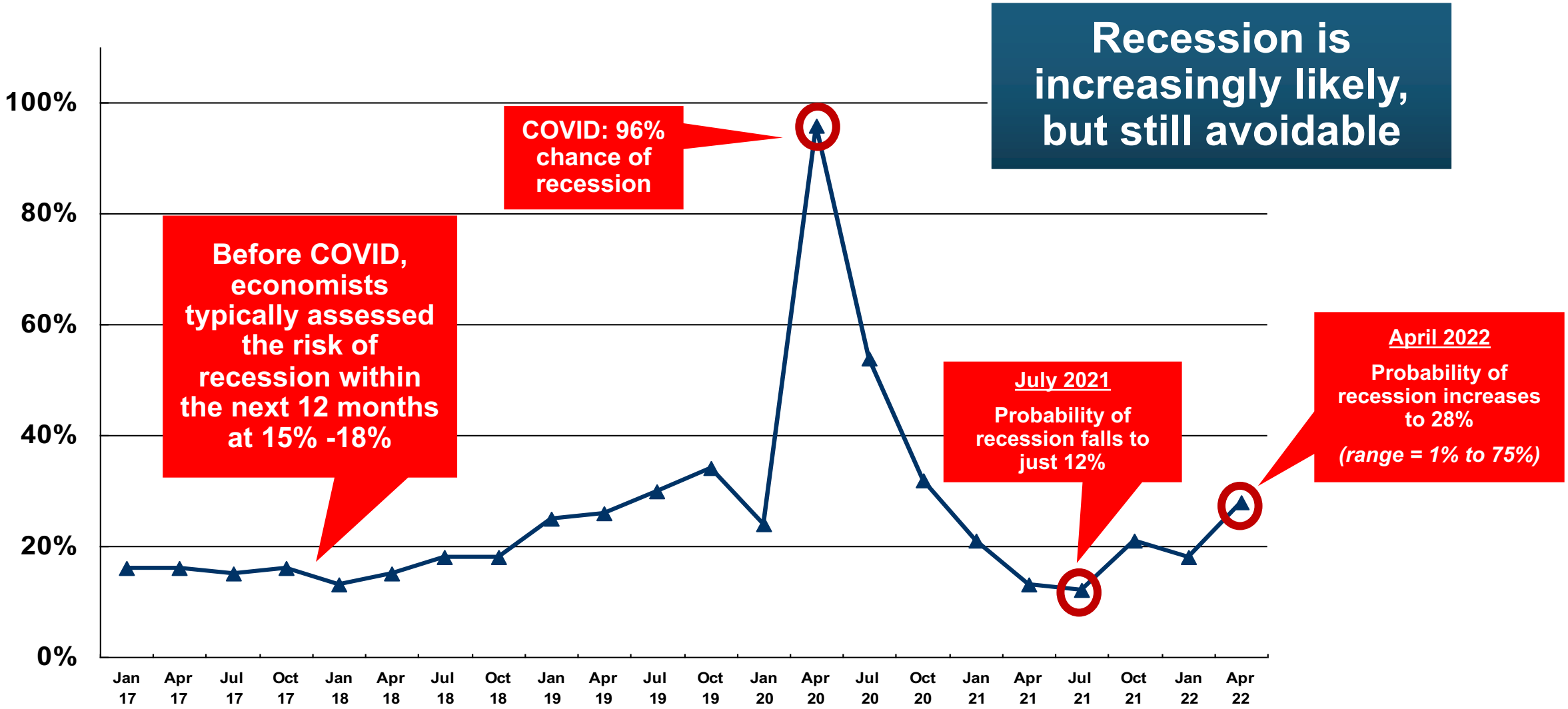
*2020-21 figures are annual; 2021 DWP figure is preliminary.
Sources: SNL Financial; U.S. Commerce Dept., Bureau of Economic Analysis; ISO; I.I.I.; Risk and Uncertainty Management Center, University of South Carolina.

US Unemployment Rate Forecast: 2007:Q1–2023:Q4



Sources: US Bureau of Labor Statistics; Wells Fargo Securities (5/22 edition); Risk and Uncertainty Management Center, University of South Carolina.

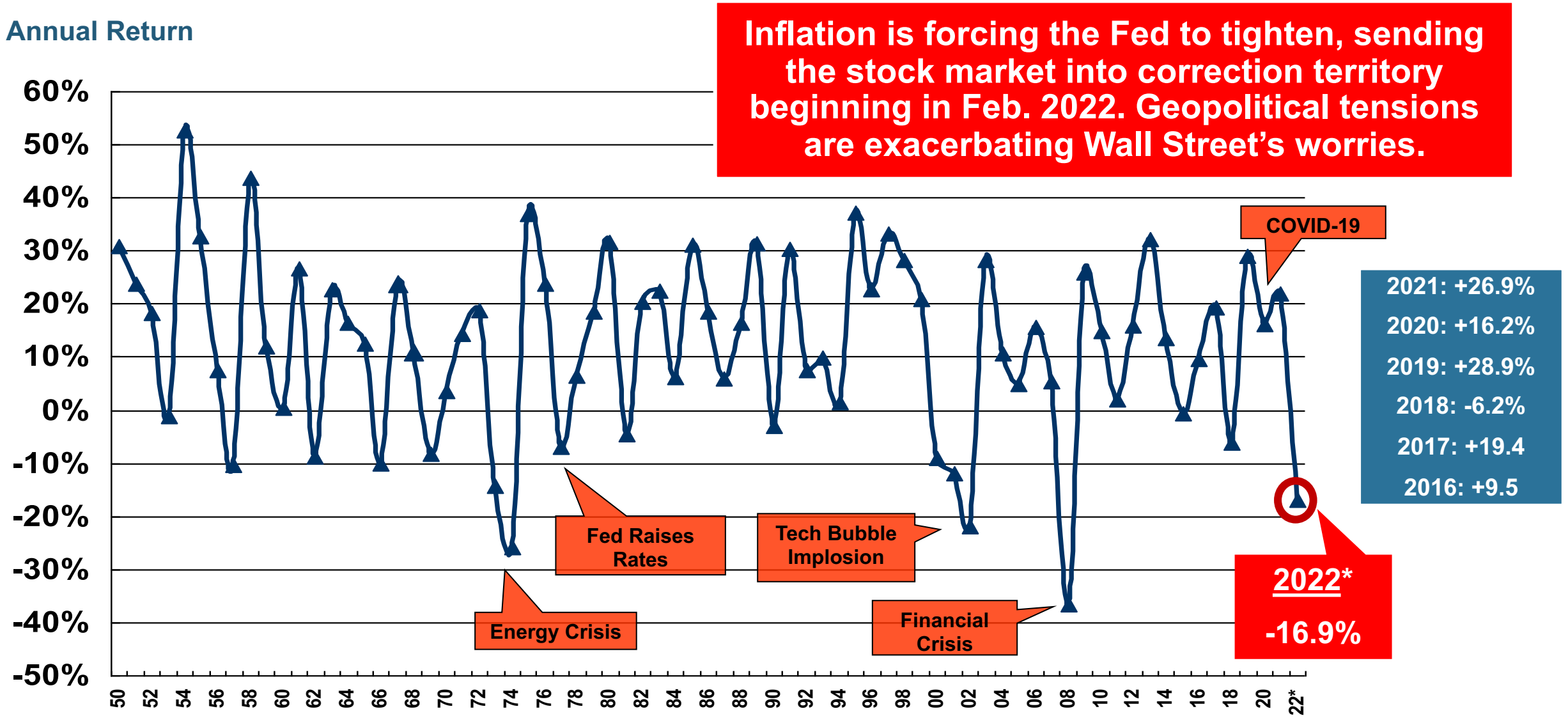
Probability the U.S. Is in a Recession Within Next 12 Months: Jan. 2017 – Apr. 2022*



*April 2022 survey included the responses of 75 economists.

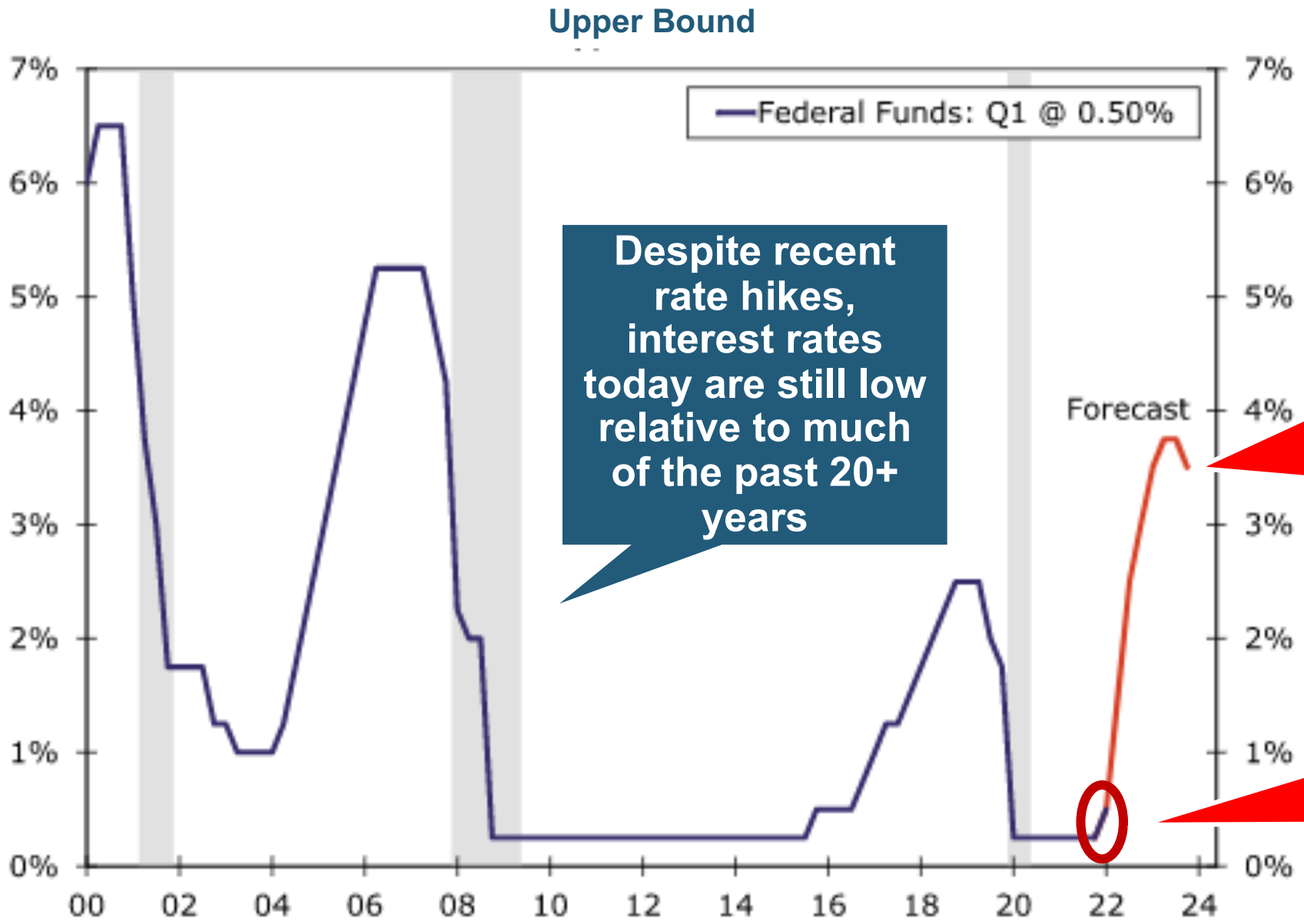
Source: Wall Street Journal surveys of economists: https://www.wsj.com/articles/recession-risk-is-rising-economists-say-11649592002; Risk and Uncertainty Management Center, University of South Carolina.

