PROLINK

Canada's Insurance Connection

THE INSURANCE PENDULUM: WHAT'S A HARD MARKET?

2020

How can businesses make the best out of the hard market?

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INTRODUCTION

Insurance pricing has been on the rise for a while now, with widespread premium hikes across all types of insurance. After years of stable or even decreasing premiums and ever broadening coverage, commercial insurance companies have had to react to a profit crunch.

This “hardening” of the market, with lower risk tolerance, higher rates and tighter acceptance criteria, has not occurred in over a decade. Canadian businesses are struggling to navigate this unfamiliar environment.

Before we get into hard markets, let’s quickly refresh how insurance works. Insurance is designed as a way to transfer financial risk away from individuals and/or businesses into a community risk pool.

Buyers of insurance contribute to the pool by paying a premium. When a loss occurs, the insurance company accesses the collective pool to pay for that loss. The contributions of many fund the losses of a few.

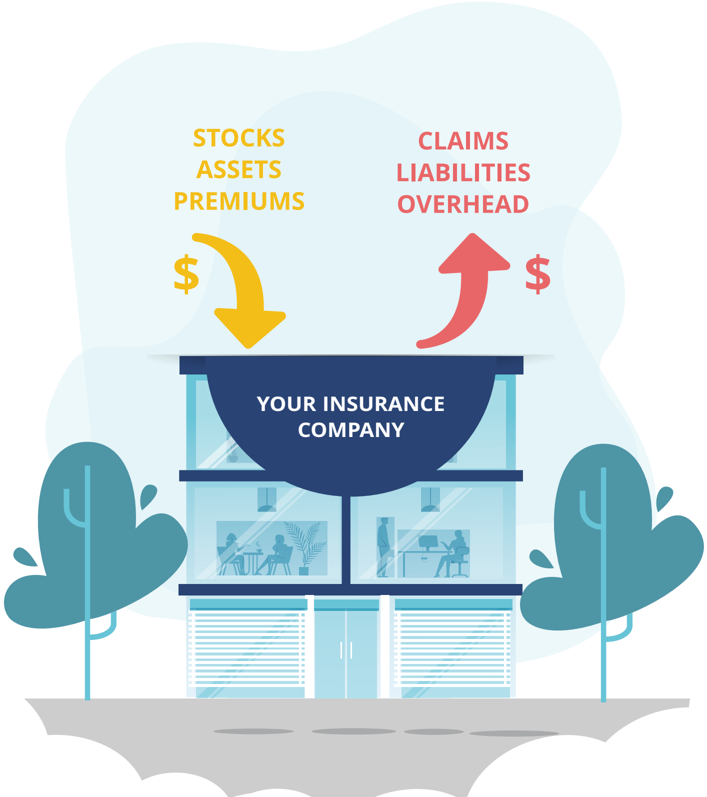

FIGURE 1. The insurance risk pool uses incoming funds to pay claims, overhead costs, and other liabilities.

So why are rates up? How long will it last? And what does it mean for your business?

IN THIS REPORT, DISCOVER:

1. How the insurance industry defines a hard market;
2. Which factors create a hard market;
3. What the future looks like in the insurance industry, particularly after the pandemic;
4. What the implications are for your commercial insurance;
5. What you can do to successfully navigate the hard market.

SO WHAT'S A HARD MARKET?

LIKE A PENDULUM, THE INSURANCE MARKET SWINGS BETWEEN SOFT AND HARD MARKETS EVERY FEW YEARS.

When the market is soft, insurance companies seek to expand. In a good economy, there's a greater capacity to take on risks, and coverage is widely available. Insurance companies are more willing to relax underwriting criteria to write more clients and grow revenue. For clients, that means attractive policy terms, flexible contracts, and lower premiums. Increased competition between insurers reduces rates even further; companies can afford to charge less because they're making high returns on investment income. These conditions are known as a **SOFT MARKET**, or a buyer's market.

A **HARD MARKET**, or a seller's market, is quite the opposite. With more losses and low returns on investments, the capital to fund transactions isn't as readily available and insurers are reluctant to take on risks. To protect existing clients and ensure there is adequate financial security to pay for claims, insurance companies have to **tighten underwriting rules, restrict coverage, and raise premiums.** The result is less coverage to go around to meet the high demand for insurance.

The cycle softens over time as carriers' high rates and selectivity balance out the premiums collected against the claims paid out.

