ANTHONY JONES
INSURANCE BROKERS

Overview

The Insurance Pricing Cycle - Soft and Hard Market Conditions

Introduction

Insurance pricing goes through cycles driven by the supply and demand for insurance cover on a global scale. It alternates between periods of 'soft' and 'hard' market conditions.

In a 'hard' market – insurance is harder to place, and premiums increase. We have experienced hard market conditions over the past four years. All insurers have been addressing profitability issues across entire portfolios generally and individual lines of business specifically. We have seen extreme rate increases, cover refusals and cover restrictions against a backdrop of wider business inflationary cost pressures such as labour supply, wages, raw materials, and energy/fuel costs.

In a 'soft' market, premiums are stable or falling, and insurance is more readily available. Usual rules of supply and demand apply - new capital enters the market, causing it to soften. In 2019, after two poor years of results and falling returns, insurers started to increase prices. Some of this was voluntary but some was imposed by regulators concerned that the solvency of the industry was being impaired by consistent rate inadequacy. The pace increased sharply through 2020 explained in part by the Covid-19 pandemic and insurers' reactions to it.

Overview

We expect to see a flattening of rate increases from insurers from now to the end of the year. The rate of increase will slow but nevertheless rate rises should be expected, and we are a long way from "given" rate reductions or a return to soft market conditions. Some clients are seeing substantial premium increases due to sector, claims, product line or risk management standards but the tide has now finally turned towards stability.

Insurers are being a lot more selective about the brokers they wish to support, trading with brokers they trust and are competing for clients where they believe the risk management processes and risk mitigations will allow for long term profitability with less of a focus on the underlying rates alone. In turn, this has led to incumbent insurers looking to protect their market share by defending their accounts from competition by minimising rate increases and looking to incentivise loyalty with the return of Rate Stability Agreements, Low Claims Rebates and Risk Management Bursaries.

Brokers who are close to clients can differentiate their clients to underwriters through long term partnerships around risk attitudes and actions. The ability to work on claims understanding, reserves and defensibility being absolutely part of that partnership.

The insurance industry is under pressure from customers, regulators and indeed us as brokers. Insurer service is weak generally with access to underwriters and speed of response being of concern but claims service being the most discussed. Standards need to be re set and adhered to by many insurers where "customer focus" is top for those who want to be successful but are failing to deliver. Customer expectations are rising, and insurer brand is a critical part of choice.

How do insurers make money?

Insurance companies aim to make an underwriting profit. To do this they must keep their combined ratio below 100%. This is made up of 3 components:

- The cost of claims or loss ratio.
- The costs to acquire the business or commission ratio.
- The costs the insurer incurs to service the business or the expense ratio.

In other words, for every £1 of premium they collect, the sum of the claim's costs, commissions and the insurers expenses must be less than £1 to achieve an underwriting profit. A 100% combined ratio means breakeven and gives a negligible return on the amount of regulatory capital an insurer must hold to support its underwriting activities.

Are insurers making any money?

There has been improvement in overall underwriting performance in 2022 as issues with higher inflation, higher natural events, less favourable prior years' reserve development and higher motor claims frequency were addressed with rating increases.

Aviva, RSA, Allianz, AXA, Travelers and Zurich were all below 95% for 2022 and both Chubb and AIG below 90%. The London market represented by Lloyd's of London is reporting 92.2% for 2021 and 91.4% for 2022, compared to 102.1% in 2019 and 110.3% in 2020.

A 95% combined ratio – which many insurers target – would deliver an approximate 8% return on capital.

Claims inflation costs are concerning the insurance sector. In June 2023 the Prudential Regulation Authority has written to insurers flagging the need to monitor the impact to reserves from ongoing claims inflation, and act accordingly.

"There is a risk that persistently elevated claims inflation might result in a material deterioration of solvency coverage for some firms unless they take appropriate mitigating actions."

One thing in favour of insurers is rising interest rates. Investment opportunities of premium taken in have moved in the right direction, but few will think this has a material difference to risk selection and better underwriting decisions. We do not see a return to “Cashflow Underwriting” – a feature of previous soft markets where insurers buy in business knowing that the rates they are charging are below economical in the hope they can raise rates substantially in the future.

Insurers remain highly selective – some areas of focus:

- Trades with high fire hazard are seen as unattractive, including food, waste, timber, tyres, paper, plastics, and chemicals, along with risks that are not protected by adequate protections.

- Liability risks with significant injury/damage potential or with long tail claims development or with potential for frequent low-level claims, typically public liability where lots of people are a feature. Some products liability areas where rights of recourse are almost impossible – i.e., China.