S&P 500 Index Returns, 1950–2022*



,
*Through May 25, 2022.
Source: NYU Stern School of Business: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html;
Center for Risk and Uncertainty Management, University of South Carolina.

Federal Funds Target Rate: Up, Up and Away!



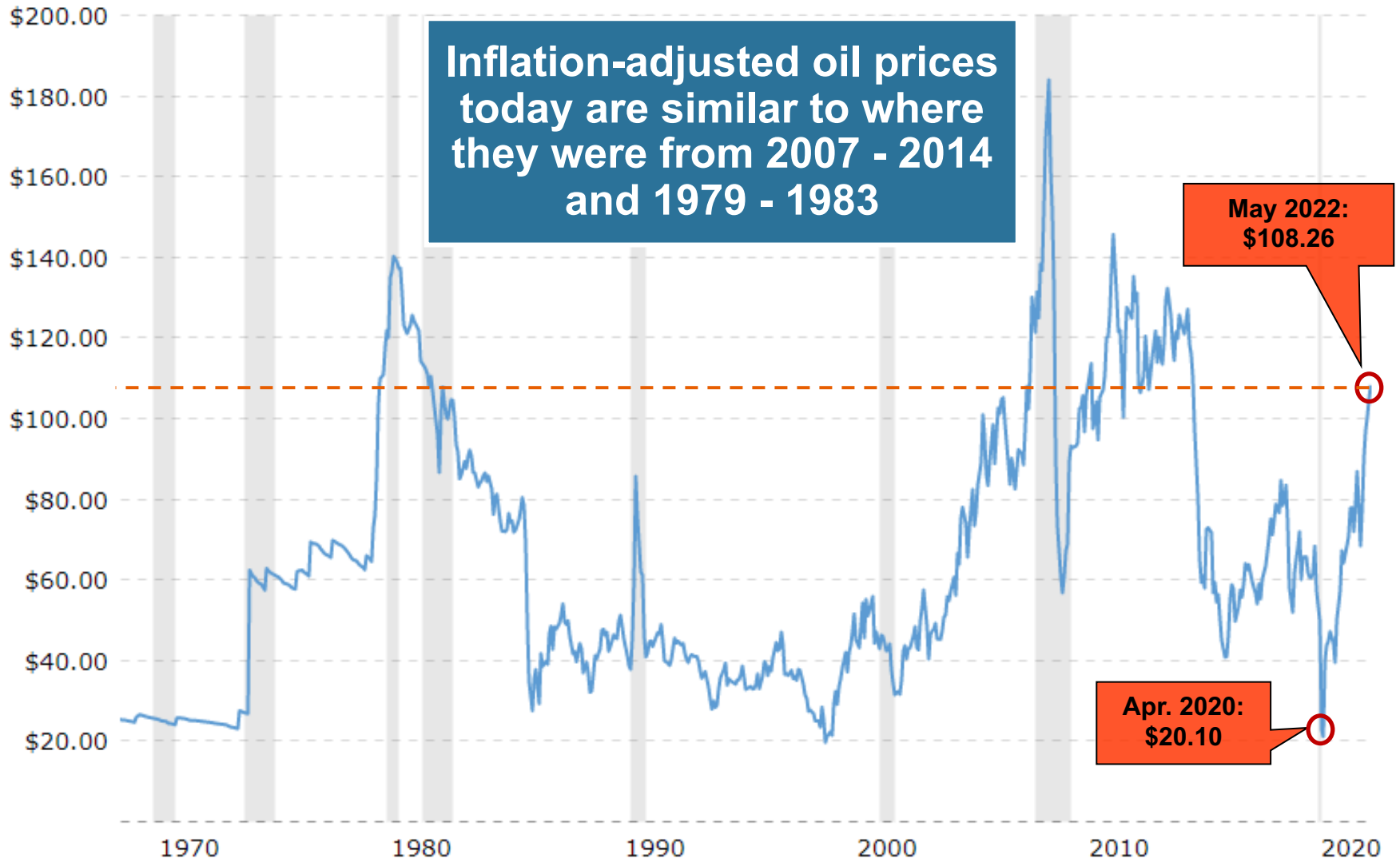
Despite recent rate hikes, interest rates today are still low relative to much of the past 20+ years

The Fed is expected hike rates into 2023 to 3.75%. If the objective of lower inflation is met (or in sight), the Fed will likely lower rates in late 2023 to keep unemployment low

The Fed hiked short-term rates on May 4th by 50 basis points to a target range of between 0.75% and 1.0%

Source: Federal Reserve Board and Wells Fargo Economics (5/22); Risk and Uncertainty Management Center, University of South Carolina.

Crude Oil Prices: Price per Barrel, Mar. 2002 – May 2022 (Inflation Adjusted)



Crude above $100/bbl—a quintupling from its pandemic low—causing market panic and fueling inflation fears. The Russian invasion of Ukraine, US ban of Russian oil is exacerbating oil price pressures.

Sources: Macrotrends.net accessed 5/6/22 at: https://www.macrotrends.net/1369/crude-oil-price-history-chart; Risk and Uncertainty Management Center, University of South Carolina.

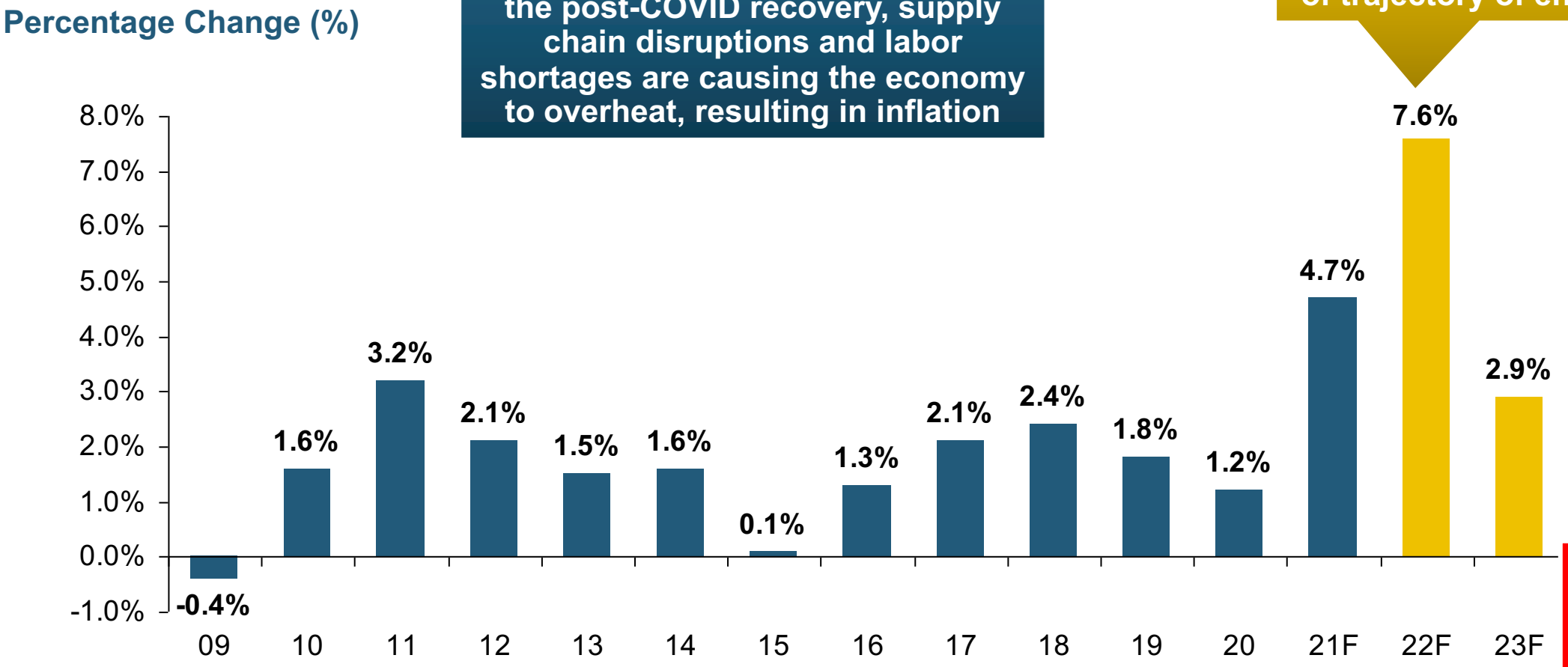
Inflation

Inflation is the #1 Small Business Concern…and It's Also a Major Concern of Insurers

