Rate Increases Decelerate in Hardening Market but Take Caution

Insurance coverage is one of the biggest line item expenses for business owners, so knowing what lies ahead is important for sustaining consistent operations. To make informed decisions, having an overall understanding of the market—hard or soft—and where it's headed is critical.

While keeping an eye on emerging risk and trends can be quite daunting, it's a welcome break when indicators move in a favorable direction. The 4Q 2020 slowing of rate increases brought hope that the hardening market might take a turn. For informed expectations and risk management strategy, we look at key trends and what is likely ahead.

SOFT AND HARD MARKETS

In a soft market, insurance companies are concerned about growth, so they are aggressive with terms and conditions—which means they're also aggressive with policy pricing. They lower deductibles and may even include additional coverages. This is a time when competition for new business is high among insurance companies.

In a hard market, insurance companies are concerned about profitability. They raise rates, cut back on coverages offered, and decrease capacity. We're seeing this for larger accounts where insurers are pulling back on the amount of coverage they're willing to offer. The contraction increases demand, which means less competition for insurers. This continues to be a main driver of the hard market.

Currently, we've seen 13 consecutive quarters with increased premiums. Though there has been some slowing of increases in the market, a hardening market with increased pricing and decreased capacity is likely to continue for several reasons: natural disasters, nuclear verdicts, and loss cost trends. With interest rates unable to go much lower, this too plays a part in driving some of the current spike and the likelihood of continued market hardening.

STORM DAMAGE & DEDUCTIBLE IMPACT

Insured losses from Winter Storm Uri have been estimated as high as $20 billion according to catastrophe (CAT) modelers and industry analysts. As more information comes in, that number likely will balloon when all losses are finally calculated. With very low deductibles, the insurance industry is poised to take a big hit.

For many years, storm coverage for property CAT losses, particularly in the Southeast, has contained deductibles based on a percentage of the total insured property value. This leaves the cost of smaller claims and a large portion of bigger claims to be borne by policyholders. However, the Texas storm is unique in that damages from pipes bursting in homes and businesses are not under percentage deductibles but smaller fixed-dollar amounts instead, which means the carriers will bear the brunt of the costs.

For example, a $400,000 home with a 2% wind deductible means an $8,000 deductible. If there is fencing or minor items to replace, the costs of these smaller claims would fall under the deductible threshold. However, when property coverage is under a $500 or $1,000 deductible, thousands of small claims will come into play that otherwise would not have been submitted.

This scenario becomes exacerbated when you consider a commercial building. A $4 million building might carry an $80,000 deductible, with the building owner bearing much of the costs of claims. Outside of the percentage deductible, the carrier pays for the lion's share of the losses, which has an impact on property rates after a large CAT event.

In the Texas storm, roofs were not designed for the weight of the snow and ice, pipes burst, and a warm front followed directly after. This means water was everywhere with a long period of melting. With water, warmer weather, and mold development in the mix, it's going to be a long dig out for Texas. And with an event this large that also is widespread, the cost for repairs goes up exponentially.

In a hurricane, there's often the dispute of whether damage was caused by flood or wind, and most losses shift to the National Flood Insurance Program (NFIP). However, for this storm event, the insurance industry is going to bear not only the impact of high losses and low deductibles but also much higher repair costs.

WORKERS COMPENSATION

After a major workers compensation carrier released significant reserves in the first quarter, it raised the question of whether or not reserve releases would start to accelerate. Other top workers compensation carriers also weighed in with a mixed response of increased rates, decreased reserves, and a position that the line is at or near the bottom.

With response varied across the board, this bears watching because workers compensation has been a saving grace amid the others lines, and it has now seen uncharacteristic rate increases over the last three of quarters.

"Florida filed for a rate decrease for 2021, but nationally, you're starting to see rates go up in workers compensation," said IOA President Jeff Lagos. "We seem to be at a turning point with some carriers pulling out, while others are still very aggressive in the line."

INTEREST RATES

One of the biggest drivers of the hard market is interest rates. Investment income is one of the key vehicles insurance companies use to maintain profitability. Low interest yields have been an accepted reality for some time for insurers and reinsurers, which means a change is required in reserve strategies.

To provide some perspective, in December 1990, interest rates on a 10-year Treasury bill were at 8.22%. As of mid-March 2021, they were hovering around 1.7%, which is up slightly from the prior quarter but still not a significant enough increase. For insurance companies, investment strategies such as using a 100% combined ratio are no longer plausible, and considerable adjustments have had to be made, especially over last two decades.

In Europe, a negative rate policy has been used by some central banks, allowing rates to fall slightly below zero on their bonds. Reuters reported in February 2021 that the Bank of England "did not want to send a signal that it intended to set a negative rate, but regulators should start getting banks like HSBC, Lloyd's, and Barclays ready for the possibility that the policy is implemented in the future." Lenders would need at least six months to be prepared, according to the central bank.

