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MARKETPLACE
INSIGHTS

Fractured, Lumpy, & In Transition

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Local Touch. National Strength.™

We had the best year in our history in 2021 as the world began to return to normalcy. We earned a record $3.4 billion and our book value per share increased by 34.2%.

Prem Watsa, CEO, letter to shareholders
Fairfax Financial

With insurers reporting record returns for 2021, there are signs the hard market is beginning to break up like the ice covering a lake in spring.

"Fractured," "lumpy" and "in transition" are a few of the words our experts are using to describe the current Canadian commercial insurance marketplace. That's because while many insurers were very successful in returning their portfolios to an underwriting profit last year, the results are quite varied across companies and portfolios. Insurers have also begun to display a much wider range of appetites for certain risks, and underwriting profitability is not necessarily a good predictor of whether a company will be conservative or competitive. Despite aggressive rate actions, some insurers finished the year with a combined operating ratio (COR) still uncomfortably close to 100, and are not yet well positioned for growth.

In some lines, insurers have begun to temper the substantial rate increases they have sought the last few years, and there are areas (such as commercial auto) where we are seeing the return of competition between insurers for new business. However, some of the most significant areas of difficulty remain exactly that: difficult. Property insurance is still challenged as the fundamentals informing insurer strategy are mostly unchanged. Likewise, cyber insurance losses, while down slightly from the alarming peak of 2020, remain high and without a clear path for insurers to achieve profitability.

Direct premiums written (i.e., topline revenue) for Canada's predominantly commercial insurers grew a sizable 15.2% to $15.9 billion in 2021 compared to the prior year. The substantially rate-driven revenue growth was accompanied by an almost 13% drop in claims costs during the same period. These two factors combined to give the sector a return on equity of 15%, making 2021 the third most profitable year for the Canadian industry since 1975, after 2003 and 2004.

It's worth noting that 2003 and 2004 were also the later years of the last hard market (2001-2004), another potential signal that the current one is in its final stages. However, a major reason that insurers are reluctant to significantly ease hard market conditions this year is that their results from 2021 are difficult to analyze and were influenced by many unique factors that are unlikely to repeat. In particular, most insurers view the suppression of claims activity as a brief holiday that is coming to an end with the disappearance of public health measures aimed at slowing the spread of COVID-19. As work-from-home arrangements reduce or end and more people return to commuting to work (and having collisions), shopping in brick-and-mortar stores (where they can slip and fall), economic activity ramps up and courts begin to deal with the backlog in cases so claims can get settled, insurers anticipate an end to the relief in claims costs they enjoyed last year.

Moreover, even as the pandemic subsides along with the suppression of economic activity it created, new challenges for the industry have emerged from the past two years. Rapidly rising inflation closely coupled with the disruption to global supply chains for manufacturing and construction materials—exacerbated by geopolitical tensions such as the Russian invasion of Ukraine—rising labour costs and labour scarcity are all expected to add considerable new pressures to property claims costs for the next few years, which must ultimately be reflected in premiums.

Despite the constellation of historically unique factors that create so much uncertainty, there is new optimism about the financial health of the industry. Rising interest rates will bring renewed growth to insurers' investment income, easing some of the pressure to achieve aggressive targets for underwriting profitability. By contrast, one area where insurers continue to be frustrated is with staffing and workloads. Even with a return to profitability, the underwriting rigour insurers adopted in the current market will likely remain in place for the long term. With that rigour comes increased workloads as underwriters, brokers and customers must all gather and process increasing amounts of information. In recent years many companies and technology providers to the industry have talked up how advanced data analytics, artificial intelligence and other "fintech" applications would modernize the industry. And yet the unceasing increase in workloads over the last few years for all commercial insurance stakeholders demonstrate that insurers continue to struggle with replacement of legacy systems and digital transformation that can deliver meaningful advances in operational efficiency and service to customers and brokers. This fact underscores the need for customers to continue maintaining a high level of engagement with their Navacord representative, including building in long lead times for renewal negotiations, in order to obtain the best outcomes in a market that is fractured, lumpy and in transition.