U.S. Inflation Rate: 2009-2023F*

There's a great deal of concern that trillions of dollars of stimulus plus the post-COVID recovery, supply chain disruptions and labor shortages are causing the economy to overheat, resulting in inflation

Inflation accelerated sharply in 2021 and early 2022. Inflation is now not expected to moderate until Q2 2022; Forecast is highly dependent of trajectory of energy prices



Insurer Concerns About Inflation

Rate Inadequacy

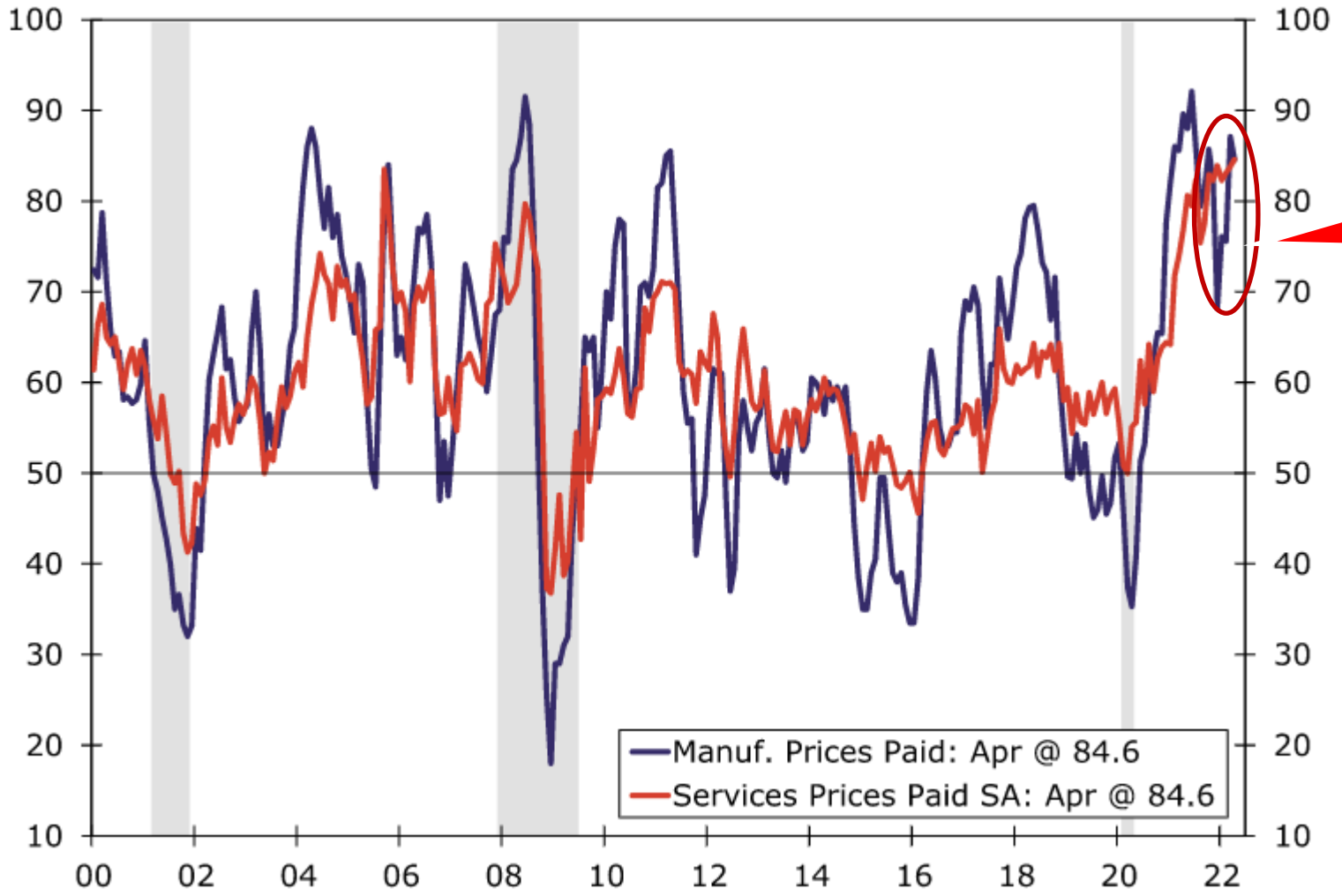
Reserve Inadequacy

*Annual change in Consumer Price Index for All Urban Consumers (CPI-U).

Source: U.S. Bureau of Labor Statistics; Wells Fargo Securities (5/22); USC Center for Risk and Uncertainty Management.

Inflationary Pressure Has Broadened Across Much of the Service and Manufacturing Sectors

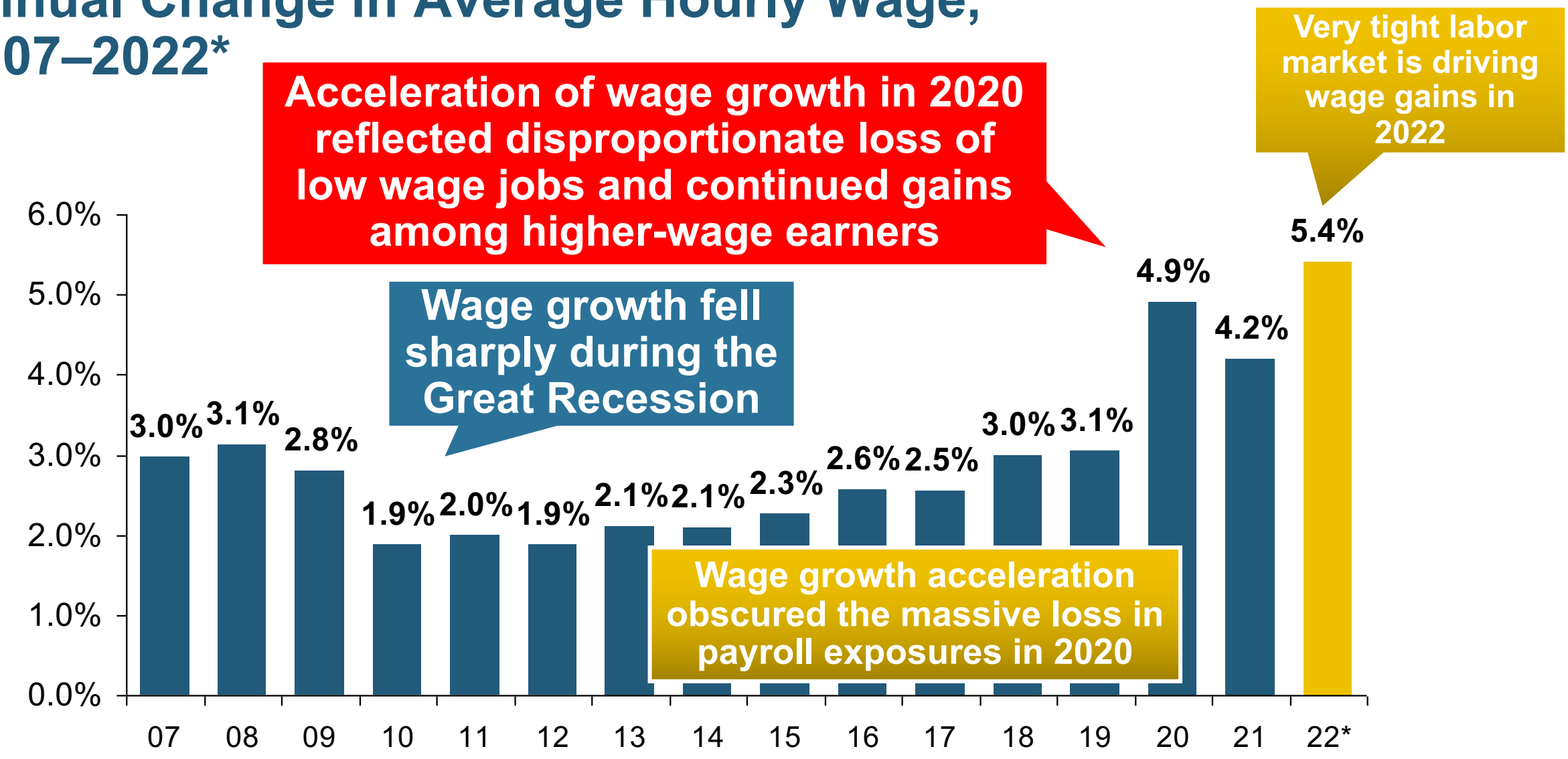
(Index Value > 50 Indicates Expansion of Inflationary Pressures)



The vast majority of service and manufacturing businesses are reporting higher prices for their inputs

Sources: Institute for Supply Management and Wells Fargo Economics.

