Interim Property & Casualty Market Update

Presented by Lockton Companies

August 2020

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Google tells employees to work from home until July 21.

CNN 07/27

Fed outlook gloomier as virus spreads.

WSJ 07/24

Jobless claims creep up amid fears of new closures.

STASTISA 07/24

Moderna, Pfizer coronavirus vaccines begin final stage testing.

NYT 07/27

Uncertainty

AS SUMMER 2020 COMES TO AN END, “UNCERTAINTY” REMAINS THE WATCHWORD FOR BOTH THE U.S. ECONOMY AND THE PROPERTY AND CASUALTY INDUSTRY. The resurgence of the COVID-19 virus in states that power the U.S. economy (Texas, Florida, California and Illinois) threaten livelihoods and raise fears of a second, nationwide shutdown. At a minimum, many businesses are seeing increased operating restrictions, uncertain supply chains and reduced demand.

The National Bureau of Economic Research (NBER) officially declared the U.S. to be in a recession, starting in February 2020. This marks the first U.S. recession since the “Great Recession,” which began in December 2007 and lasted until June 2009.

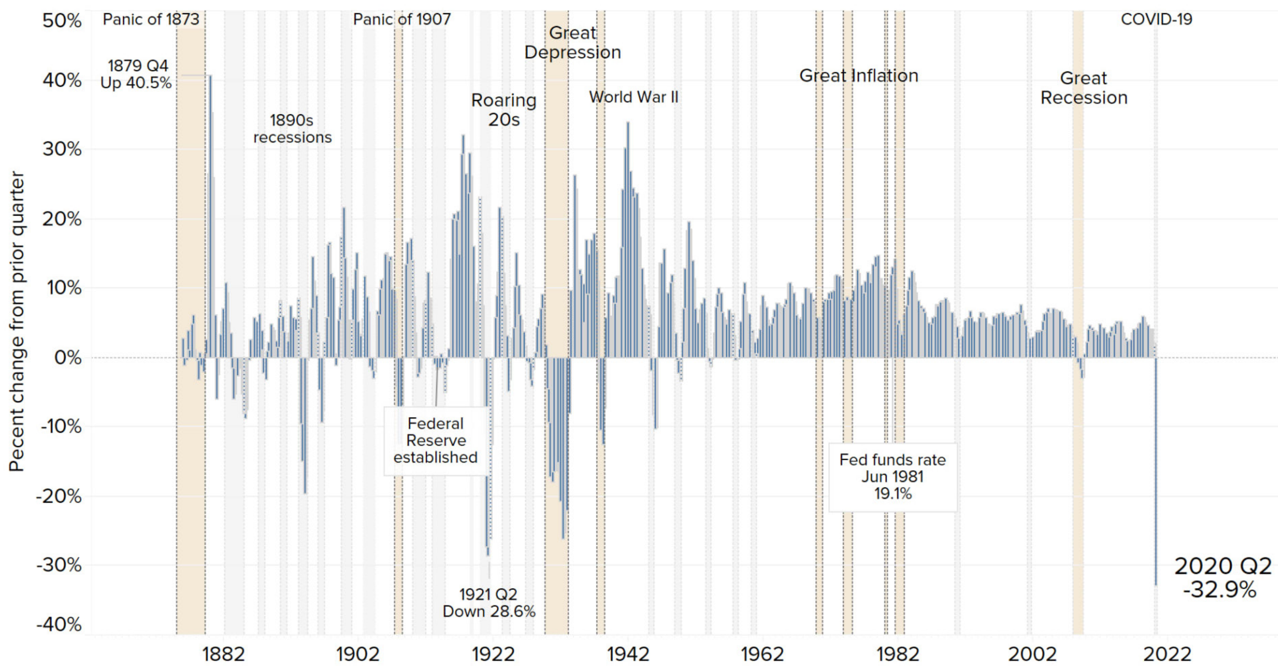
Unemployment rates remain near record levels with nearly 22 million Americans out of work or about 13% of the labor force. Millions more remain in a “work from home environment” as companies struggle to maintain sales and profitability.

Industry outlook

Construction	◀▶
Healthcare	◀▶
Transportation	▲
Manufacturing (Industrial)	▼
Manufacturing (Consumer Goods)	▼
Food processing	▲
Energy	▼
Real Estate	▼
Hospitality	▼
Technology	▲
Retail	▼

We acknowledge the tremendous uncertainty facing our clients and remain actively engaged with them to provide guidance and help find solutions.

