LloydSadd

NAVACORD®

MARKETPLACE
INSIGHTS

A Transition to an Uncertain Future

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Local Touch. National Strength.™

As I see it, MGAs provide an important role in the Canadian insurance industry. To brokers, they offer capacity from quality insurance carriers that niche or underserved brokers may not have access to. To insurers, they offer broad distribution in Canada to areas where they may not have regional offices.

— Greg Irvine, President,
Underwriting Solutions, Navacord

The Canadian insurance market is starting to show signs of softening. But the world around us is more uncertain than ever, making it difficult to predict the future.

The return to profitability for insurance companies that began a year ago has continued throughout 2022 and is finally beginning to yield opportunities for commercial insurance customers.

Direct written premium for Canada's predominantly commercial insurers grew by more than 12% in the first half of 2022 to $8.4 billion, compared to $7.5 billion for the same period in 2021. The steady revenue growth combined with a 3% drop in claims compared to a year ago helped lift the industry to a strong combined ratio (COR) of 73.5, down from 79.3 one year prior. Key Lloyd's syndicates, that were among the first markets to start withdrawing capacity at the beginning of the hard market cycle, also continue to come back strong with profitable underwriting income helping the aggregated results for Lloyd's Canada to a combined ratio of under 73.

Like Lloyd's, many insurers that have worked their way back to positive results are now looking to grow their top line revenue.

As a result, we are seeing more markets that had reduced capacity over the last three years begin to consider submissions and offer more favourable terms and conditions again, and even a renewal of competition between companies for larger business they deem profitable. Indeed, over the past three months we have observed a turn towards competition in some liability lines which we expect to continue through the end of December 2022, as some insurers race to meet annual new business targets in the final quarter of the year. The good news is that customers that combine effective management, a reasonable claims record and strong risk management protocols may be able to find more favourable terms and conditions and/or rate reductions through a thoughtful approach to the current marketplace. However, customers should keep in mind that some of these reductions will be coming from experienced underwriters handling a line or class and will be sustainable, and other insurers may not have the same long-term strategic view of that same line or class, and so their rate reductions may prove unsustainable.

In fact, it's very difficult to predict whether the transitioning market we have observed in recent months will continue as is, improve further or even reverse itself again. Insurance companies have done everything they can to clean up their own portfolios, but the factors affecting insurance pricing now have more to do with environmental and macroeconomic variables outside of their control. Foremost among these at the moment is inflation, which is having a dramatic impact on property insurance pricing (see "Property Insurance Forecast" below). A closely related problem is ongoing supply chain disruption caused by geopolitical conflict, lingering COVID-related issues (such as administrative backlogs in government departments), and access to foreign markets. Inflated pricing, delays and/or total lack of availability of everything from construction materials, to computer chips, to new vehicles, have all put added pressure on claims costs for the near term.

In addition, like all businesses right now, companies throughout the entire insurance industry are struggling to attract and retain

INSURANCE 101:

Combined Operating Ratio (COR):
A key performance indicator that compares losses paid and expenses against premiums earned. If the COR is above 100, the insurer is unprofitable based solely on underwriting performance. Most companies target a COR of 95% or less.

Subscription Policy:
A policy in which multiple insurers share the risk associated with providing the insurance. It is called a subscription policy because the insurers participate in the policy by "subscribing" to it. That is, insurers can choose whether or not they would like to join in the offering of the policy.