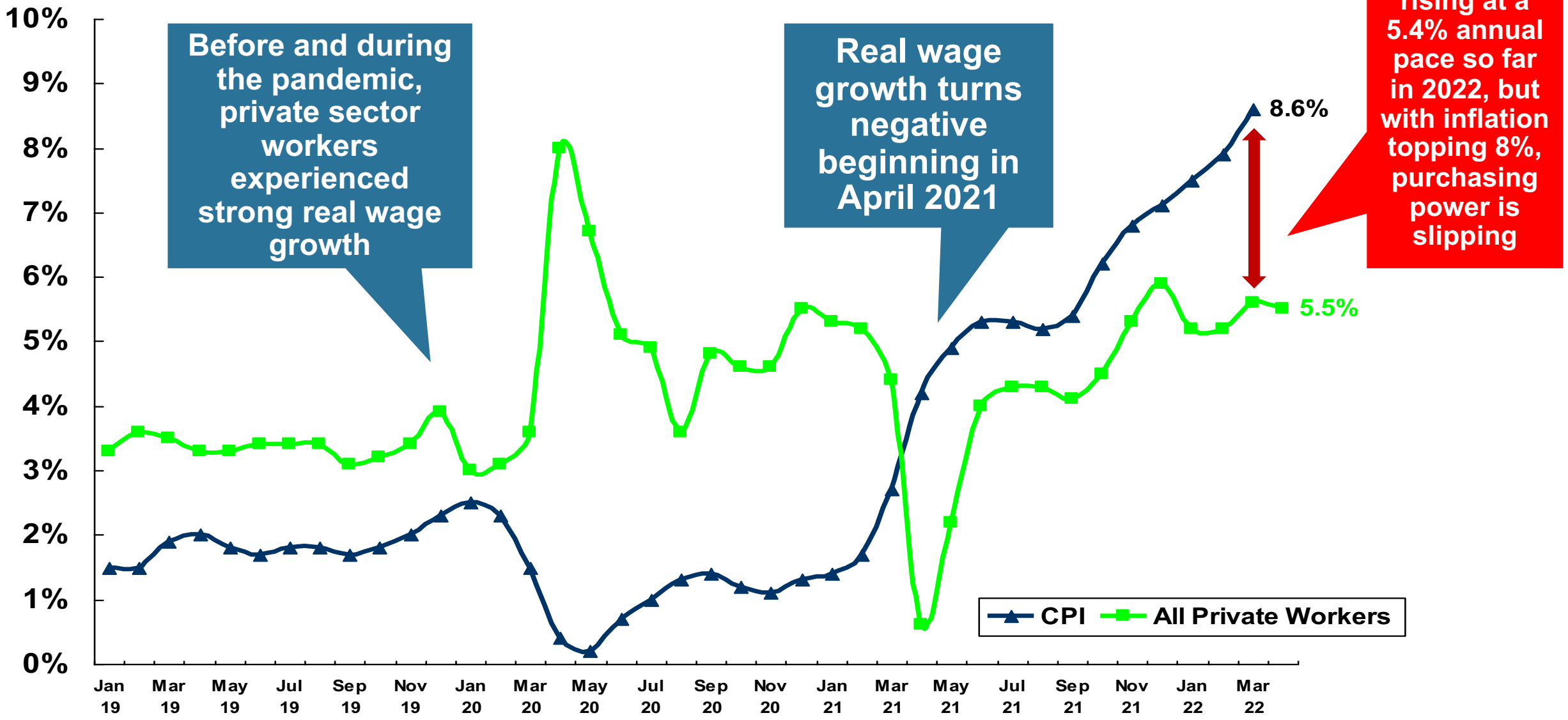
Annual Change in Average Hourly Wage, 2007–2022*



*2022 figure is average of monthly year-over-year increases through April 2022.

Sources: US Bureau of Labor Statistics at http://www.bls.gov/data/#employment; National Bureau of Economic Research (recession dates); Risk and Uncertainty Management Center, Univ. of South Carolina.

Inflation (CPI) vs. Hourly Earnings Growth: Jan. 2019 – Apr. 2022*

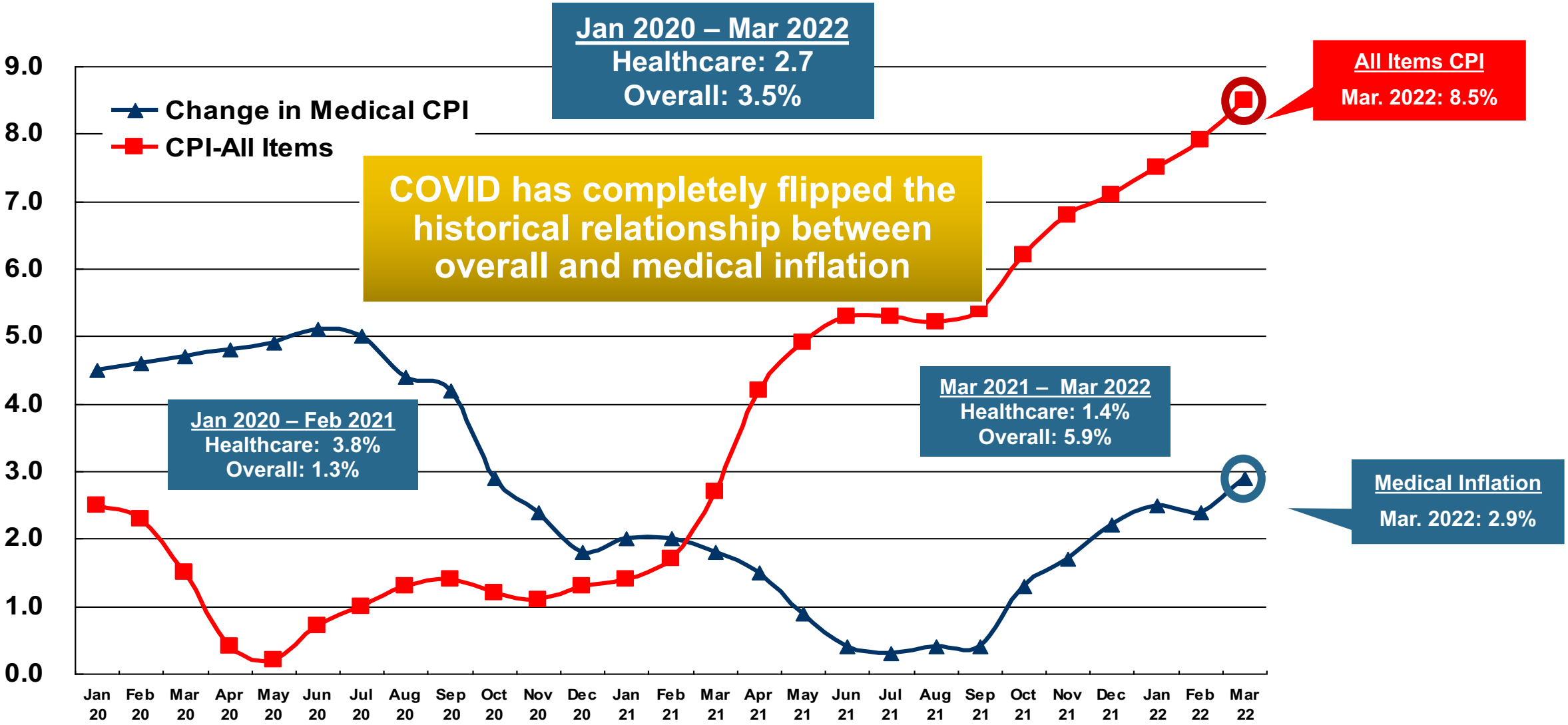


Sources: U.S Bureau of Labor Statistics; Risk and Uncertainty Management Center, University of South Carolina.

Producer Price Index: Lumber and Wood Products, Jan. 2020 – Apr. 2022

Sources: US Bureau of Labor Statistics; Risk and Uncertainty Management Center, University of South Carolina.

Medical Cost Inflation vs. Overall CPI During COVID, Jan. 2020 – Mar. 2022 *(Percent Change from Year Ago)*



Sources: US Bureau of Labor Statistics; Risk and Uncertainty Management Center, University of South Carolina.

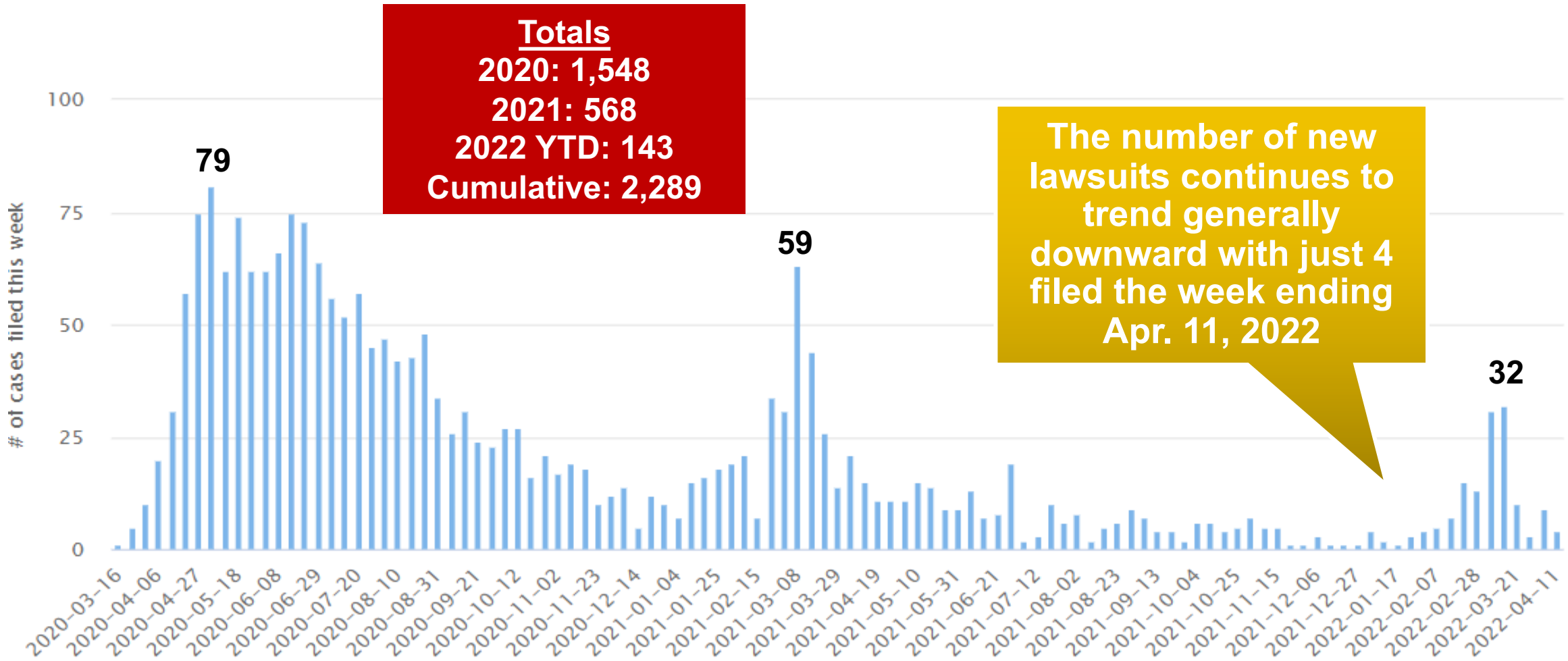
What Has Changed Since the Pandemic?