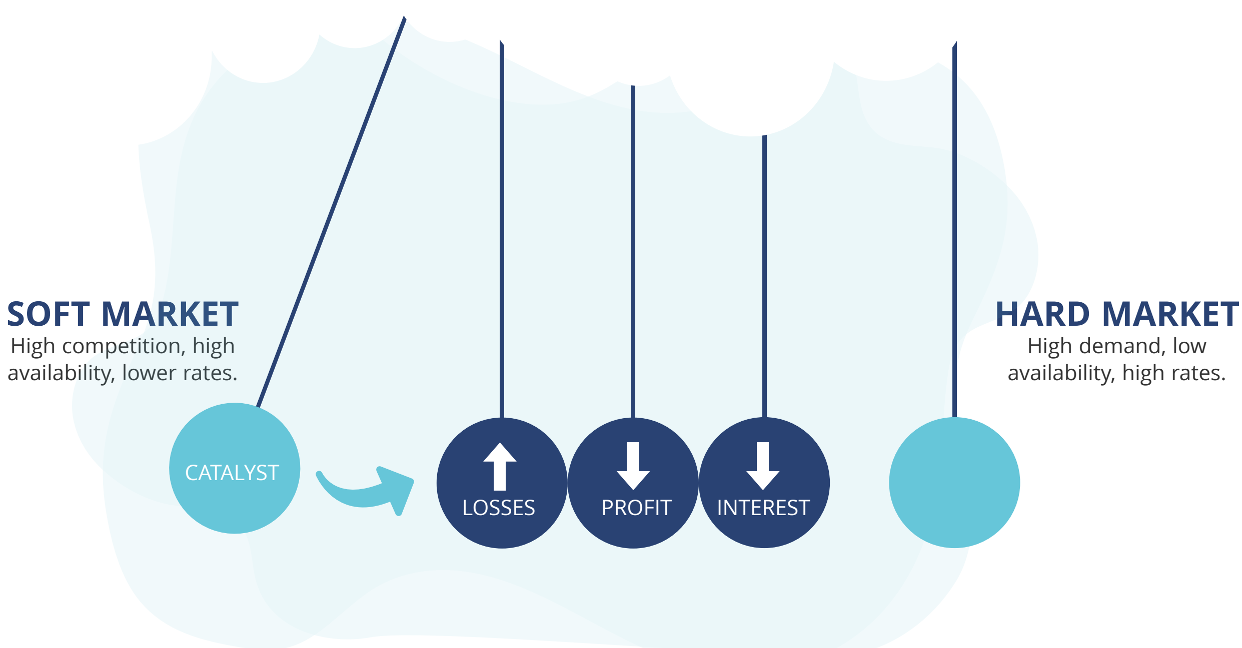

FIGURE 2. The insurance market is cyclical in nature. Increased losses, decreased underwriting profit, and negative interest are catalysts for a hard market. Eventually, stringent risk selection, higher premiums, and market stability promote higher interest, higher profits, and decreased losses, resetting the market.

WHAT'S DRIVING THE HARD MARKET?

Insurance companies use a combination of underwriting profit from premium revenue and investment income to pay for losses. And right now, insurers, by and large, simply aren't making enough money to cover the rising cost of claims. There are many contributing factors, but the three of the biggest drivers are: higher-than-expected losses, low underwriting profit, and low interest rates.

FACTOR 1. HIGHER LOSSES AMONG INSUREDS

Claims have been growing in frequency and severity year over year, with higher-than-expected losses among insureds. In 2018 alone, insurance companies paid out a total of $6.5 billion and $3.7 billion in claims for commercial property and liability insurance respectively. The hardest hit sectors? Commercial General Liability (CGL), Directors & Officers Liability (D&O), and Commercial Property.

FIGURE 3. The losses incurred by insurance companies in 2018 alone.

Why are claims up? Social trends are a key factor in CGL and D&O claims. In an increasingly litigious society, companies are being held accountable both for conventional hazards (e.g. bodily injury, property damage, auto accidents) as well as unforeseen issues (e.g. social ills, harassment, environmental damage) more than ever before. And with public sentiment toward larger businesses and corporations becoming more negative, attorneys are keen to take claims to trial. The result? Profuse litigation, high settlements, and higher claims payouts in legal fees and compensatory damages.

Climate change is another reason. Record-breaking numbers of catastrophic weather events nationwide have led to extensive property repairs and more accidents. In 2019, the Insurance Bureau of Canada (IBC) reported $1.3 billion dollars worth of insured damage caused by intense flooding, rain, snow, and windstorms. Costly disasters are compounding losses for insurers and if they continue, premium hikes will follow.

FIGURE 4. The factors causing increased losses (claims) for insurers.