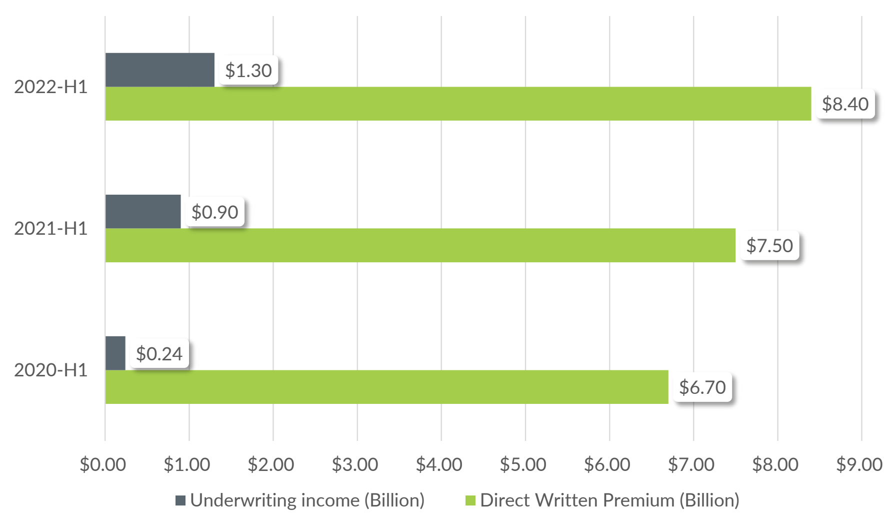
Direct Premium Written:
Direct premiums written are the total premiums written by an insurance company before considering reinsurance ceded (i.e., net premiums written). Direct premiums written represent an insurance company's "topline" growth during a given period. When direct premiums written exceed direct premiums earned a company is said to be experiencing an increase in underwriting volume.

staff at a time when workloads have never been higher and the overall labour force is shrinking—due to Baby Boomers continuing to leave the workforce and the impact of COVID-19 on previously healthy people, among other factors. However, hard market conditions in the insurance industry have also morphed staffing issues into new areas. As insurers narrowed their appetites and removed entire classes of risk from the general insurance market, a great deal more business began flowing to managing general agents (MGAs) in the "wholesale" market. As a result, the MGAs are now struggling to provide the levels of service they did in the past, as they have become flooded with submissions. There is no easy fix for the industry's overall staffing issues either, as few observers anticipate a retreat from the new underwriting rigour adopted during the hard market, which is one of the major contributors to increased workloads, along with the Great Resignation and impacts from the industry learning to work entirely from home.

A related staffing issue is the movement of key underwriting personnel with technical expertise in certain lines of business from one company to another, as those companies expand or contract their appetites for certain risks. Your Lloyd Sadd representative can help steer you through this transitioning market, where many pieces and people are in motion all at once, to find the right market for your risk and seize some of the opportunities that have recently emerged—while they are available.

Back In Black

Strong revenue growth has helped insurers to improved underwriting income and a return to a profitable combined ratio.



This year, we will bring in 50-plus new advisors into our organization, and next year one of our focus areas is to see if we could bring in 100 new advisors into our business.

— Shawn DeSantis, CEO
Navacord

Property Insurance Forcast

WHAT TO EXPECT

- **Ongoing capacity restrictions due to catastrophic losses, but some renewal of competition on good risks**
- **Impact of January reinsurance treaty renewals remains to be seen**
- **Some tempering of mandatory rate increases, but offset by increases in valuations due to inflation**

Property insurers seeking to minimize exposure to catastrophic losses continue to be selective about the amount of capacity they will deploy on any one risk, and the types of risks where they will deploy it. Nevertheless, now that many insurers have returned their property portfolios to profitability, they have begun to temper their demands for hefty mandatory rate increases on all renewals. Many customers will see rate increases ranging from flat to only low single digits.

Moreover, a number of insurers looking to retain hard won market share, gained in part through the retreat of Lloyd's in the hard market, are showing a renewed willingness to offer competitive terms and conditions on certain classes of business as Lloyd's continues to return capacity into the Canadian market in select segments and on select risks. Customers with larger risks that are in good financial shape, have few to no losses and strong risk management protocols in place may find opportunities in the current market.

However, it's not clear how long these current market conditions will hold, especially as we approach the January 1 treaty reinsurance renewal season. Large catastrophic losses such as Hurricanes Fiona and Ian are "capital events" for reinsurers, meaning they have to raise new capital through increases to reinsurance premiums after paying out heavy losses to insurance companies. It remains to be seen how the interplay between increased reinsurance costs for primary insurers and their desire to retain and increase market share and grow top line revenue will play out in 2023.

IMPACT OF INFLATION

Currently overshadowing all discussions about capacity and rate in the property segment is the growing cloud of inflation. In fact, the holiday from rate increases customers may enjoy at the moment is effectively wiped away by inflation adjustments to premiums dictated by increases to valuations of assets at the current rate of inflation. The cost in materials and labour to repair or replace a building today has risen sharply compared to what it would have cost to replace the same building a year ago. The result is widespread concern across the industry that many assets are no longer insured to their correct value, and will leave many customers woefully underinsured in the event of a total loss.