COVID-19 Changed How Every Industry Operates, Including Insurers

COVID & Business Interruption

Technology Risks

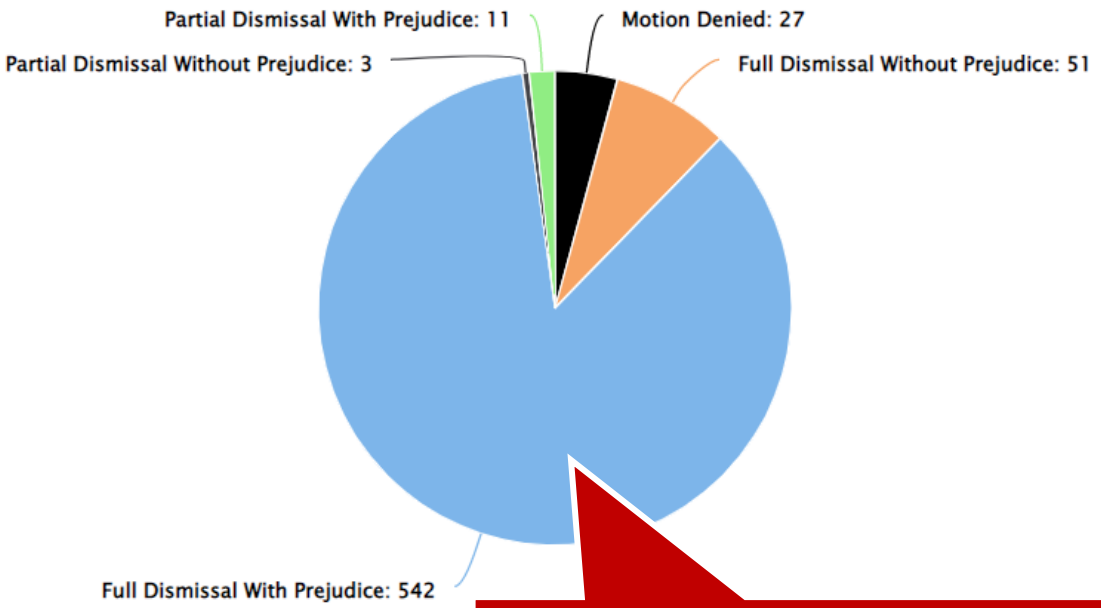
Weekly Number of COVID-Related Lawsuits Filed:
(Weeks Ending Mar. 16, 2020 to Apr. 11, 2022) [Latest Available]



Source: Covid Coverage Litigation Tracker, University of Pennsylvania School of Law. Accessed 5/25/22 at: https://cclt.law.upenn.edu

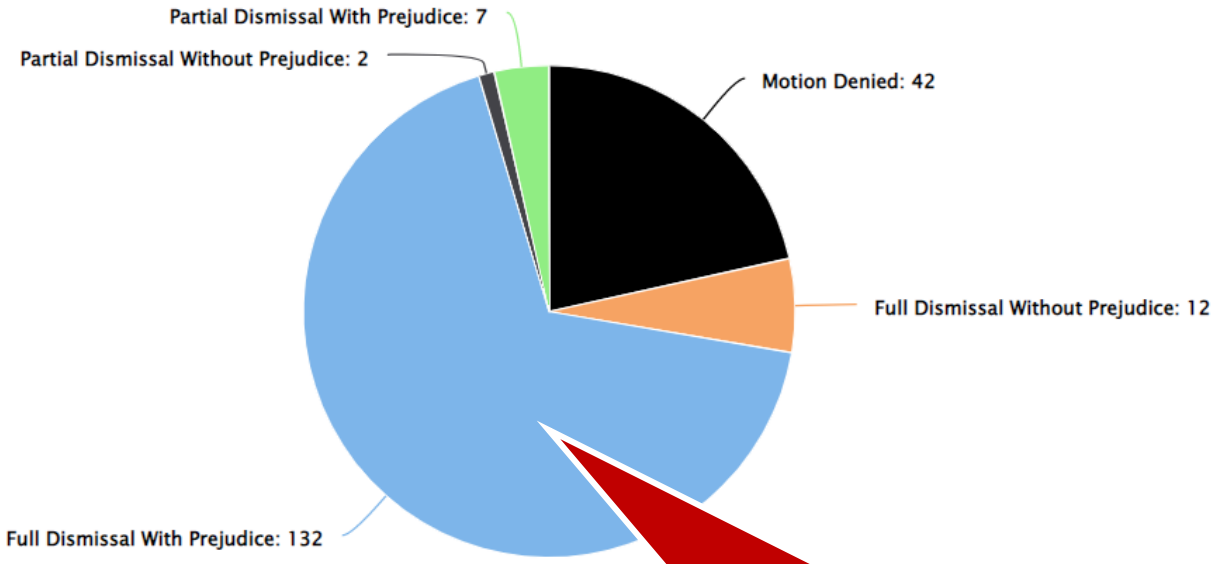
COVID Litigation: Merits Rulings on Motions to Dismiss: Federal vs. State Courts *(Total through Apr 11, 2022) [Latest Available]*

Federal Courts



Insurers have won full dismissals in 94% of federal court cases involving Covid

State Courts



Insurers have won full dismissals in 74% of state court cases involving Covid

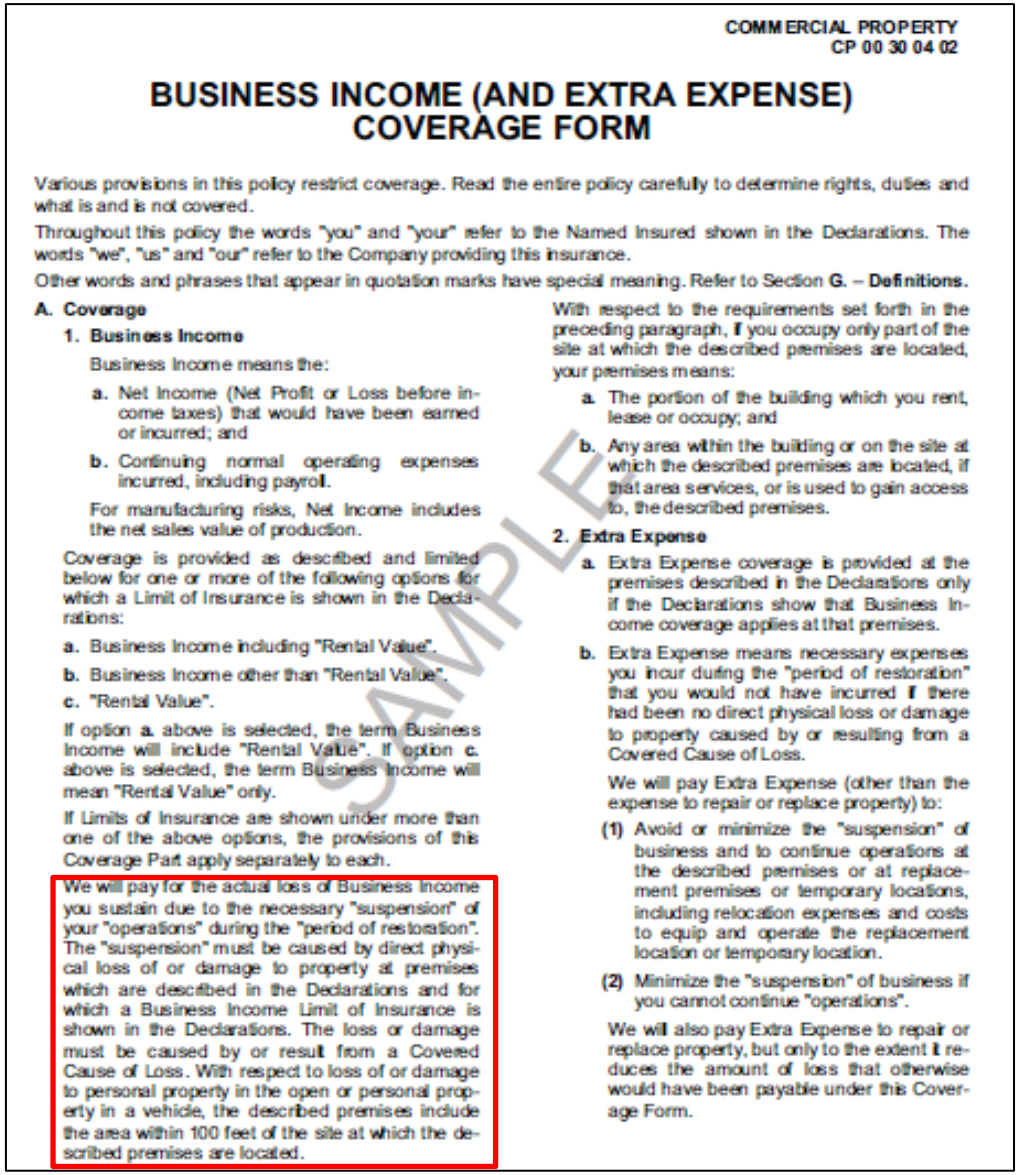
Source: Covid Coverage Litigation Tracker, University of Pennsylvania School of Law. Accessed 5/25/22 at: https://cclt.law.upenn.edu

Business Interruption Coverage (BIC) & COVID-19

- **Business interruption policies clearly exclude COVID-19 claims *and courts agree***

- **The ISO Business Income form contains the following language:**

  - ***"We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration". The "suspension" must be caused by direct physical loss of or damage to property…The loss or damage must be caused by or the result of a covered cause of loss." [from ISO form: CP 00 30 04 02]***



COMMERCIAL PROPERTY
CP 00 30 04 02

BUSINESS INCOME (AND EXTRA EXPENSE) COVERAGE FORM

Various provisions in this policy restrict coverage. Read the entire policy carefully to determine rights, duties and what is and is not covered.

Throughout this policy the words "you" and "your" refer to the Named Insured shown in the Declarations. The words "we", "us" and "our" refer to the Company providing this insurance.