FACTOR 2. LOW UNDERWRITING PROFIT

An insurance company's profitability and financial health is determined by a value known as the **COMBINED RATIO**. The combined ratio is calculated by measuring incurred losses and expenses against the total collected premiums over a period of time.

$$\frac{\textbf{INCURRED LOSSES}}{\textbf{COLLECTED PREMIUM}}$$

This value is usually reported as a percentage: the lower the ratio (below 100%), the healthier the insurer and the higher its underwriting profit. In contrast, a high ratio (above 100%) means that the company is paying out more in claims and overhead expenses than it's collecting in premium revenue.

When investment returns are strong, the industry's combined ratio can remain in the 105% to 112% range for a few years before a hard market develops**.** But a persistently poor investment environment can induce a hard market at even lower combined ratios. The average combined ratio of Canadian property and casualty insurers has been inching upwards for the last few years, reaching 98.6% in 2018. The industry average for 2019 isn't available yet, but several insurance companies, like Economical and Lloyd's, **have already posted percentages in the early hundreds in the first quarter of 2020.**

FACTOR 3. LOW INTEREST RATES

Nearly every insurance carrier uses the funds collected from premiums by investing in other markets, like stocks, bonds, and other interest-sensitive assets. That means a combined ratio slightly over 100% doesn't necessarily make a company unprofitable if their investments are paying off. Even so, changes in interest rates have the potential to significantly reduce or eliminate insurers' investment income altogether.

Interest rates are used by central banks and other monetary authorities to either stimulate or inhibit economic growth. During periods of economic decline, businesses tend to hold onto money instead of spending or lending it. To boost the economy and prevent further deflation, banks lower interest rates, which encourages borrowing and investment. When the market gets too hot and runs the risk of inflation, banks then increase rates to discourage borrowing.

Central banks slashed rates after the 2008-09 financial crisis and haven't restored them back to pre-recession status. Nearly a decade of persistently low rates has considerably reduced insurers' investment income and with it, their appetite for risk.

THE KEY TAKEAWAY?

The market is hardening because:

1. Claims are rising in frequency and severity with higher payouts all-around.

2. Years of price reductions and heavy loss trends across the commercial liability marketplace are negatively impacting underwriting profit.

3. Low interest rates are curbing investment income and underwriting losses are eating into the returns.

The heart of the matter is: insurance companies are paying out more money than they can get back in premiums and investments. To offset these challenges, carriers are being much more cautious about what risks they can take on. They're pulling back on coverage, lowering limits, and raising premiums. And until the insurance industry starts making money again—fewer claims, lower payouts, higher returns—rates will keep climbing upwards.

A hard market seems like an opportunistic way for insurers' to make more money off of buyers. But these actions are essential and entirely remedial in nature, intended only to: **protect existing clients; correct years of significant losses; and finally, improve the overall health of the insurance industry.**

WHAT'S ON THE HORIZON?

After a few tough years, the Canadian insurance industry as a whole continues to operate at a loss in all types of insurance. With billions of dollars in claims far outpacing premiums and investments, the industry was experiencing a hard market in 2019 and into the first quarter of 2020.

These conditions will, no doubt, persist with the outbreak of COVID-19. While the true impact of the pandemic is yet to be seen, the ongoing effect of global uncertainty and the shutdown of the economy will likely extend the hard market beyond what was originally anticipated well into 2021.

THE PANDEMIC FACTOR

However, insurers cannot rely on rising premium rates alone to overcome this gap as coronavirus-related losses continue to materialize. Here's why:

1	**PRICING RELIEF:** According to Intact, pricing relief offered to Canadians facing financial difficulty may have the boomerang effect of increasing rates for the rest of the year.
2	**MORE BANKRUPTICES:** Bankruptcies yield more claims. Even before the coronavirus struck, the D&O market was facing a record number of shareholder class action lawsuits. As the economy slows, businesses close down, and executives face blame for decisions related to the pandemic, the market will only worsen. Lloyds estimates that COVID-19 will ultimately cost the global insurance industry over $100 billion.
3	**DETERIORATING INVESTMENT INCOME:** Banks have once again set their interest rates close to 0% in an attempt to forestall the impending financial fallout of the pandemic. Depending on the severity of claims going forward, a market correction of this kind may take years to rebound.

THE (PARTIAL) SILVER LINING

The good news? The suspension of courts will lead to longer wait times for pending civil actions. And even when courts reopen, they'll attend to criminal matters before civil matters. This delay might encourage attorneys and juries to be more amenable to negotiated settlements, resulting in lower claims payouts.