U.S. ECONOMIC BOOMS AND BUSTS



SOURCE: NBER (GNP, 1895-1948), St. Louis Federal Reserve (GDP, 1948-present). Data are not seasonally adjusted or adjusted for inflation.

More troubling, the U.S. economy plunged 32.9% on an annualized basis between April and July. This represents the steepest decline in history, exceeding even the Great Depression. By comparison, the worst quarter during the financial crisis of 2008 was the 8.4% GDP drop in the fourth quarter of that year. The previous low-water mark was a 10% slide in the first quarter of 1958, while the worst in recorded history came in Q2 of 1921. Over the first half of 2020, contractions were seen in personal consumption, exports, inventories and investment.

Precautionary measures taken by the United States to manage the COVID-19 pandemic — restricting travel, shuttering nonessential businesses, and implementing universal social distancing policies — are having severe economic consequences that will be felt for some time to come. Furthermore, deteriorating trade relations with China, together with rising social unrest in many U.S. cities, and a looming election season have left many business leaders increasingly uneasy about the economic outlook.

Enhanced unemployment insurance payments lapsed at the end of July, and while negotiations around an extension are ongoing, the outcome remains highly uncertain. Similarly, moratoriums around evictions, mortgage forbearance, and student-loan payments are also due to lapse. Absent new action by Congress, there is likely to be a large contraction in August with increased financial stress for millions. These factors will only intensify the economic downturn.

Despite initial hopes for a sharp “V-shaped” recovery in Q3 and Q4 2020, 54% of economists now expect a more gradual “U-shaped” recovery as states struggle to get outbreaks under control. Under this scenario, the economy bottoms at the end of 2020 and begins a slow recovery through 2021 as people gradually return to their normal behavior patterns. **A more pessimistic outlook involves a “W-shaped” recovery where a secondary outbreak of coronavirus infections forces another round of closings and social distancing, stalling any recovery. If this happens, any economic growth could be years away, not months.**

Property & casualty outlook

Despite the pandemic, the change in the market continues to be less about surplus and more about adequacy of returns. Despite a significant drop in the stock market in Q1, the negative impact on capital was largely erased in Q2, and capital is only about -7% off its peak.

There has also been approximately $11 billion of new capital raised by companies with significant commercial P&C or reinsurance operations. On top of this, several startups have added another $5 billion or so, for a total of $16 billion in new capital.

With the yield on 10-year government bonds falling to 0.59%, investment income continues to decline. And, with interest rates likely to remain stagnant for several years, the focus has clearly shifted to underwriting profitability and return on capital. In a sharp departure from the soft market, carriers have made it very clear they are willing to lose market share in pursuit of these objectives.

Years of increased loss severity across multiple lines, combined with lack of meaningful tort reform, have led the marketplace to move in lockstep to increase selectivity, reduce capacity, raise attachment points and retentions, and significantly increase rates. Reinsurance is a similar story with facultative, facilities, treaty ILS and retro sectors also hardening.

COVID-19 did not cause the hard market, but the pandemic has further aggravated the trend. Business activity has slowed and reduced the overall exposure base. Carriers are also struggling with the prospect of significant litigation associated with the virus and bracing for courts to potentially "rewrite" or expand policy language. State mandates around premium forbearance and presumptive compensability have further complicated matters.

Absent significant tort reform and/or a change in interest rates, underwriting and pricing discipline are here to stay. **This will not be a one-year phenomenon, and insureds are likely to see continued pressure through at least 2021.** It will be critical to rethink corporate risk tolerance and volatility thresholds and use sophisticated modeling tools to guide retention and limit selection. Alternate risk structures, including captives, will become increasingly attractive.

Against this backdrop, THE MARKET SAW A NUMBER OF SIGNIFICANT CHANGES between April and July of 2020, including:

- Increased scrutiny of layer relativity in client credit capacity/collateral adequacy.
- Narrowing of appetite based on class of business or operations.
- Increased exclusions, especially as respects pandemics or the use of certain chemicals.
- Intense focus on fleet safety practices.
- Capacity reductions as respects property, auto liability, directors and officers liability, and umbrella/excess.
- Increased layer relativity as respects excess casualty.
- Reduced property capacity.