Other words and phrases that appear in quotation marks have special meaning. Refer to Section **G. – Definitions.**

A. Coverage

1. Business Income

Business Income means the:

a. Net Income (Net Profit or Loss before income taxes) that would have been earned or incurred; and

b. Continuing normal operating expenses incurred, including payroll.

For manufacturing risks, Net Income includes the net sales value of production.

Coverage is provided as described and limited below for one or more of the following options for which a Limit of Insurance is shown in the Declarations:

a. Business Income including "Rental Value".

b. Business Income other than "Rental Value".

c. "Rental Value".

If option a. above is selected, the term Business Income will include "Rental Value". If option c. above is selected, the term Business Income will mean "Rental Value" only.

If Limits of Insurance are shown under more than one of the above options, the provisions of this Coverage Part apply separately to each.

We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration". The "suspension" must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations. The loss or damage must be caused by or result from a Covered Cause of Loss. With respect to loss of or damage to personal property in the open or personal property in a vehicle, the described premises include the area within 100 feet of the site at which the described premises are located.

With respect to the requirements set forth in the preceding paragraph, if you occupy only part of the site at which the described premises are located, your premises means:

a. The portion of the building which you rent, lease or occupy; and

b. Any area within the building or on the site at which the described premises are located, if that area services, or is used to gain access to, the described premises.

2. Extra Expense

a. Extra Expense coverage is provided at the premises described in the Declarations only if the Declarations show that Business Income coverage applies at that premises.

b. Extra Expense means necessary expenses you incur during the "period of restoration" that you would not have incurred if there had been no direct physical loss or damage to property caused by or resulting from a Covered Cause of Loss.

We will pay Extra Expense (other than the expense to repair or replace property) to:

(1) Avoid or minimize the "suspension" of business and to continue operations at the described premises or at replacement premises or temporary locations, including relocation expenses and costs to equip and operate the replacement location or temporary location.

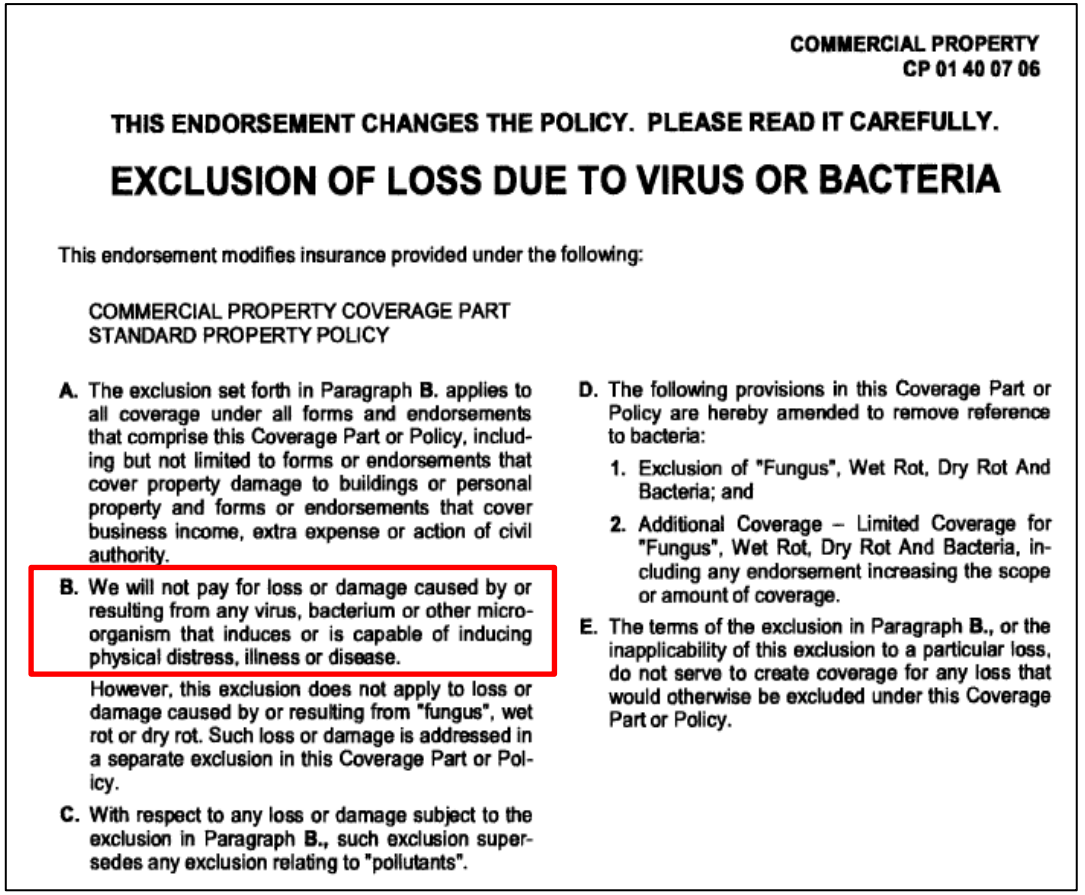
(2) Minimize the "suspension" of business if you cannot continue "operations".

We will also pay Extra Expense to repair or replace property, but only to the extent it reduces the amount of loss that otherwise would have been payable under this Coverage Form.

SAMPLE

Exclusion of Loss Due to Virus or Bacteria

- Business property and hence business interruption coverage also clearly excludes loss or damage due to viruses via exclusion
- *Such exclusions more commonplace now*
- The ISO "Exclusion of Loss Due to Virus or Bacteria" contains the following language:
  - *"We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease."* *[from ISO form: CP 01 40 07 06]*



COMMERCIAL PROPERTY
CP 01 40 07 06

THIS ENDORSEMENT CHANGES THE POLICY. PLEASE READ IT CAREFULLY.

EXCLUSION OF LOSS DUE TO VIRUS OR BACTERIA

This endorsement modifies insurance provided under the following:

COMMERCIAL PROPERTY COVERAGE PART
STANDARD PROPERTY POLICY

A. The exclusion set forth in Paragraph **B.** applies to all coverage under all forms and endorsements that comprise this Coverage Part or Policy, including but not limited to forms or endorsements that cover property damage to buildings or personal property and forms or endorsements that cover business income, extra expense or action of civil authority.

B. We will not pay for loss or damage caused by or resulting from any virus, bacterium or other microorganism that induces or is capable of inducing physical distress, illness or disease.

However, this exclusion does not apply to loss or damage caused by or resulting from "fungus", wet rot or dry rot. Such loss or damage is addressed in a separate exclusion in this Coverage Part or Policy.

C. With respect to any loss or damage subject to the exclusion in Paragraph **B.**, such exclusion supersedes any exclusion relating to "pollutants".

D. The following provisions in this Coverage Part or Policy are hereby amended to remove reference to bacteria:

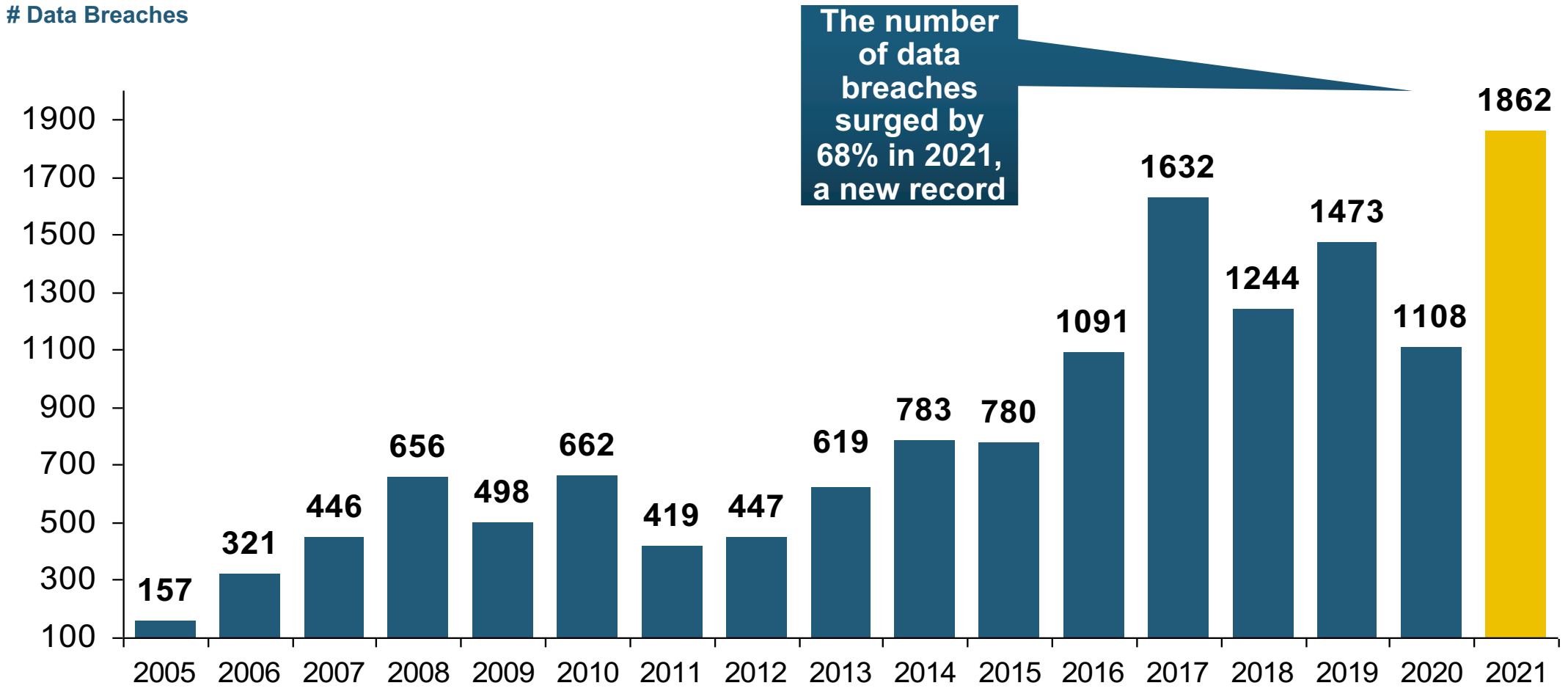
1. Exclusion of "Fungus", Wet Rot, Dry Rot And Bacteria; and
2. Additional Coverage – Limited Coverage for "Fungus", Wet Rot, Dry Rot And Bacteria, including any endorsement increasing the scope or amount of coverage.