Even better news? The insurance industry is strong and well-positioned to deliver. After all, the industry is built in a way to sustain people and organizations through the worst of times. The rapidly changing nature of the pandemic makes market changes difficult to predict, but one thing's certain: insurance companies and brokers are doing everything they can to accommodate clients and ensure everyone is adequately protected amid these extenuating circumstances.

WHAT DOES A HARD MARKET MEAN FOR YOU?

Even the most prepared organizations will have to adapt to the hard market. Overall, businesses can expect to face:

HIGHER PREMIUMS: Sustained rate increases across all lines and all insurers. You might notice a spike in your premium at renewal time, this year and next.

REDUCED COVERAGE: Carriers may not have the capacity to offer the same level of coverage going forward. Many will be looking to rein in or shed non-core or poorly performing risks and redeploy their capital more effectively elsewhere.

STRICTER UNDERWRITING CRITERIA: Insurance companies will be very selective about the types of risks they can cover. You may be asked for more information regarding your business's risk profile, claims history, and characteristics.

FEWER INSURANCE OPTIONS: Less competition amongst insurers means it might be more difficult to find affordable terms, renew your current policy, or make changes to your existing coverage, especially when it comes to specialty items.

HOW CAN YOU PROTECT YOUR BUSINESS?

The hard market is here to stay for the foreseeable future. While you may need to be prepared for some rate increases, there are several practical steps you can take in the meantime to trim down your costs and bolster your risk profile.

1. REVIEW YOUR COVERAGE

Take the time to go over your policy, preferably with an expert, and make sure you're not over- or under-insured. Review your cancellation clauses, premium provisions, and exclusions. Ensure that your business's greatest exposures are covered. Plus, the better you know your policy terms, the more closely you can stick to them and lower your chances of non-renewal or cancellation.

2. MANAGE YOUR RISKS

Show your insurance provider that you're serious about protecting yourself. Be strategic about risk management. Reassess your loss prevention practices. Keep employees informed on potential exposures and how to avoid them. Maintain detailed business records—this will be critical in the event of an audit. Comply with all governmental orders regarding business operations; for more information on best practices for re-opening your business, click here. **Remember, the cheapest loss is the one avoided**. And being proactive about safety is never a bad thing—for your business and for your premium.

3. BE TRANSPARENT

Transparency is key. Insurers will be critical when reviewing loss trends so try to provide them with as much information as possible. Be prepared to explain, very clearly, all the factors leading up to a specific loss and what steps you've taken to mitigate the risk of recurrence. Communicate where you are in the budget process. Alert your insurers to material changes in your operations so as not to jeopardize your coverages.

4. BE A GOOD CLIENT

Insurance companies pay attention to details and your premium is likelier to stay reasonable if you're a diligent and reliable client. So be sure to comply with all policy conditions, especially warranties and vacancy clauses. Start the renewal process a little earlier this year and submit your application well before the deadline, especially if you need to adjust your coverage.
And be patient if your insurer is taking time to get back to you—given the circumstances, underwriting decisions might take longer than expected.

5. DON'T MISS PAYMENTS

Be cognizant of your company's financials and be vigilant about paying your bill. One of the biggest drivers of higher insurance rates is when a client has a cancellation from non-payment. Even worse? Getting cancelled for missing insurance payments means you'll be stuck with high rates for years to come.

6. PLAN AHEAD

Premium increases will be unavoidable for the next little while. Plan ahead, budget accordingly, and account for extra insurance costs when it comes to your expenses.

7. PARTNER WITH A BROKER YOU TRUST

During a hard market, make it a priority to partner with a competent and honest broker that has strong carrier relationships, a background in your industry, and above all, a clear understanding of your needs. Communicate with them early and often to gauge how the hard market will affect your business. Brokers—like PROLINK—are knowledgeable advisors who will keep you up-to-date on industry trends, help you shop around for options, and guide you to the coverage you need. It's our job to advocate for you.

8. KEEP YOUR EYE ON THE PRIZE

Remember, price isn't everything. We know it's hard to not focus on pricing, especially in the middle of a pandemic when you're trying to save. But shifting your business to the lowest-cost provider isn't always in your best interests, whether it's a soft market or a hard market. Don't compromise on quality for a cheaper premium. Focus on carriers that specialize in your industry and that will provide you with exceptional service when you need it the most.

NEED GUIDANCE?

With over 35 years in the industry, PROLINK has seen it all—soft markets, hard markets, and everything in between. We'll take the time to understand your unique circumstances and get you the best possible protection at the best possible rate, no matter what's happening in the market.

If you have any questions about your business, your continuity planning, or your insurance, we are only a call or email away. And if you're curious about how the hard market will affect your personal insurance, click here.

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