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Pandemic Losses Forestall Liability Insurance Turnaround

Written by James B. Auden | Published September 24, 2020 on CarrierManagement.com

Projecting future property/casualty insurance market profit is always challenging. The economic and social impact of the ongoing coronavirus pandemic greatly compounds the uncertainty of this effort.

Longer-tail liability lines in particular will incur large losses from this event that will take multiple years to resolve. However, more aggressive underwriting and pricing actions driven by recent poor experience and fear of large pandemic-related losses could move this market segment to a considerably better profit position post-crisis.

Underwriting performance in numerous casualty segments has suffered in recent years from an extended period of price competition and rising claims severity, in part from social inflation that's led to higher litigation defense and settlement costs and rising jury verdicts. Liability insurance products like directors and officers liability are also affected by claims frequency issues in areas including merger objection suits.

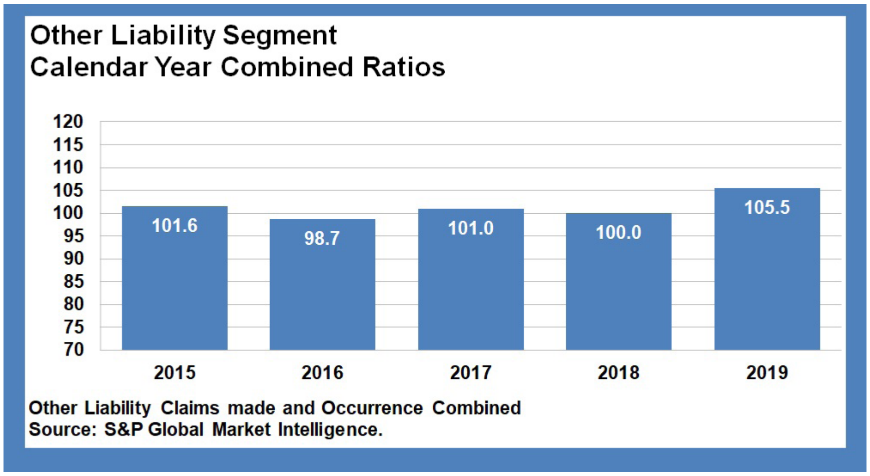
A review of P/C industry results shows underwriting losses for the other liability segment (occurrence and claims made business) rising, with the combined ratio deteriorating above 105 in 2019 from a range of 99-102 in the previous four years. Larger underwriting losses in the last three years were not uncommon for several additional casualty insurance segments, including commercial auto, medical

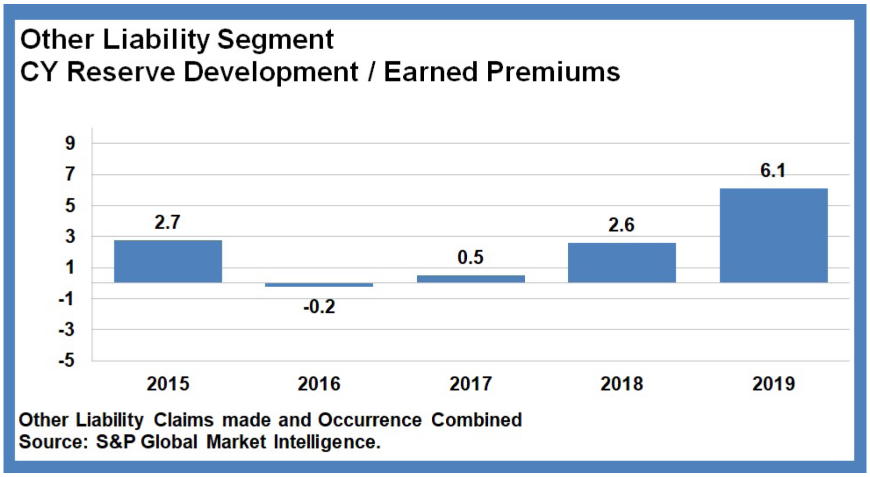
Executive Summary

Will double-digit price increases be enough to turn around underwriting losses in liability insurance lines? Fitch Ratings Analyst James Auden examines recent trends in pricing and underwriting results.

professional liability and product liability, due to similar loss severity issues.

Ultimate accident year performance for recent years is likely to prove weaker than reported results as reserve deficiencies materialize from rising claims costs. Adverse loss reserve development in the other liability line added six points to the segment's 2019 calendar year loss ratio.

