PROLINK

Canada's Insurance Connection

THE INSURANCE PENDULUM: WHAT'S A HARD MARKET?

2022

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

TABLE OF CONTENTS

INTRODUCTION

Insurance pricing has been on the rise for a while now, with widespread premium hikes across all lines. After years of stable premiums, broad coverage, and rate reductions, commercial insurance carriers can no longer afford to keep cutting prices.

As a result, the market has hardened and Canadian businesses have been struggling to navigate this unfamiliar environment for the last few years.

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.

In an ideal world, everyone contributes to the pool by paying a fee to cover the potential loss of millions of dollars. When there's a claim, the insurance company uses this collective pool, in addition to other investment income (from stocks, bonds, and assets) to pay for the loss.

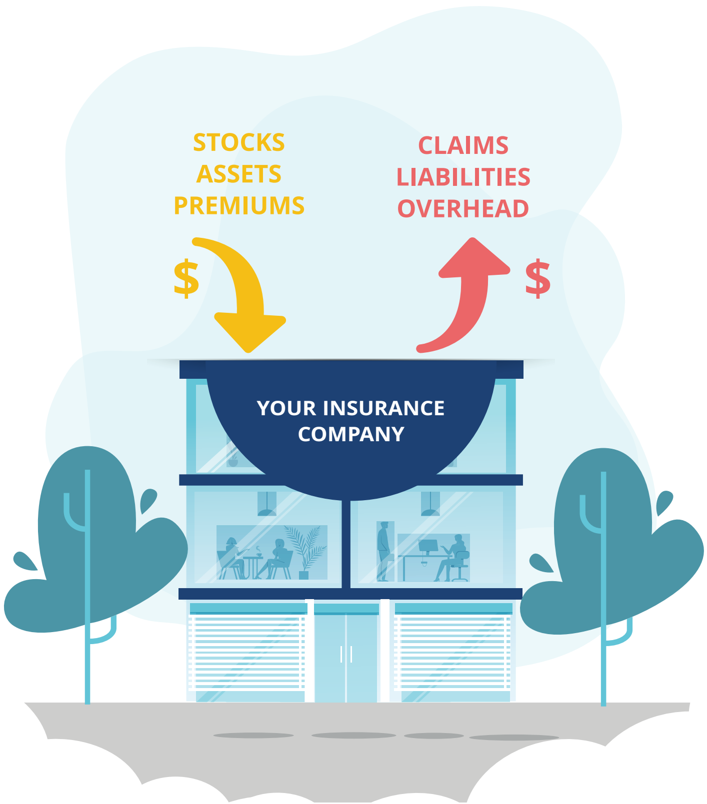

FIGURE 1. The insurance risk pool uses incoming funds to pay claims, overhead costs, and other liabilities.

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 does the future look like in the insurance industry, particularly after the pandemic;
4. What are the implications 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 OSCILLATES BETWEEN SOFT AND HARD MARKETS EVERY FEW YEARS.

The insurance market is cyclical and much like a pendulum, it oscillates between soft markets and hard markets every few years.

When the market is soft, insurance companies are looking to expand. The economy is good, there's a greater capacity to take on risks, and coverage is widely available. Carriers are more willing to relax their underwriting criteria so they can write more clients and grow their business. For consumers, that means attractive policy terms, flexible contracts, and lower premiums. Increased competition between carriers 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 risks. To protect existing clients and ensure they're financially secure enough to pay for claims, insurance companies must **tighten underwriting rules, restrict coverage, and raise premiums.** There's a high demand for insurance, but less coverage to go around.