Looking ahead, it is unclear how the property and casualty industry will adapt to the financial pressure it faces. What is clear, however, is that change is inevitable. Potential scenarios include:

- Channel consolidation continues with global brokers building scale to protect market share and reach
- Prolonged pandemic with long-term near-zero interest rates increasing market consolidation, particularly among small and midsized insurers
- Asian insurance carriers penetrate US, London, and EU markets through increased acquisition activity
- Markets seek to achieve portfolio profitability through even greater emphasis on automation, technology and data

20Q2 financial results

- In the second quarter of 2020, overall premium growth was nonexistent as the impact of the economic shutdown on insurable exposures largely offset improvements in rate. Investment income felt the effects of lower yields and lower alternative income.
- Aggregate underlying results were better than expected when looking at non-CAT/COVID combined ratios.
- Q2 combined ratios were adversely impacted, however, by heavier YOY CAT losses (6.7 pts versus 4.2 pts). Carriers varied in accounting for COVID losses, but this also added to the deterioration in the combined ratio.

2020 Q2 CARRIER RESULTS

	Net written premium (in millions) 3 months ending 06/30/20			Calendar year combined ratio 3 months ending 06/30/20		
Carrier	2020	2019	Change	2020	2019	B/(W) over prior year
Chubb	$7,736	$7,764	-0.4%	112.3%	90.1%	-22.2
Travelers	$7,346	$7,450	-1.4%	103.7%	98.4%	-5.3
AIG	$5,549	$6,581	-15.7%	106.0%	97.8%	-8.2
Liberty Mutual	$9,780	$10,039	-2.6%	105.2%	101.2%	-4.0
The Hartford	$2,903	$2,902	0.0%	96.9%	99.9%	3.0
CNA	$1,930	$1,874	3.0%	112.3%	95.7%	-16.6

Executive risk

The market for executive risk has been hardening for the past 15 months, regardless of industry segment. **The market is fatigued and strained, and it is becoming increasingly difficult to incite competition.** Lead underwriters are driving rate increases, and excess markets are now much less likely to drop down or offer additional coverage enhancements.

For public companies, an already elevated D&O claim environment has seen increased frequency in recent years. Annual average claim volumes have doubled and created significant exposure for the foreseeable future. Through the second quarter of 2020, carriers have been seeking an average rate change of 20%-30%. Increases are largely in response to increased claims frequency and associated defense and indemnity payments. These increases are following all the way up the tower, and in many cases, the excess layers are seeking higher increases than the primary.

The coronavirus pandemic has added an additional layer of uncertainty, especially for those companies within essential industries. Management liability underwriters are deeply concerned about the ability of some companies to remain in business and/or litigation related to any actions taken in response to the virus.

As a result, carriers are being more conservative with limit deployment and cutting back on capacity at renewal. In the current landscape, it is not uncommon for programs to now be built in increments of $5 million or $2.5 million, especially in challenged sectors or for high-risk companies (companies with stock volatility, an IPO/secondary offering, debt leverage, M&A activity or claims experience).

The market is also seeing a concerted effort by underwriters to increase retentions to $2 million or $2.5 million for securities claims, impacting small, mid-cap and larger companies alike.

Rate trend

	Trend	Range
Executive risk	▲	20%-30%

Property

The property market entered 2020 with ample capacity but a general reluctance to deploy it. The prior two years have produced losses in excess of $200 billion, pushing combined ratios well over 100%. CAT losses have been significant, but attritional losses are also rising. Reinsurance has also become more expensive, leading carriers to hold more net and reduce limits, increase sublimits, and restrict terms and conditions. There is also a heightened focus on risk quality and compliance with engineering recommendations. Most critically, unlike in other hard markets, new markets have not emerged to compete for business.