Insurers normally apply an annual increase to account for inflation at renewal, usually in the range of 3-5%. However, the rate of inflation has risen so sharply and so fast in 2022 that guidance documents published in January that underwriters use to apply appropriate inflation adjustments for different classes of risks are already out of date. Insurers are now applying inflation adjustments ranging from 4% to 8% or even higher, and continue to worry that even these are not enough to keep up with current real rate of inflation (currently sitting just below 7% in October, down from above 8% in the summer).

Related to the issue of inflation is ongoing supply chain problems adding significant amounts of time required to obtain construction materials, replacement parts and components, and even labour required to perform repairs and rebuilding. What used to take a couple of weeks to source now routinely takes 8-10 weeks or longer. These delays have significant implications for determining appropriate periods of business interruption coverage (i.e., beyond one year), especially for revenue generating assets.

Inflation Ate My Rate Holiday: Case Study

A customer owns a building valued at $10 million. In 2020, they insured the building at a rate of $.08 per $100:

$10 million/$100 = 100,000 x $.10 = $10,000 premium.

In 2021, the insurer asks for a 10% rate increase, bringing the rate to $.088 per $100:

$10 million/$100 = 100,000 x $.11 = $11,000 premium.

In 2022, the insurer offers a flat rate increase at renewal. However, inflation has driven up the replacement value of the building to $11 million:

$11 million/$100 = 110,000 x $.11 = $12,100 premium.

Therefore, inflation drove a 10% increase in premium even without a 10% increase in rate.

Spotlight On Construction Lines

We are seeing the return of some capacity for construction project insurance—including builder's risk and wrap-up liability—from both domestic markets and from Lloyd's, which will provide relief following a major curtailment of capacity on those lines over the last few years. At the same time, errors and omissions (E&O) insurance for engineering risks remains in a hard market state due to ongoing high frequency and severity of claims, especially related to large projects, such as public-private partnership (P3) and design-build contracts.

In surety, insurance companies enjoyed moderately steady premium growth in the first half of the year due to many of the same inflationary factors driving premium increases in other lines. However, surety loss ratios remain low and pricing is very stable, helped in part by some new capacity from a few established domestic insurers deciding to enter the surety market.

Liability & Auto

WHAT TO EXPECT

- **Minimal to flat rate increases, commensurate with changes in a company's revenues**
- **Renewed competition for some lines of business**

Loss ratios in general liability (CGL) fell sharply in 2021 and have continued that trend in 2022. These favourable results have allowed insurers to continue offering favourable terms and conditions on risks with good operations and minimal losses. Customers should see only minimal rate increases upon renewal. As the fourth quarter began, we observed a sharp turn towards competition between insurers in some lines of business, particularly pollution coverage and excess D&O, as companies attempt to meet their new business targets for the year.

Inflation may cast a shadow over some liability lines renewals, in that liability premiums are calculated based largely on a company's revenues. If revenues increase due to the increased price for goods sold or services provided due to inflation, just like in the property lines example, premium increases due to higher revenue may offset any potential premium decrease expected from a rate reduction. To help your broker get the best outcomes at renewal or in a re-marketing exercise, it can be useful for customers to distinguish between a company's growth in revenue due to inflation (such as the need to pass on rising costs of inputs) and actual growth of the business in terms of increased production or number of units sold, for example.

Auto Insurance Forecast

WHAT TO EXPECT

- **Continuation of renewed competition for well-managed fleet business**
- **Ongoing rate actions driven by increased physical damage claims costs**

Insurance company auto premium growth was muted during the pandemic by rebates and refunds and widespread changes in driving habits. Most if not all of those rebates have been discontinued in 2022, and as anyone who commutes to work lately can easily observe, vehicle use patterns have largely returned to pre-pandemic levels. Consequently, the claims holiday insurers enjoyed the last couple of years is coming to an end, as demonstrated by elevated physical damage losses in some provinces, despite reduced collision frequency.