COVERAGE TIP

Push Back On "Best-Terms" Pricing

A hallmark of the hard market has been insurer restrictions of capacity within property lines. Consequently, brokers now usually have to convince multiple insurers to "subscribe" to a risk to insure 100% of a building's value. Usually there is a lead insurer that issues a single policy wording that the other insurers agree to follow, with each insurer covering a portion of the risk (say 20% each among five insurers). Each insurer may rate the risk differently—some would seek a premium based on a rating of $0.08 per $100 of value, another may want $0.10 and another $0.12. In normal "split-rate" pricing, the premium charged to the customer is a blended average of those different ratings with each insurer receiving a portion based on their individual rate for the risk.

However, it sometimes happens that insurers may bid on a portion of a subscription "subject to best-terms pricing" (in this case, "best-terms" means best for the insurance company, not the customer). In a best-terms pricing scenario, five different insurers may all bid on a portion of the risk with ratings ranging from $0.08 to $0.20, but the final premium will be based on applying the highest rating (i.e., $0.20) for all subscribing insurers, which can potentially increase the cost of the premium by orders of magnitude.

Last December, the Canadian Council of Insurance Regulators (CCIR) issued a statement condemning the practice of best-terms pricing, noting that it leads to "adverse premium inflation [that does] not support the fair treatment of customers." Legislation banning best-terms pricing with respect to residential condo corporations is already in place in B.C. and Alberta and is expected to follow in other provinces in the coming years. Customers should feel empowered to push back against the use of this unfair practice, and inquire if there is more than one company on their property insurance policy, and whether or not best-terms pricing is being enforced. Navacord brokerages have been successful in bringing split-terms to other classes of property besides residential realty. Not all brokers know to ask or insist upon it.

Property

WHAT TO EXPECT

- **No letup in hard market conditions: rate increases, restricted capacity**
- **More details and documentation required**
- **Inflation and supply chain issues driving up costs of building repair/replacement**

Rate hardening on commercial property lines continued throughout 2021 and the same market conditions are expected throughout this year. Most markets are still not willing to increase the amount of capacity they will deploy on any one risk, requiring brokers to continue being creative in how they structure large property programs. In most cases this means recruiting multiple insurers as subscribers to a single policy, necessitating submissions to multiple companies.

The classes of property risk that remain challenging differ based on the region of the country where the risk is located and the catastrophe risks it is exposed to. Insurers continue to restrict capacity and look for rate increase of 5% or more in areas including:

- Residential realty, especially wood frame housing in Western Canada with earthquake exposure, and property anywhere in the country with flood exposure
- Anything with wildfire exposure
- High-hazard manufacturing

Property insurers continue to demand ever more details in the underwriting process, especially on older buildings. Insurer requests for information on building maintenance protocols, service and replacement history for all systems such as electrical, plumbing and HVAC—and supporting documentation for all of these—are now routine. Customers are advised to budget appropriate time and resources to gather this information to help their broker tell the best possible story about the risk.

INFLATION AND SUPPLY CHAIN

A new factor that is now complicating the property market is the spike in inflation. Increasing costs for labour, materials and fuel are quickly driving up the real costs to repair or replace a building. Insurers usually factor in an increase of 2.5%-3% for inflation upon policy renewal. However, several insurers have already signalled they are raising the increase to 5% in response to the current rate of inflation, which may still not be enough to match the real rate. Customers need to consider how inflation may create a gap between the values at which their buildings are insured for replacement costs and the now rising real cost to replace them—i.e., insurance-to-value (see Here's What You Need To Succeed below).

A closely related factor that further compounds increasing building and replacement costs is the ongoing disruptions in global supply chains for manufacturing and construction materials. Simply put, these days it may take much longer than the standard allowance of 12 months for building repairs or replacement to be completed because materials and parts (and even labour) may not be available. This is particularly true for replacement of any specialized components like air handlers, chillers, servers or manufacturing equipment. Customers who own properties that generate income should take these factors into account for the indemnity period of the business interruption portion of their property program.

Every single time that insurers have reported such above-average profits, competitive forces have quickly acted to cut the industry's return on equity in half — to an average of 7.4% — within two years.