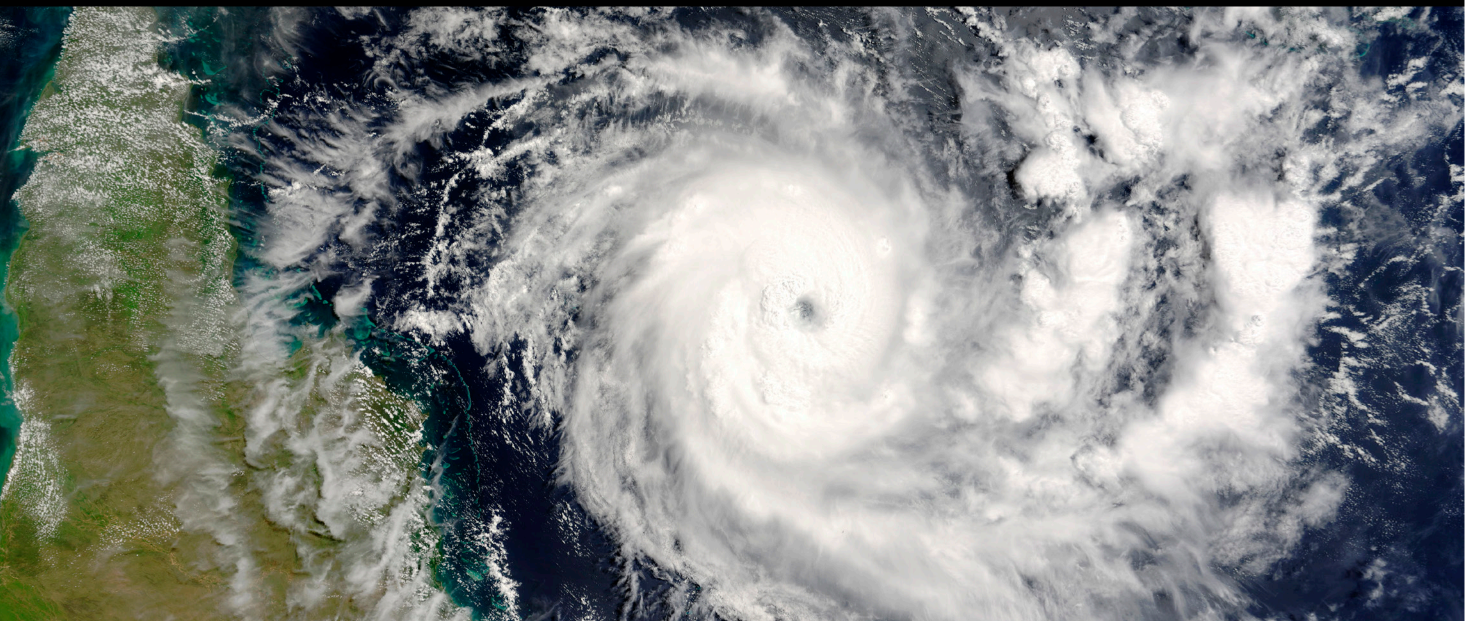
Difficult occupancies, including food, manufacturing, hospitality, retail, habitational/multifamily, or those with poor loss records or significant CAT exposures are seeing sharp rate increases. Similarly, accounts below technical pricing levels or that lose key capacity are seeing the largest rate corrections. Analytics and CAT modeling have become more important than ever to develop and negotiate the most financially efficient program structure.

The COVID-19 environment has also made the marketing process more difficult. Business conditions have led to reduced exposures, especially as respects business interruption and led to challenges around valuations and limits. The pandemic has also made it increasingly problematic to conduct engineering or jurisdictional inspections. This limits the opportunity to attract additional capacity onto programs.

The property market has also been impacted by a wave of claims and litigation filed for business interruption losses related to COVID-19. Although most markets remain confident that the lack of direct physical damage and restrictive policy language will largely insulate them from significant losses, this may be an overly optimistic outlook. As with 9/11, the plaintiff bar is already challenging the policy language and tempting courts and state legislators to “find coverage.” Under such a scenario, losses might quickly wipe out industry capital and put the entire economy at greater risk. Even with a federal backstop for any payments, the industry is ill equipped to adjust losses of this scale.

Beyond COVID, the property market is also addressing an uptick in claims associated with riots, strikes and civil commotion. Underwriters are looking closely at insureds’ located in urban areas and asking additional questions. Although coverage is still available, there is discussion of new sublimits or retentions associated with this exposure. The civil unrest has also caused new business interruption claims for businesses that had just reopened. Adjusting these losses could prove challenging.

> Programs have seen an increase in the number of markets needed to complete a program and renewals are frequently coming down to the last minute. Given market pricing, many buyers have also opted to purchase less limit.



"Uncertainty" for the property market also includes the ongoing impact of climate change.

The escalating frequency and severity of extreme weather-related events has put a spotlight on the potential insurance risk and impacted carriers' ability to predict and price for anticipated loss.