E. The terms of the exclusion in Paragraph **B.**, or the inapplicability of this exclusion to a particular loss, do not serve to create coverage for any loss that would otherwise be excluded under this Coverage Part or Policy.

Technology Risks

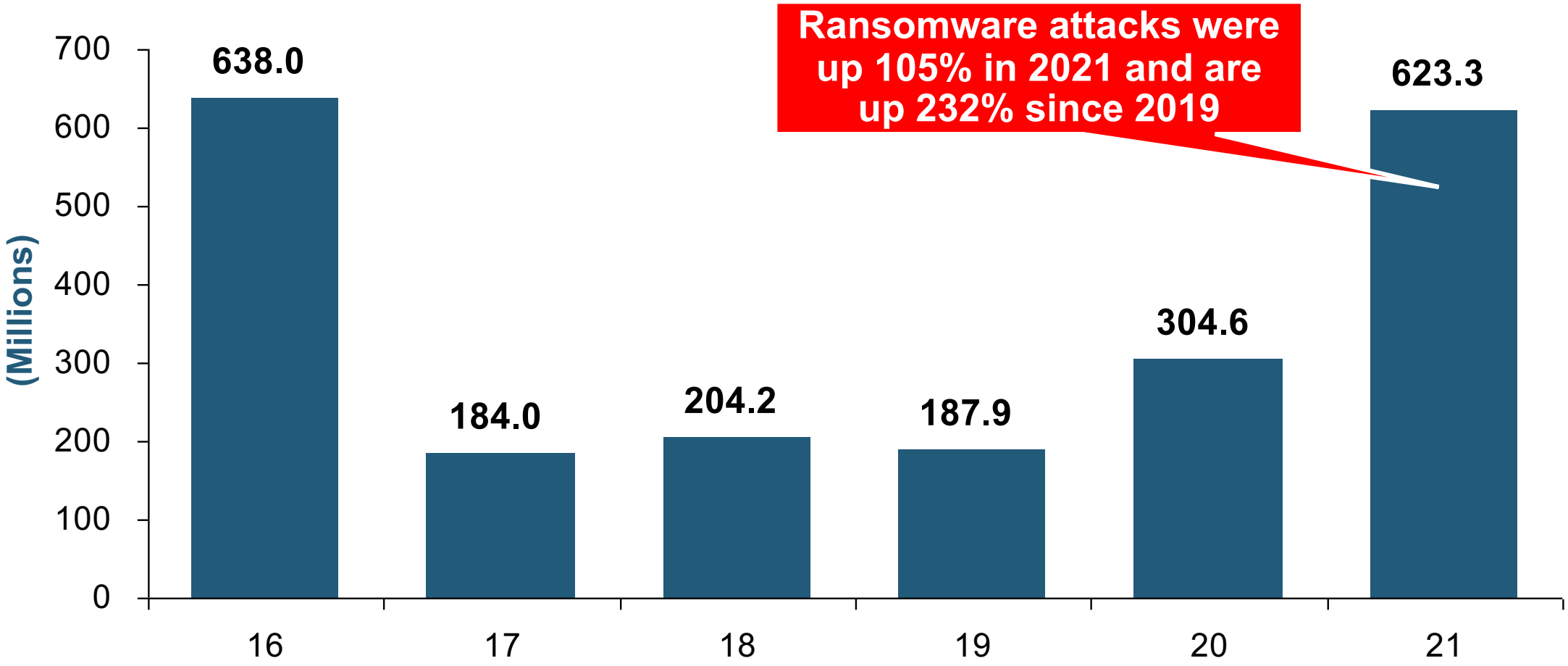
Large Increase in Attacks Leading to a Hardening of the Cyber Insurance Market

Data Breaches 2005-2021, by Number of Breaches (Compromises)



Source: Identity Theft Resource Center, accessed at: https://www.idtheftcenter.org/post/identity-theft-resource-center-2021-annual-data-breach-report-sets-new-record-for-number-of-compromises/ .

Volume of Ransomware Attacks, 2016–2021
(Millions)



Sources: 2022 SonicWall Cyber Threat Report, accessed at: https://www.sonicwall.com/medialibrary/en/white-paper/2022-sonicwall-cyber-threat-report.pdf;
Risk and Uncertainty Management Center, Univ. of South Carolina.

Large Cyber Attacks in 2020 and 2021, the Russia/Ukraine War Are Forcing Changes in Policy Language

- Traditional War Exclusions
- "Physical War" versus "Cyberwar/Cyber Operations"
- Direct War versus Collateral damage on entities that were not the intended targets
- Attribution of the source of the attack
- Attacks by non-state actors associated with a state
- Differing targets of the attack
- Aggregation of cyber risk
- War vs. Terrorism vs. Cyber Terrorism

Source: Adapted from Brown & Brown "*Russia and Ukraine – Cyber Risk Update,*" *at:* https://www.bbrown.com/insight/russia-ukraine-cyber-risk-update/ ;
Risk and Uncertainty Management Center, Univ. of South Carolina.

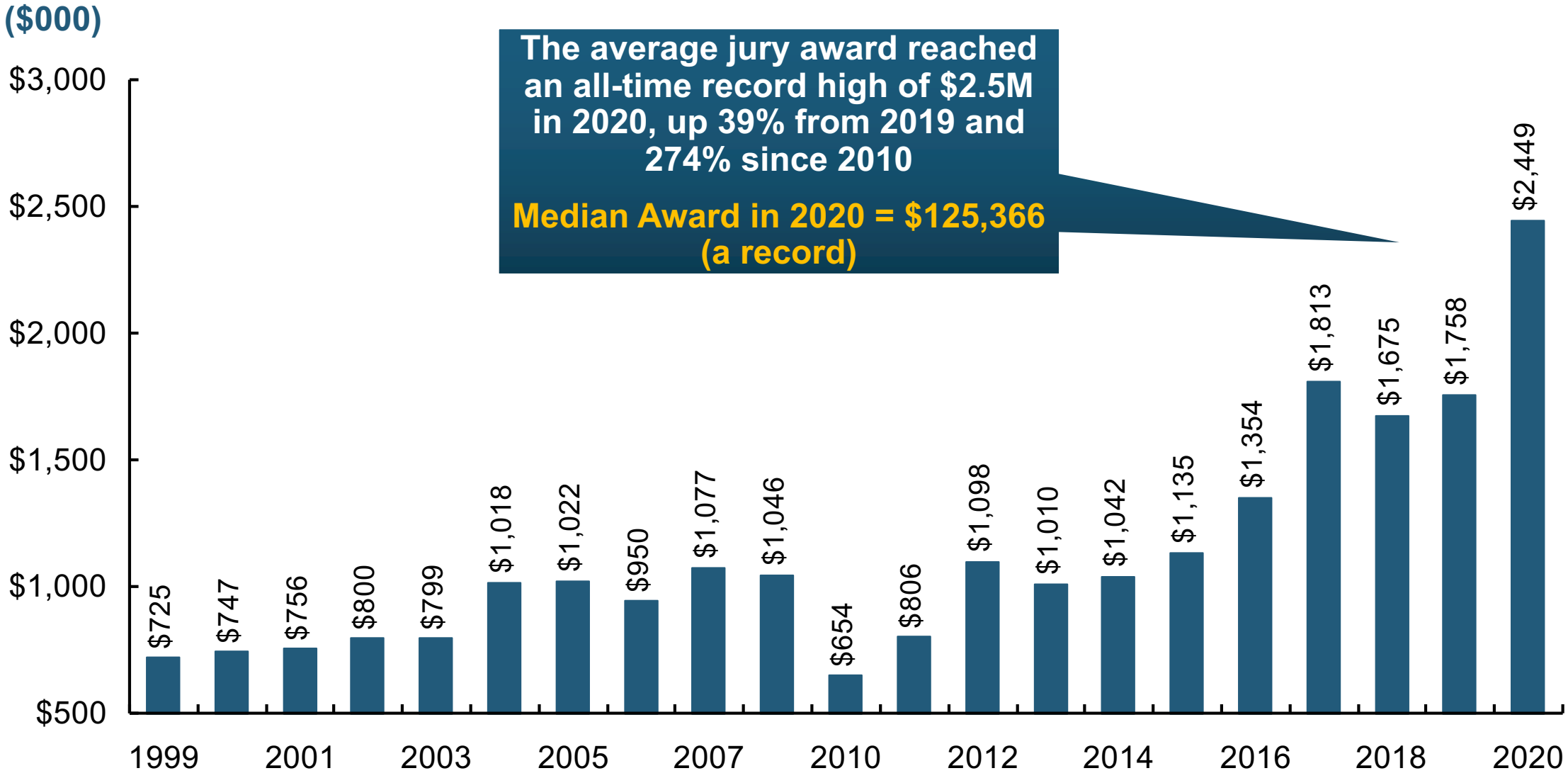
Social Inflation & Litigation Trends

Rising Litigation Costs Are a Concern for Businesses Large and Small—*and Their Insurers*

Major Driver of Rate Across Multiple Lines

42

Average Jury Awards, 1999 – 2020 (latest available)



Source: Jury Verdict Research; *Current Award Trends in Personal Injury* (61st Edition), Thomson Reuters; Risk and Uncertainty Management Center, Univ. of South Carolina.

Drivers of Social Inflation

"Nuclear" verdicts	
From 2014 to 2018, U.S. plaintiff awards have ***almost doubled*** in total dollar amounts, with a few ***exceeding $1 billion***. Plaintiff awards in the commercial trucking industry have increased dramatically in number and size. The American Transportation Research Institute (ATRI), looked at trucking litigation data on 600 cases between in 2006 and 2019. In the first five years, it found 26 cases in which the awards exceeded $1 million; in the last five years, there were nearly 300.	**Lines most affected:** -Commercial auto liability -Product liability -Medical malpractice **Factors thought to contribute:** -Sympathetic jurors, distrust of corporations; -Plaintiffs' attorney use of emotion-driven "reptile brain" tactics; -Attorney advertising and public desensitization to large numbers, leading to a "jackpot mentality" among prospective plaintiffs.