Here again, it is instructive to look at some of the macroeconomic factors driving the elevation in claims costs for physical damage and repair. Even before the pandemic, a major factor driving the increase in repair costs was the amount of computerized technology that is now standard in most vehicles manufactured today. The spike in demand for computer chips during the pandemic, and the global shortage that resulted, has only exacerbated this trend, as well as added to the length of time it may take to repair vehicles while parts are in short supply.

A similar factor having to do with manufacturing supply chains is the rising cost of renting replacement vehicles for the duration of the repair, if a rental vehicle can be obtained at all. In 2020, car rental companies made massive reductions to the size of their fleets as demand plummeted due to public health restrictions preventing personal and business travel. (For example, a Statistics Canada study found that the rental vehicle fleet in British Columbia shrank by a third in 2020, compared to 6.6% annual growth between 2015 and 2019.) Rental companies have struggled to return their fleets to pre-pandemic levels because of the lack of availability of new vehicles. Consequently, it can be very difficult to obtain a rental vehicle for two to three weeks at a competitive price. This situation is obviously compounded by the increases in time required to repair a vehicle when parts take longer to source, as noted above.

Directors & Officers (D&O)

WHAT TO EXPECT

- **Pricing continues to stabilize, from flat to low single-digit increases upon renewal**
- **A more welcome environment for businesses in solid financial shape**
- **Increasing focus on execution of ESG platforms**

D&O premium volumes climbed through 2021 amid moderate loss ratios. As a result, pricing has continued to stabilize in 2022 to lower single-digit rate increases. There is also renewed capacity as Lloyd's begins to deploy more in the sector once again. Clients that were penalized in the hard market could now possibly find premium savings through a re-marketing exercise. We continue to see more appetite for businesses in a strong financial position, including energy companies that are benefiting from record high commodity prices.

Hard market conditions remain in place for companies with past claims, those in a weakened financial position due to pandemic hangovers such as an inability to return to pre-pandemic staffing levels (e.g., hospitality, airlines, long term care homes) or dealing with supply chain issues. High risk sectors that were difficult to insure even before the hard market remain so now, including sectors such as life sciences, crypto currency and cannabis.

ESG

A growing area of focus for D&O underwriters (as it is for banks, lenders and private equity investors) is a company's environmental and social governance (ESG) platform and what they are doing to execute on it. Companies with strong commitments to reducing GHG emissions, robust cyber protocols and diversity and inclusion policies are increasingly viewed as having a better D&O risk profile.

On the governance side, D&O underwriters are paying more attention to the potential for "greenwashing," in which companies over promise or overstate what they are doing to make their operations more environmentally sustainable and reduce emissions without actually achieving these targets.

Energy companies in particular face a double-edged sword in the current market. Rising commodity prices are helping these companies grow, and so they wish to increase their D&O limits to match their growth. At the same time, an increasing number of D&O insurers are committing to reduce or eliminate underwriting business in the fossil fuel sector as part of efforts to achieve their own net-zero emissions targets.

Cyber Liability

WHAT TO EXPECT

- **Ongoing hard market as claims severity drives pricing**
- **Reduced sub limits for ransomware and extortion coverage**

Uptake of cyber insurance coverage continues apace, as a recent survey by the Canadian Internet Registration Authority reveals that 74% of organizations across Canada have decided to invest in the coverage in 2022 compared to 59% in 2021, despite increasing costs and requirements to qualify for coverage. Cyber insurance losses are down from the alarming peak of 2020 when cyber criminals were able to increase their exploitation of network weaknesses due to the massive and sudden shift to work from home arrangements. However, loss ratios for Lloyd's (the dominant cyber marketplace) and domestic markets remain elevated as severity of individual losses remains an issue. In response, insurers continue to drive up pricing for the product and engage in increasingly technical analysis of a company's network and IT protocols before granting coverage.

Domestic insurers in particular remain extremely selective with the industry segments they choose to insure, as well as the size of the business. For example, car dealerships may have difficulty qualifying for coverage, as well as companies with annual revenues over $1 billion, which requires a very bespoke underwriting process. Insurers are also decreasing sub limits or no longer offering coverage for particular kinds of losses such as those resulting from ransomware and social engineering occurrences.

Here's What You Need To Succeed

STRATEGIZE NOW

Our guidance on allocating sufficient time and resources for information gathering and document preparation beginning at least 90 days out from renewal remains unchanged. However, this time the reasons for doing so are more positive.