This practice conceivably could happen in the U.S. with the precedent set globally. Lagos said in response, however, "Unless we get into a negative interest rate environment like we see in Europe, pricing increases may slow up, but I don't see that happening any time soon."

SOCIAL INFLATION & NUCLEAR VERDICTS

The rise in social inflation and nuclear verdicts continues to impact premium rates. Nuclear verdicts are those that surpass $10 million, and social inflation is described as "the convergence of societal and legal trends to the tune of increased litigation, broader definition of duty to care, legal decisions tipping in the plaintiff's favor, and larger jury awards," according to AmWins.

For perspective, large awards have even entered the virtual courtroom as well with a $411 million award given for a transportation case in January 2021. In the transportation industry alone, nuclear verdicts are up 300%, according to the American Transportation Research Institute.

COVID-19 IMPACT

Where COVID-19 has caused some issues, it has made commercial auto a bit more profitable. In the past year, trucking and delivery has continued and even seen an uptick, but personal auto traffic was greatly diminished. Personal auto rates also were greatly improved, but the question remains whether there will be a return someday to the same level of congestion seen prior to the pandemic.

Miles driven are now starting to creep toward normal levels as more people begin to hit the road again. As offices open up and go to a hybrid model where employees are in the office two to three days a week, there will be a residual effect on commercial auto as well. However, there will be less people driving and less congested time frames than pre-pandemic.

Other trend considerations revolve around whether new laws, regulations, and policies foreshadow a pro-consumer or pro-business stance and their impact on future market conditions. The landscape currently here appears to be moving quickly, but the true impact on rates may not be known for a couple of quarters due to other larger factors, such as first quarter 2021 CAT losses.

Rate increases still persist, but there are signs that the rate of incline may lessen. Once the full impact of the winter storms is known, it could completely reverse the trend, and underwriters could choose to raise rates any time and at any scale.

"Looking at the insurance companies holistically, you still have pressure from large liability claims, a massive CAT event, and super low interest rates," said Lagos. "One quarter may not constitute a trend, but it certainly bears watching."

THE INSURANCE BROKER'S ROLE

The role of the insurance broker has changed over the years to go beyond brokering transactions to serving as valued advisors, providing education and risk management strategy as well as helping clients manage expectations so they can become better consumers of insurance.

For example, in the past, employee benefits was sold similar to property and casualty insurance. Agents brought in spreadsheets and played with deductibles and premiums, winning business from one agent to another. Today, employee benefits has evolved to encompass all the services around data analytics, health, employee communication, and employee engagement. A broker's goal now is to help clients to be better, wiser consumers, which doesn't necessarily mean trying to get the best price for the year ahead. The aim is to help clients engage their employees and use business practices to help create a long-term bend to the curve of their health insurance spend.

Now that we're looking at a hard market for the next few years, the same change in approach applies to property and casualty. To battle the impending market difficulties, business owners need help becoming better consumers. That's where risk management strategies, such as the use of RiskScore and an effective safety program, will play a pivotal role. These strategies aid in identifying and implementing practices that the insurance industry agrees will help bend their loss curve long term.

When you look at what drives insurance pricing, it's a function of what you do, how big you are, and how you run your business. An insurance broker must be able to explain to the insurance companies, for example, that not all restaurants are equal, and their client is better than average, and then demonstrate why.

Based on what the insurance companies have told us, RiskScore has a real impact on claims long term. Why? Utilizing the information revealed through RiskScore and working with our risk services division demonstrates a commitment to ongoing safety, onboarding people the right way, and training team members correctly. Over the long haul, these business owners are going to be better risks than those who ignore these disciplines.

ADDRESSING A HARD MARKET

An understanding of where there is control over key areas is critical when addressing a hard market smartly. It breaks down this way:

1. Business owners control their company's products and services.
2. Business owners control the size of their business.
3. Business owners control their processes.
4. Insurance companies control policy coverages, rates, and capacity based on marketplace conditions, which are not under their control.
5. Insurance brokers in their advisory and advocacy capacity can aid in risk mitigation practices, help educate on marketplace conditions, and bridge the gap between insurance companies and business owners.

Based on a company's products, services, and size, insurance brokers negotiate terms and conditions (deductibles and coverages) for their clients. When brokers help with risk management and loss control processes, such as with RiskScore®, their clients are going to pay best-in-class rates. Though rates may be going up because of market conditions, they're going to go up less than they would have if they were not best in class. They've become a better risk for the insurance companies.

How it all unwinds over the coming months and years is the billion-dollar question. At IOA, we continue to monitor developments to better serve our clients. Working together, knowing what you can control and where to find the help you need is how we fight this hard market.