Alister Campbell, President & CEO,
PACICC

Liability & Auto

WHAT TO EXPECT

- **Rate moderation and a return of competition in fleet and liability lines**
- **Ongoing challenges with professional liability**
- **Continued social inflation, especially with U.S. exposures**

Nowhere is the insurance market more fractured, lumpy and in transition than across the spectrum of liability lines. The general liability segment (CGL) showed great improvement in 2021 due to reduced losses and increased topline revenue. Other segments, such as professional liability, returned much more mixed results. Consequently, many liability insurers are in very different places as far as risk appetite. Prior to the hard market and even during, five different insurers may once have all offered terms on a risk they all like with a difference in rating of perhaps 20% between the best and worst quotes. In the current market, the response from those same five insurers may range from a difference of 20% up to 100% between the best and worst quotes, if the insurer offers terms at all.

Industries that were difficult to insure before the hard market, such as roofers, snow removal contractors and long-haul trucking, remain challenged and will continue to be as the market evolves. On a positive note, rate increases combined with reduced claims frequency in 2021 have helped a number of insurers return their auto portfolios to profitability and we are beginning to see renewed competition between insurers for well-managed fleet risks. However, any auto risk with U.S. exposure remains extremely challenging to place. Unlike Canada, the U.S. insurance market did not enjoy the same strong results for 2021. Additionally, factors such as social inflation—the rising cost of settling large losses due to judicial trends—continue to drive severity of liability claims south of the border and impact Canadian customers with exposures there.

Inflation also has the potential to impact liability lines, in that liability ratings are calculated based on a company's revenues. The rising cost of inputs may therefore require a company to raise its prices and thus increase its revenue, even if its overall business activity remains roughly the same.

Directors & Officers (D&O)

WHAT TO EXPECT

- **Still a hard market but transitioning quickly**
- **Rate increases tempering, even flattening by end of 2022**
- **COVID-related wrongful dismissal claims impacting employment practices liability (EPL)**

Substantial premium growth in 2021 and a dip in losses after previous years of volatility is helping a number of D&O insurers return to profitability. Several key insurers are shifting their focus to retention of good business, but at the right price, and so have begun tempering rate increases and reintroducing some capacity to the market (both domestic companies and Lloyd's). We may even see some rate flattening by the end of the year, but decreases are unlikely as no insurer wants to go backwards. The sector must maintain loss reserves to deal with record numbers of securities class actions claims that have been filed over the last few years. These long-tail claims typically take between two and five years to settle.

As commodity prices rise, the financial situation for companies in Canada's energy sector has improved, and D&O insurers are showing a renewed willingness to retain those risks. By contrast, pricing remains consistently high on any acquisition-based business such as reverse takeovers (RTOs) and special purpose acquisition companies (SPACs), as the market continues to see a lot of SPAC-based litigation coinciding with their growth as an acquisition vehicle in recent years (see the November 2021 Marketplace Insights newsletter).

Another area D&O insurers are paying more attention to is how well companies execute on their environmental and social governance (ESG) initiatives. Capital markets are seeing increasing involvement from activist investors targeting company boards for failing to meet stated objectives on diversity and inclusion, emissions reductions and safety culture, leading to potential market volatility. ESG is continuing to grow as a focus area for not only investors, but lenders and insurers.

OTHER FINANCIAL LINES

As expected, insurers are now seeing a rise in claims in the employment practice liability (EPL) line related to wrongful termination for non-compliance with employer vaccination mandates and related matters. Insurers are reacting by increasing EPL deductibles, and adding special deductibles for claims related to high-wage earners such as C-suite members, as these are usually the most expensive claims to settle.

Fidelity insurance also remains a challenging line with insurers seeking rate increases of more than 5%. Crime insurers are also requesting increasing amounts of information about a company's financial controls to prevent employee fraud. These underwriting requirements will likely remain in place, regardless of any market softening.

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.