RECENT TRENDS INCLUDE

- Increased development in coastal or quake-prone areas raising the cost of natural disasters
- Heightened intensity and frequency of Atlantic hurricanes since the 1980s
- Higher sea surface temperatures increasing storm intensification
- La Niña effect expected for 2020 tends to increase number of severe storms
- Fourth consecutive year with above average wind season; fifth year a storm started before the beginning of wind season
- Storms are also developing/tracking outside of traditional patterns
- Increased incidence of floods and droughts
- Record heat waves in Europe
- Wildfire activity has increased due to drier conditions.
  - 2018 was the worst California wildfire year on record
- Rise in sea level continues to heighten exposure to storm surge

As rising climate-related losses threaten the viability of insurers' books of businesses and investment portfolios, carriers are struggling to find a balance between providing coverage and mitigating their own risk. Rating agencies are also taking a more active interest in how prepared carriers are to deal with this threat. Most now look at capital adequacy relative to a company's exposure to losses from a 250-year event, rather than a 100-year event. It is highly possible that carriers could face two or more significant CAT losses in a single year and must have appropriate resources to address.

Rate trend

	Trend	Range
Non-CAT	▲	5%-15%
CAT	▲	10%-25%
Losses	▲	15%-40%

Auto liability

Auto liability remains one of most challenging lines as U.S. commercial automobile insurers have struggled with worsening underwriting results for the past 10 years, and, **despite aggressively pushing rate increases for the past six years, combined ratios remain stubbornly around $100%**. This adverse experience arose though a combination of factors, including an expanding economy, more drivers on the road, an increased level of attorney involvement, escalating jury verdicts, and a rise in third-party litigation financing. Studies have also shown that distracted driving is a significant contributing factor in most accidents. There is also increasing anecdotal evidence that shows higher accident rates in states that have legalized the use of marijuana.

Risks with large fleets, especially those in trucking and distribution, are finding it increasingly difficult to secure capacity at any price, especially those with loss activity.

Nonowned auto exposures, long overlooked by many insurers, have come under much closer scrutiny as more businesses shift to delivery services.

Although COVID-19 briefly led to lower frequency due to reduced traffic, severity continues to be an issue. In response, primary markets are demanding higher retentions, typically limiting themselves to $2 million in limits and often seeking reinsurance support.

Rate trend

	Trend	Range
Auto liability	▲	7%-15%

Umbrella/excess

Underwriters are responding to adverse case law, rising defense costs, and poor loss experience by increasing rates, demanding higher attachment points, restricting coverage, and sharply reducing capacity. They are also looking closely at jurisdictional exposure. Clients with significant fleets are seeing renewed scrutiny around driver training and the use of telematics. On the latter point, the emphasis has shifted from simply having telematics to a focus on how they are being used to improve driver behavior and drive down losses.

The number of markets willing to write lead umbrellas continues to shrink and this limits competition. Further, many carriers have reduced capacity deployed in any one layer from $25M to $10M-$15M — often without any reduction in price. By some accounts, this has reduced overall market capacity by over $600M. Virtually all programs will require more carriers and premium to achieve the same limits as expiring.

Rate increases are following through the excess liability tower and excess markets are increasingly focused on “rate relativity and adequacy.” Many clients are purchasing less limit than the prior year’s program — a decision that is more typically due to cost rather than availability of capacity. Marketplace challenges also place a premium on starting earlier and allowing more time to complete the tower.

For risks with large fleets, most umbrella markets are now requiring between $5M and $10M in primary auto limits. As noted earlier, the primary auto market is generally limited to $2M, leading to significant challenges and pricing pressure. Buffer layers, captives, reinsurance, and aggressive retention strategies are all being used to manage the gap.

Changes in the legal environment have led carriers to draft new exclusions for a cross section of mass tort exposures. These include: sexual misconduct, opioids, cannabis, traumatic brain injury (TBI)/chronic traumatic encephalopathy (CTE), glyphosate, wildfires, assault and battery, and on-premises violent acts. In a post-COVID environment, communicable disease exclusions are also being added. These exclusions can range from excluding all communicable diseases to just COVID-19. These restrictive terms and conditions can have a material impact on the value of the coverage beyond the “hard dollar” structure and pricing changes imposed upon renewal.