Commerical Auto Liability in the crosshairs

Sources: Insurance Information Institute: https://www.iii.org/article/social-inflation-hard-to-measure-important-to-understand;
Risk and Uncertainty Management Center, University of South Carolina.

Drivers of Social Inflation (continued)

Class actions and litigation funding

Class actions

A 2020 survey found ***class action defense accounted for 11.6 percent of U.S. litigation spending***. A 2019 report by Milliman found a "staggering" rise in the size of ***securities class action settlements***, to $2.4 billion in 2018 from $1.4 billion in 2017. Virtually all proposed mergers and acquisitions involving public companies now trigger lawsuits alleging false and deceptive disclosures to shareholders.

Litigation funding

Litigation funders assume all or part of litigation costs for an agreed-upon percentage of any settlement or judgment. This can allow plaintiffs to employ experts, investigators, and witnesses to develop effective strategies – options once only available to corporate defendants.

1,300+ COVID-19-related employment complaints filed in federal and state courts in 2020.

67 of those were class actions.

Source: Jackson Lewis COVID-19 Employment LitWatch

In response to ethics concerns the American Bar Association's policymaking arm in 2020 approved best practices for firms participating in these deals.

Other Factors Contributing to Social Inflation

- **Elimination of caps on non-economic damage awards in some states**
- **State legislatures dominated by trial bar**

Sources: Insurance Information Institute: https://www.iii.org/article/social-inflation-hard-to-measure-important-to-understand; Risk and Uncertainty Management Center, University of South Carolina.

Why Rate Matters

Inflation, Catastrophes, Litigation, Regulation and Economic Trends Are All Exerting Pressure on Commercial Insurance Markets

Rates Must Reflect Increased Risk, Rising Cost of Doing Business

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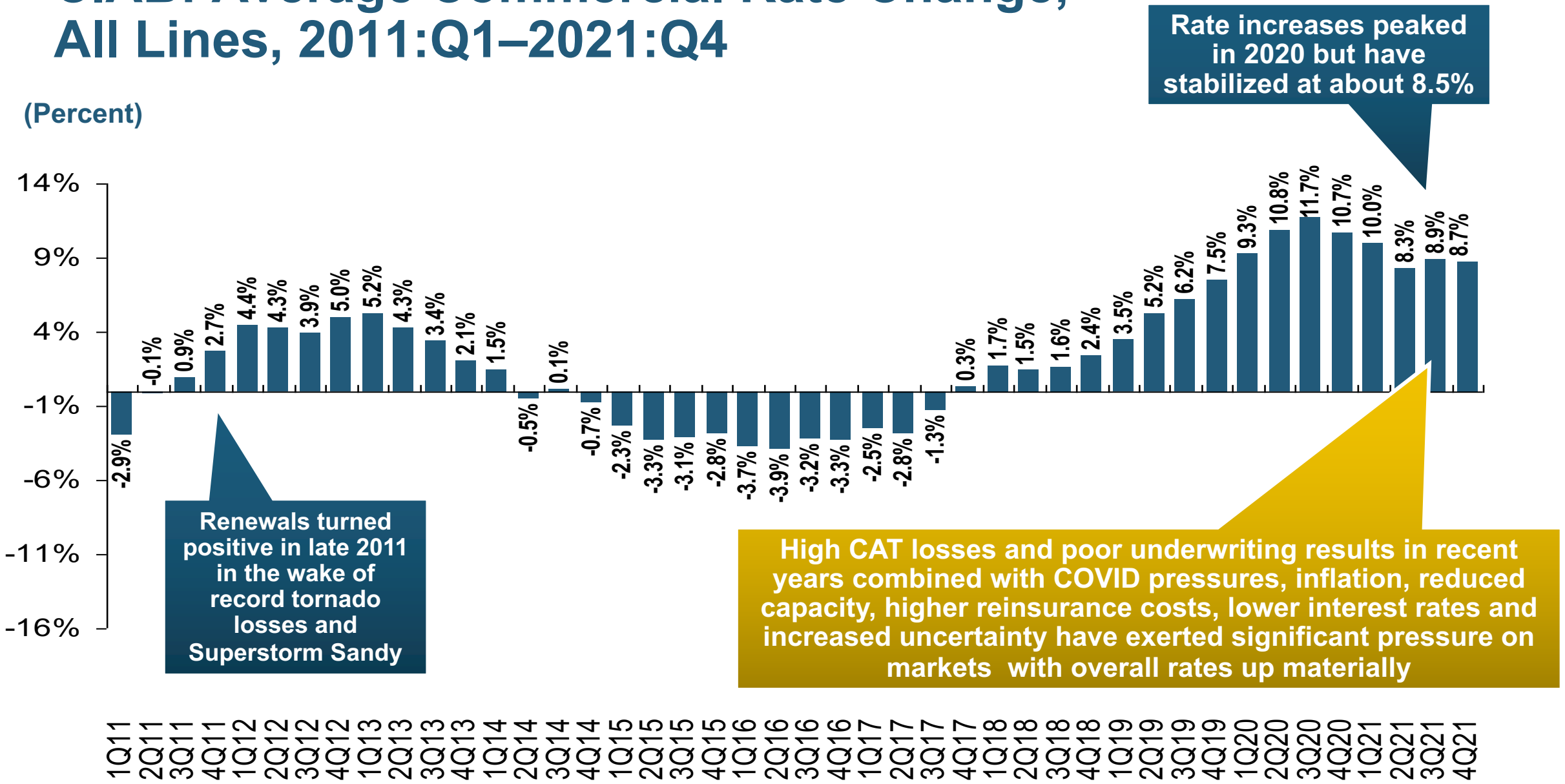
CIAB: Average Commercial Rate Change, All Lines, 2011:Q1–2021:Q4

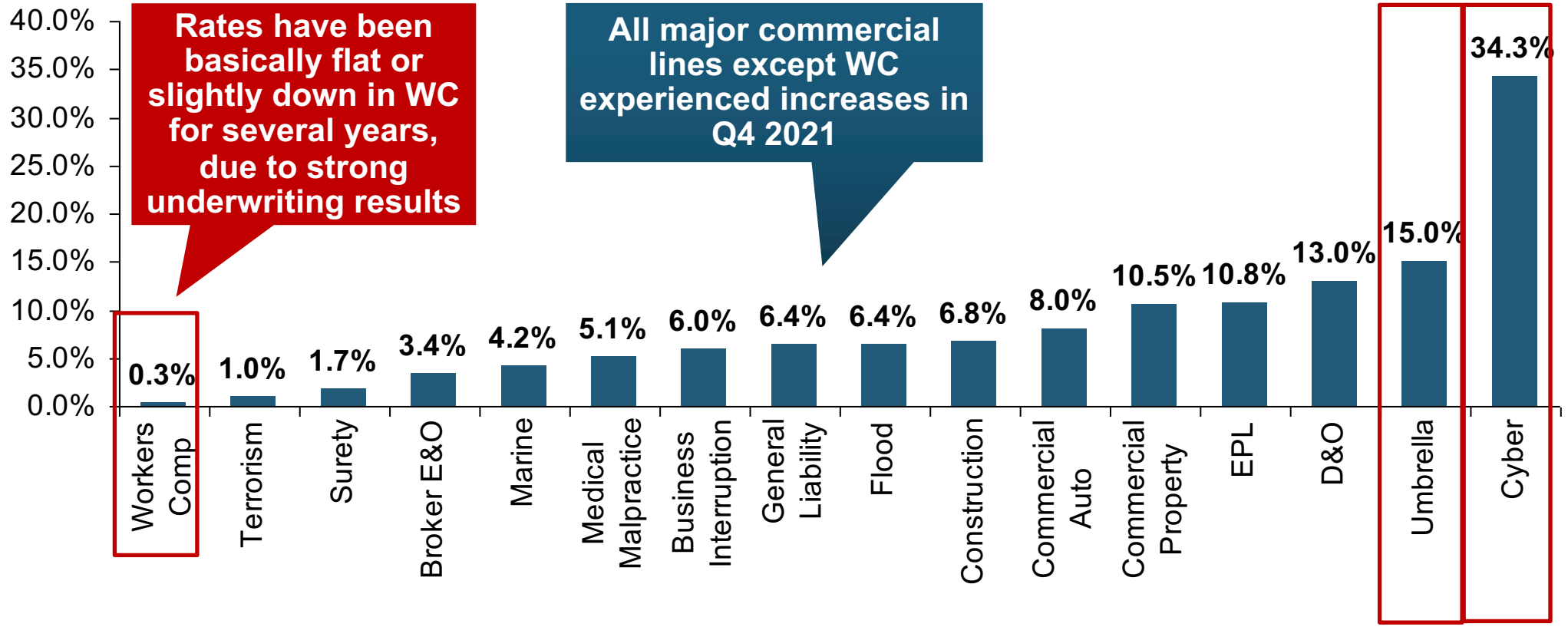


Note: CIAB data cited here are based on a survey. Rate changes earned by individual insurers can and do vary, potentially substantially.
Source: Council of Insurance Agents & Brokers; Center for Risk and Uncertainty Management, Univ. of South Carolina.

Change in Commercial Rate Renewals, by Line: 2021:Q4

Cyber is seeing record increase, in response to major breaches in 2020 and 2021, overtaking Commercial Umbrella

(Percent Change)



Note: CIAB data cited here are based on a survey. Rate changes earned by individual insurers can and do vary, potentially substantially.

Source: Council of Insurance Agents and Brokers; USC Center for Risk and Uncertainty Management.

SUMMARY

- Small Business Concerns Are a Reflection of the Concerns of Americans from Coast to Coast
- Inflation is the #1 Worry of Small Business
- Inflation Is Leading to Material and Persistent Claims Inflation
- Insures Will Necessarily Need to Manage this Risk, Primarily through Rate Adjustment
- Record CAT Losses, Social Inflation Represent Additional Pressures on Many Key Commercial Insurance Lines
- Rate Matters: Rate, Reserve Adequacy Are Key to Maintaining Insurance Market Stability

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