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

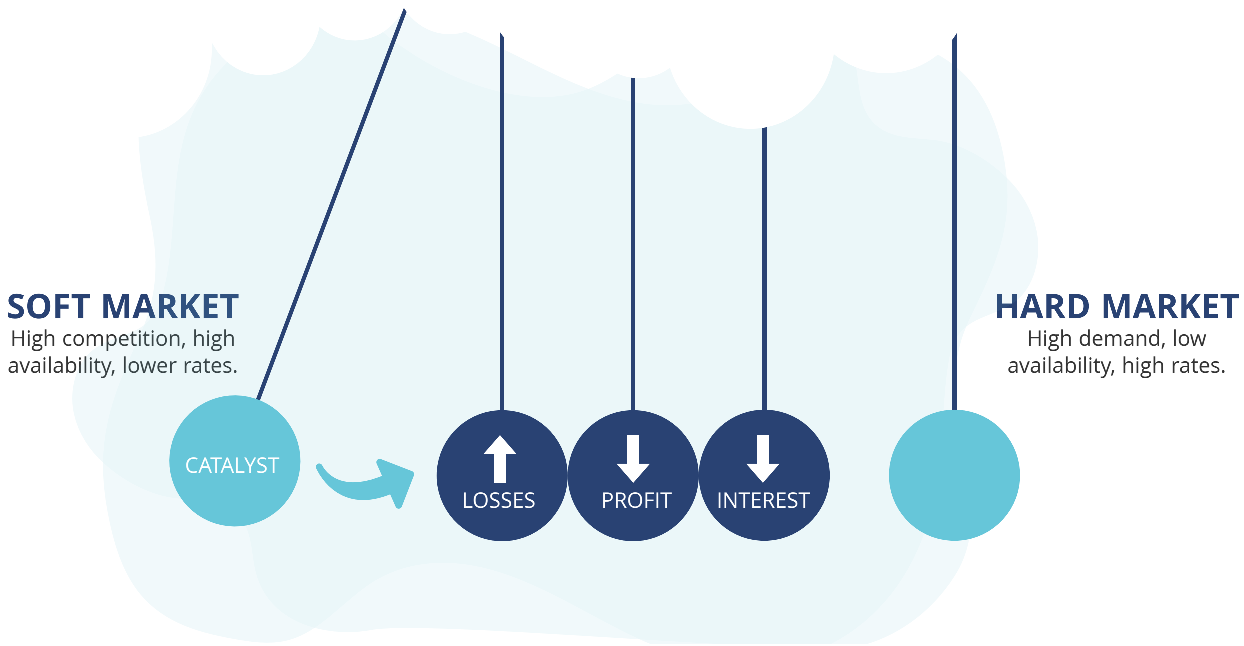

FIGURE 2. The insurance market is cyclical in nature. Increased losses, decreased underwriting profit, and negative interest are catalysts for a hard market. Eventually, stringent risk selection, higher premiums, and market stability promote higher interest, higher profits, and decreased losses, resetting 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 for the last few years, insurers, by and large, simply haven't been making enough money to cover the rising cost of claims. There are many contributing factors to high claims costs, 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

Before the hard market began in 2019, claims were growing in frequency and severity for years, with higher-than-expected losses among insureds. In 2018, insurance companies paid out a total of $6.5 billion and $3.7 billion for commercial property and liability insurance claims respectively. The hardest hit sectors at the time? Commercial General Liability (CGL), Directors & Officers Liability (D&O), and Commercial Property.

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

Why did claims go up? Social inflation is 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 heightened public sentiment against larger businesses and corporations—especially with the COVID-19 pandemic—attorneys are keen to take claims to trial. The result? Profuse litigation, high settlements, and higher claims payouts due to 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. Going into the hard market, the Insurance Bureau of Canada (IBC) reported $1.3 billion dollars worth of insured damage caused by intense flooding, rain, snow, and windstorms in 2019. In 2021, that figure shot up to $2.1 billion. Ultimately, costly disasters are compounding losses for insurers, leading to premium hikes all-around.

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 their 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.

Generally speaking, the insurance industry's average combined ratio is likely to be in the 105% to 112% range for a few consecutive years leading into a hard market**.** According to a report from Deloitte, the average combined ratio of Canadian property and casualty insurers was inching upwards leading into the hard market, with the five-year industry average at 97.5% between 2015 and 2019.

FACTOR 3. LOW INTEREST RATES

Nearly every insurance carrier uses the funds collected from premiums to build their reserves 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 are more inclined to hold onto money instead of spending or lending it. To boost the economy and prevent further deflation, banks lower interest rates (close to 0%), which encourages people to borrow money, invest in assets, and build capital. Over time, the economy recovers. If the market gets too hot and runs the risk of inflation, banks then increase rates to discourage borrowing.

Most banks slashed rates after the 2008-09 financial crisis and haven't fully restored them back to pre-recession status. And while low interest rates can enable investment spending, they're not sufficient enough to generate high returns over a prolonged period of time. 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 has hardened because:

1. Claims have risen in frequency and severity with higher payouts all-around.

2. Years of price reductions and heavy loss trends across the commercial liability marketplace have negatively impacted 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 have been 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 is operating at a loss in all lines 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 have persisted with the outbreak of COVID-19, with the ongoing effects of global uncertainty and economic shutdowns extending the hard market beyond what was originally anticipated well into 2022.

THE PANDEMIC FACTOR

Unfortunately, with pandemic-related losses continuing to materialize, insurers cannot rely on rising premium rates alone to overcome this gap. Here's why:

1	**RISING CYBER CLAIMS:** Cybercrime was rising long before the hard market, but the COVID-19 pandemic, the subsequent workplace disruptions, and widespread digital transformation have led to a dramatic surge in increasingly devastating and costly ransomware attacks and payouts. To ensure they're financially secure enough to cover other claims, cyber insurers have had to restrict coverage, raise premiums, and enforce baseline cybersecurity controls for businesses before they can even qualify for Cyber Insurance.
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. Due to a slow economy and countless business closures, the market has worsened, with executives facing immense scrutiny for pandemic-related decisions.
3	**DETERIORATING INVESTMENT INCOME:** In early 2020, banks had once again set their interest rates close to 0% in an attempt to stymie the impending financial fallout of the pandemic. Rates have risen marginally since and 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 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. Although evolving nature of the pandemic makes market changes difficult to predict, one thing's certain: insurance companies and brokers are doing everything they can to accommodate clients and ensure everyone is adequately protected given the circumstances.

WHAT DOES A HARD MARKET MEAN FOR YOU?

Even the most prepared organizations have had to adapt to the hard market. Overall, businesses have been facing:

HIGHER PREMIUMS: Sustained rate increases across all lines and all insurers. You might continue to see 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 are being 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'll still 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. **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. 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 otherwise your insurance company might void or cancel your policy. Cancellations due to non-payment are one of the biggest drivers of higher insurance rates. 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 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 40 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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