Rate trend

	Trend	Range
Umbrella/excess	▲	15%-25%

Workers' compensation

Workers' compensation insurance has been in a "soft" market cycle for many years, but this was plateauing even before COVID-19. While the industry has highlighted calendar year combined ratios in the high 80s and low 90s, these figures were supported by significant reserve releases from prior years. Removing the impact of these releases and focusing just on the accident year loss ratio highlights a significant deterioration in results. **More importantly, carriers have now largely exhausted their reserve redundancies, placing a premium on rate adequacy and underwriting profitability.** Long-term trends as respects an aging workforce and medical inflation are also unfavorable.

As unemployment increases, payrolls will contract sharply and premiums will decline, placing further strain on profitability. COVID-19 may also generate an increased frequency and severity of claims under employer's liability coverage, a historically underappreciated part of the workers' compensation policy. This could be particularly relevant as employees in essential industries return home and possibly infect their families. Pandemic exclusions on an umbrella policy may also limit available employer's liability limits for related losses.

The impact of COVID-19 will also result in delayed access to care and an inability to return employees to light or modified duty. Workers' compensation combined ratios are likely to deteriorate even further, putting more pressure on rates.

Rate trend

	Trend	Range
Workers' compensation		-2%-5%

Economic downturn will have a significant impact on workers' compensation

- As unemployment increases, payrolls have decreased sharply, causing a drop in premiums.
- Various states have issued regulations which create a "presumption of comprehensibility" for workers who contract the virus. A compensable diagnosis of COVID-19 may also lead to an increased frequency of employer's liability claims, a historically underappreciated part of the workers' compensation policy.
- The long-term nature of workers' compensation claims allows carriers to hold /invest cash for years before setting claims. However, as bond yields have fallen, investment income has also declined, putting upward pressure on pricing.
- COVID-19 has also impacted access to the healthcare system and/or slowed medical treatment. Employers are also less likely to be able to return injured workers to light or modified duty. Both trends will likely cause workers' compensation combined ratios to deteriorate even further and impact rates.
- Longer-term trends as respects an aging workforce and medical inflation are also unfavorable.

Summary

The hardening market and COVID-19 pandemic have had a profound impact on both sides of the insurance transaction.

Underwriters

- Insurers have reduced overall capacity deployed and/or nonrenewed based on profitability or class of business. Capacity is available — but there will be less deployed on any one risk, and pricing will look significantly different.
- Clients with large fleets, difficult products, CAT-exposed properties, adverse loss histories and/or poor follow-up on loss control recommendations may struggle to find coverage.
- Market conditions have led to a flood of submissions, and underwriters have become highly selective. Poorly detailed submissions are quickly rejected.
- Underwriters in the field have less authority and must submit quotes for additional layers of review. In addition to the constraints already imposed by a “work from home” environment, this has slowed the process and can result in quotes coming down to the deadline.
- The number of restrictive terms and conditions is increasing.
- Increased activity and higher rates have resulted in markets meeting Gross Written Premium (GWP) growth targets, earlier in the year. This can sometimes impact their incentive to provide flexibility around terms and pricing.

Buyers

- The economic outlook for most sectors remains highly uncertain. Liquidity, expense management and flexibility are critical.
- Many businesses are forecasting continued reductions in payroll, revenue and business interruption values.
- In reaction to ongoing shutdowns and social distancing requirements, firms have adapted their service models, changed operations, or simply closed their doors. In many cases, this has changed the overall risk profile.
- Buyers have reacted to higher premiums by purchasing lower limits, raising retentions/ attachments, and exploring alternative risk structures.
- On certain lines of business, the incumbent market has significant leverage as loss control inspections are hard to complete or competitive options cannot be found.
- Interest in single parent, group captives, and alternative risk structures has surged.

How to improve your outcomes

Start **early** and develop a flexible plan

Meet with key markets and understand their position, perspective, and unique issues

Ensure underwriters understand how your risk profile and operations have changed

Provide more detail around payroll, fleet, and sales projections

Evaluate the financial efficiency of the current program

Review loss projections based on new realities

Prepare for credit discussion

Review/prioritize terms and conditions, including premium audit provisions

Use analytics to highlight key trends and model different structures

Consider use of higher primary limits, buffer layers, or fronts

Engage with experts in global markets and reinsurance

Review potential synergies associated with placing multiple lines with key insurers

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