- Motor fleet with heavier exposures are still seeing increases due to increased loss potential and a lack of market competition. For Motor, this includes Haulage and Logistics, Couriers and Motor Trade, and Self-Drive Hire fleets. More broadly, claims cost inflation for motor insurers is driving rate increases and tighter risk selection. The uptick in theft and fraud nationally adds to issues.

- Whilst Directors and Officers liability pricing has stabilised over the last year, there is a reluctance for insurers to go too far with such a long tail account. Environmental, Social and Governance (ESG) pressures bring scrutiny from shareholders and the public. Covid related insolvency claims against directors are just becoming more evident. Employment practice claims remain prominent.

- Cyber insurance buyers are benefiting from better understanding of supply chain attacks and ransomware specifically and increased focus on organisations investing in and implementing adequate and suitable security controls and procedures to minimise and mitigate the threat of a Cyber-attack.

Macro Issues

Weather and Climate Change

Natural catastrophes in the UK and globally are an obvious feature affecting property insurance buyers and insurers. Insured claims for 2022 exceeding $132bn (the past 10-year average is $81bn).

Insurers act like a bookmaker – they limit financial exposure by buying insurance protection themselves in the form of reinsurance. The levels of losses have caused prices to rise considerably and whilst rates at the half year 2023 have stabilised there is no sign of reduced pricing. We are not seeing rate decreases for even the best managed risks.

Inflation

Inflation is affecting several lines of business.

1. **Property and Business Interruption**

   Due to building material price increases and building cost inflation we see insurers uplifting the indexation they are using on property insurance. To understand the cost to rebuild, brokers and underwriters are reviewing sums insured to reflect the cost and speed issues in dealing with a property loss. If you add to the mix the globalised localised impact of weather-related losses to the supply chain and again properties exposed to weather in densely populated UK areas, you do indeed have the perfect storm.

   A periodic professional valuation of buildings and plant to provide an accurate reinstatement cost assessment for insurance purposes should be carried out.

   Underinsurance can have disastrous consequences for any business suffering a major property damage claim, as their insurance will not fully cover the loss, threatening their ongoing viability.

2. **Motor Fleet**

   Motor Fleet claims inflation continues to increase rapidly at 9.3% in 2022 (Claim Metrics) with a peak of 15.2% in June 2022. Increases in the costs of materials and labour, alongside a rise in energy prices, have all impacted claims costs. Add to these shortages of new vehicles, rising theft losses of high value vehicles and the challenges of repairing new technology and all of this is expected to feed into future premium pricing. With inflation expected to remain high for the foreseeable future, EY expects losses to continue in 2023, and forecasts a Net Combined Ratio of 108.5% this year.

3. **Liability**

   Liability remains impacted by changes to the Ogden Discount Rate in 2017 and 2019, whilst social cost inflation continues with medical advancements and higher damages awarded for care provision, NHS compensation costs rising faster than inflation and wider exposure to emerging psychological risks such as mental health, abuse and discrimination. Inflation is pushing up claim pay-outs, including loss of income costs, as wages increase. It's also driving up the cost of legal and other services. Liability claims inflation continues to exceed the underlying Consumer Pricing Index rate and insurers are generally aspiring to rate uplifts of around 10% to keep pace.

Coverage

Policy coverage has reduced significantly since 2018 and especially since 2021, much to the detriment of clients. Insurers learned lessons from the financial and reputational impact of unclear coverage arising from the Covid pandemic and took advantage of a limited supply of market capacity to restrict their coverage. Any event that would cause a wide-ranging impact which is not reasonably quantifiable is now often excluded, with non-damage coverage business interruption policies being the obvious example.

Liability coverage for mental injury, anguish and nervous shock is bit by bit being restricted – often now when it is resultant from physical bodily injury.

Look also to cyber insurance. Insurers are looking to exclude systemic events affecting the internet. From March 2023, all Cyber policies "must exclude liability for losses arising from any state backed cyber-attack" (Lloyd's of London, 2023).
Property and Casualty insurers also cannot accept exposure to Russia (or Belarus) in view of its invasion of Ukraine and subsequent increased sanctions, nor in Ukraine itself in view of the perils. These are targeted exclusions which is very different to the entire sections of Business Interruption coverage the market saw removed immediately following the pandemic, when we witnessed the emergence of blanket Communicable Disease (LMA5393) and Cyber (LMA5400) exclusions.

Environmental, Social, and Governance (ESG)

There is an increased expectation that companies will actively address ESG considerations in their structures and operations. Those failing to address these issues may risk ESG-related litigation which may impact Directors' and Officers' liability risk.

Failure to carry out fiduciary duties related to climate change, supply chain assessments and disclosure requirements are also increasing resulting in companies being accountable to regulators, customers, employees, and investors.