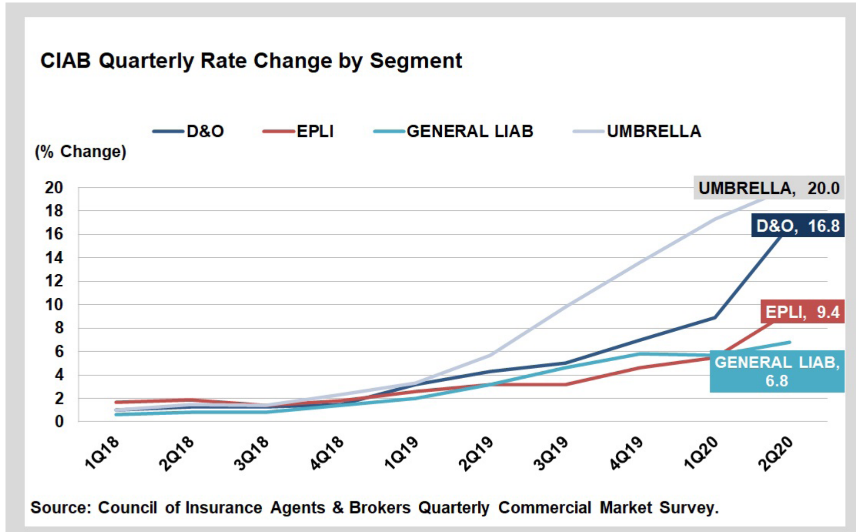




Liability writers have reacted to performance deterioration with meaningful pricing actions. Changes in risk appetite and limits profile by several larger commercial underwriters has boosted pricing momentum in several liability segments, particularly in higher-limit and excess coverage.

The ongoing coronavirus pandemic in 2020 adds substantial uncertainty regarding near-term loss experience for commercial insurers. At midyear 2020, North American publicly held insurers reported approximately $7 billion of GAAP incurred losses tied to the pandemic, and this figure is bound to expand further by year's end as events unfold and underwriters assess risk exposures. Loss activity is spread across multiple products, including event cancellation, business interruption, workers compensation and numerous liability products, such as D&O and employment practices liability. Liability losses to date are largely incurred but not reported (IBNR), reflecting limited actual claims filings and potential for substantial increases in pandemic-related litigation fueled in part by the expansion in third party-litigation funding to finance claimant actions.

Concerns of pandemic losses have fueled further rate increase momentum across many commercial lines segments. The Council of Insurance Agents & Brokers Commercial Property/Casualty Market Report for second-quarter 2020 measured a 10.8 percent increase in all commercial insurance premium rates for the period, the highest level since first-quarter 2003. The largest individual segment increases include many liability lines: D&O, EPLI general liability and umbrella.



Other market experts point to even higher rate increases in the most recent quarter. Marsh reported that U.S. financial and professional liability rates were up 30 percent in second-quarter 2020. Aon's Quarterly D&O Pricing Index indicated a 61 percent increase in price per million of coverage for renewing policies in second-quarter 2020 vs second-quarter 2019.

Recent socioeconomic changes are also influencing claims experience in areas, which may provide a reduction in incurred losses for 2020. Examples include fewer accidents at business establishments with fewer employees or customers on the premises. And courthouse closures over several months led to a 13 percent decline in core class action suit filings in 1H20, according to Cornerstone Research.

Corporate actuaries will need to assess whether recent changes in exposures and claims frequency represent an aberration or shift in trend when setting 2020 reserves. Maintaining a more cautious approach to incorporating favorable frequency ratios in current accident year loss picks could serve to partially offset reserve weaknesses from prior periods. While settling liability claims in 2020 was inhibited by a slowdown in the judicial system, liability insurers may also have an opportunity to reduce reserve uncertainty as a number of policyholders facing cash flow pressures in an economic downturn may currently be more inclined to settle a claim rather than continue a lengthy legal process.

Full effects of the coronavirus pandemic on P/C insurers will likely drive liability segment underwriting losses higher in 2020. However, future profit fundamentals are boosted by sharp cumulative rate increases and tighter underwriting terms that will also more frequently include tighter virus exclusions across many segments.

Comparing the current day with the last time liability rates rose this rapidly helps in considering potential timing and strength of a recovery in underwriting performance. The last true P/C industry hard market followed a first-ever statutory net loss in 2001, tied to very soft market conditions, sizable reserve deficienciesand large losses from the 9/11 event. Most liability product segments reported massive losses in this period, including a 122 combined ratio for 2001 in other liability.

Several years of pricing and underwriting actions and recognition of substantial adverse reserve development were required to return to an underwriting profit. The other liability segment moved to a 97 average combined ratio from 2006-2008 and moved to a redundant reserve position for many years afterward.

Liability insurance pricing, underlying performance and reserve weakness were considerably worse in the last extreme soft market versus the current day. And shock losses from the 9/11 event represented a larger portion of industry capital and earnings than pandemic-related losses will likely represent.

This historical comparison may point toward a faster, but not immediate, return to statutory underwriting profitability in liability lines in this cycle—perhaps in 2022 or 2023—that will still hinge on continued movement toward pricing adequacy, resolution of prior reserve issues and accurate recognition of pandemic-related losses.

After meeting these three tasks, sustaining performance longer term remains inhibited by several factors. Further declines in interest rates reduce the contribution from investment income on longer-tail reserves, requiring greater underwriting earnings to meet return objectives. Also, loss cost inflation tied to litigation-related risk is unlikely to abate. Meaningful liability reform efforts are not at the forefront of current public policy debates. Maintaining rate increases at a pace that keeps up with loss costs over the longer term is unlikely given market competitive factors and historical precedents. CM

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