Cyber Liability

WHAT TO EXPECT

- **Investment in IT security and protocols to qualify for coverage**
- **Greater emphasis on threat detection and prevention**

Cyber insurance remains one of the most challenging areas of the insurance market due to extremely high frequency and severity of losses. Losses slowed somewhat in 2021 compared to the alarming heights they reached in the first year of the pandemic, but loss ratios for most companies remain above the unprofitable 100 threshold. In response, some insurers have contracted their limit availability for certain coverages and certain classes of business while other markets have pulled out altogether. Other markets focused on large cap companies are now only interested in writing excess cyber above an initial layer of $2 million or more—meaning they are effectively seeking a $2 million deductible. Lloyd's controls almost 60% of the market, which is a consequence of domestic cyber insurers being extremely selective with the industries they are targeting and the limits they will extend.

More importantly, insurance companies are changing their approach to risk selection and demanding much more from customers in order to obtain coverage. Insurers want to be certain that customers take information technology (IT) protocols seriously—by investing in them and having the proper employee training in place—before they will qualify for a quote. If they do qualify, the coverage is much more expensive now than it was a few years ago.

However, cyber insurance remains one of the best value-added insurance purchases. Insurers are increasingly focused on threat detection and risk control to avoid paying losses in the first place. Access to professional services to prevent a loss before it occurs, as well as expertise to deal with it if a loss does occur, are important components of the cyber insurance premium.

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Here's What You Need To Succeed

A Fresh Perspective

Between the last two years of the pandemic and a volatile economy, many companies have made major shifts in their core business strategy and product lines, how and where their employees work, who their customers are and how they reach them, how and where they are sourcing their inputs from and many other possible changes. All of these changes require a careful thought process about whether a company's insurance coverage needs to change. As a result of changes to your operation, your company may be exposed to new risks for which it is not currently insured, while other risks may have decreased in magnitude. Now is a good time to talk to your Navacord representative about any recent changes with your company and review the adequacy of your coverage.

A Fresh Appraisal

The sudden, sharp rise in inflation has created major concerns in the industry about whether property clients have appropriate insurance to value. Rising prices for construction materials, fuel and labour—as well as delays and difficulties with even obtaining any of them—have made it next to impossible for insurers to accurately forecast rebuilding and replacement costs, even a short distance into the future. The subject needs to be part of ongoing conversations with your Navacord representative.

For customers whose buildings and property are their largest assets, it makes sense to invest in a professional property appraisal every three to five years to get peace of mind that if you have to replace with like kind and quality, they are well insured for that value.

Time, Resources, Documents

Despite positive signs of rate easing, the hard market endures. Even as it fades, most insurers' renewed underwriting rigour will likely remain in place for the foreseeable future, keeping underwriter workloads high. This means that clients must continue to plan for long lead times (beginning at least 90 days out from policy renewal) and budget the resources necessary for information gathering to create strong submissions. Insurers continue to make increasingly detailed requests for documentation to support their rating. This may include everything from maintenance logs to bills and purchase orders for building systems and services, and much more. Work with your broker to plan your lead times and resource requirements accordingly.

Market Knowledge And Access

We forecast that the current fractured market will continue. Longer standing and better-managed insurers will have opportunities to write profitable business, while others simply aren't positioned for growth yet. Working with a specialized brokerage that has a good understanding of a particular client's niche in the insurance industry and how different insurers are currently approaching that niche is crucial for obtaining the best results.

Company Results

Year-end 2021 Combined Operating Ratios (COR) for several key commercial insurers. A number greater than 100 indicates a loss.

AIG	**76.3**	*Arch*	**62.9**	*Chubb**	**48.5**	*CNA*	**86.6**
Allianz	**85.2**	*Berkley*	**46.6**	*FM*	**34.1**	*Northbridge~*	**89.1**
Liberty	**101.6**	*SGI*	**92.7**	*SovGen*	**88.2**	*Travelers~*	**83.7**
*Aviva***	**90.7**	*Intact***	**87.9**	*Zurich*	**69.4**		

* 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.

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After several months of integration and transition planning, on June 1 we welcomed RSA's employees to Intact and increased our premium base by 70%. This added scale enhances our ability to invest in our core capabilities of data, risk selection and claims.

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