In a hard market, the incumbent insurer usually offers the best solution for the client, and the renewal is a matter of getting the best possible outcome in the circumstances. But the recent softening in the market on some lines gives brokers an opportunity to look at options for customers where they may not have had many over the last two to three years. Now may be the time for customers to participate in a strategy conversation with their broker about whether it's a good time to explore market alternatives.

In these times of economic uncertainty and as appetites shift between insurers, it's also more important than ever for clients to be dealing with a broker that has a lot of options of markets they can turn to, and who also knows the customer's industry and business very well.

KNOW THE VALUE OF YOUR ASSETS

The recent spike in inflation has upended valuations and the cost of replacing something in today's dollars. Consequently, in the event of a loss, many customers may find that their assets are no longer insured to the correct value. Large assets like buildings are the chief concern here, but customers should not overlook the lead times and expense of replacing things like vehicles, computers and IT equipment in the current environment of strained supply chains.

Customers with significant assets such as buildings are advised to spend the money to have an appropriate and professional valuation done at least once every three to five years to ensure they are insuring to the correct value. Ensure that vehicles and equipment are insured for replacement based on what's available now.

A further consideration is the structure of the insurance program in the event of a total loss. One key factor to consider is the impact of the coinsurance penalty clause in a property policy on potential changes to property values due to inflation. Property policies containing a "minimum percentage" coinsurance clause (typically 90%) run an increased risk of trigging the penalty clause if inflation results in the insured value of a building at inception falling below the threshold when the actual replacement cost is determined following a claim. (See "Inflation Ate My Loss Coverage" sidebar.) This will result in the insured receiving less than the expected "full replacement value" on their settlement. Buildings that have not been appraised by a qualified insurance appraiser within the past two years to determine the insurable replacement cost are particularly at risk. Talk to your broker about ensuring that your buildings and property have the most favourable coinsurance clause available, and for direction to a qualified replacement cost appraiser.

Inflation Ate My Loss Coverage: Case Study

- In 2017, a customer purchases a building. They also purchase a property insurance policy with a $10 million limit to cover the costs, in materials and labour, to replace the building in the event of a total loss.
- Over a period of five years, assuming an annual rate of inflation of 3% per year, the actual cost to replace the building in current dollars has risen to $11.59 million. However, the customer does not update the valuation of the building during this time and renews the property policy annually with a $10 million limit.
- In 2022, the building has a serious fire and is a total loss. It needs to be rebuilt. The customer makes a claim on their property policy but only receives the $10 million limit. The customer will now have to participate in the loss in the amount of $1.59 million in order to replace the building.

MANAGEMENT NARRATIVE

Current economic realities with inflation and other factors may be distorting the picture of what has really gone on with your business over the last year. Did your sales really grow by 10% or is that increased revenue merely due to your need to pass along higher operating costs?

In preparing for renewal, it's important to gather together not just the financials, but the narrative around them in the form of the management discussion and analysis. Be prepared to tell the story, including any recovery from pandemic-related dips and where your growth opportunities are.

Company Results

Mid-year 2022 Combined Operating Ratios (COR) for several key commercial insurers. A number greater than 100 indicates a loss.

AIG	**79.8**	*Arch*	**61.6**	*Chubb**	**60.9**	*CNA*	**88.4**
Allianz	**90.3**	*Berkley*	**55.7**	*FM*	**47.8**	*Northbridge~*	**81.9**
Liberty	**59.2**	*SGI*	**105.2**	*SovGen*	**87.1**	*Travelers~*	**73.7**
*Aviva***	**91.7**	*Intact***	**85.3**	*Zurich*	**75.8**	*Lloyd's*	**72.8**

* These companies write substantial personal lines business as well

~ Includes results of personal lines portfolio

** Includes results of significant personal lines portfolio

If you have questions specific to your business, or would like additional information, please reach out to your Lloyd Sadd Advisor.

We see the sea surface temperatures are rising – that means storms are going to be able to beef up more and, as they're growing in size and in terms of the amount of precipitation and moisture that they hold, they will also be able to travel much further north, which is exactly what we saw [with Fiona].

— Dipika Deol, Senior Vice President,
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