INTRODUCTION

CHALLENGING. That is the best way to describe the current state of the property and casualty market in the US. While many are characterizing this as a hard market, the current increases aren’t to the level of those exhibited during the hard market conditions in the early 2000s. But for many companies, it may still feel like a hard market because they have experienced significant rate increases, reduced capacity, and changes in terms and conditions. Some have also seen long-term partnerships change as markets modify their portfolios to match their new capital deployment strategies.

AVERAGE COMMERCIAL RATE INCREASES BY LINE

These dynamics are driven by decreased carrier profitability that is the result of years of declining rates, a persistent low interest rate environment, rising claim severity and increased frequency of severity, large natural catastrophe losses, and emerging risks. The tightening isn’t a result of reduced market capacity but rather carriers refining how they deploy their capital. Political instability and uncertainty of future economic growth is putting additional pressure on the P&C marketplace.

Underwriting discipline has a renewed focus, and carriers are looking closely at each client’s unique risk characteristics to determine pricing, retentions, limits and terms. The net effect is increased variability in outcomes. Underwriters are asking for more information, reviewing the adequacy of each client’s risk management and controls, and evaluating executive management’s commitment to mitigating loss.

Challenging doesn’t mean unmanageable! We are actively engaged with our clients to help position them for the best possible renewal outcomes. Our approach includes:

- Preplanning, with a focus on our client’s risk tolerance, current program design, and overall carrier capital deployment strategies.
- Leveraging analytics, as well as qualitative factors, to appropriately differentiate our clients.
- Exploring alternate risk finance strategies and less traditional program structures.
- Assessing market options.

In this edition of the Lockton Market Update, we will discuss the current landscape for each line of business and share ideas about how to manage through the challenging market conditions.
Two consecutive years of severe losses in the property market are driving rate increases and a tightening of terms across many accounts. To put this into context, 2017 and 2018 accounted for 25% of the $850 billion in property losses incurred over the past 20 years. Of the losses in 2017 and 2018, nearly two-thirds were due to catastrophes (CATs) such as named storms and wildfires.

The property market is clearly focused on recovering from these losses resulting in increased underwriting discipline. Capacity isn’t exiting the market, but deployment is becoming tighter. Commercial property rates were already tightening, but recently, the increases have become more dramatic. Even clients with clean loss histories or benign risk profiles are experiencing increases of 5%-10% while certain segments and accounts with large CAT losses are experiencing even more significant increases.
In general, respondents from all regions agreed that underwriters were approaching renewals more aggressively. “In most classes (with the exception of Work Comp) and industries, underwriters start with asking for an increase,” said one respondent from a large Southwestern firm. “For the most part, rates/premiums are going up across the board.” Said another respondent from the Southeast, “We are continuing to see increases on most lines into the second quarter this year even on loss-free accounts.”

Rate Changes in Other Lines

NOTABLE LINES OF BUSINESS

COMMERCIAL PROPERTY

As previously mentioned, Commercial Property was the most problematic line of business this quarter, with a premium pricing increase of 8.5%. Brokers in the Southwest and Northwest identified wildfires as one of the major reasons for carrier restrictiveness in this area (recall that California had the nation’s worst fire season in 2018 and the “worst in recorded history for the state”), while in the Midwest brokers named flooding as the culprit, likely referring to the floods plaguing Midwestern communities since March 2019 around the Mississippi and Missouri Rivers. The Southeast was also victim to significant flooding in the past few months, thanks to a wet winter followed by an even wetter spring.

Carriers took note. According to a respondent from a midsized Northwestern firm, “The commercial property market for higher hazard classes and wildfire areas is tightening, and we are seeing non-renewals.” And in the Southeast, one respondent observed, “Property market has seen increase in Cat deductibles and application of water damage sub-limits - in addition to increase in program rates.”

In some particularly high-risk areas, respondents noted they weren’t just seeing significant increases in premiums; they were seeing non-renewals as carriers pulled back from lines seriously impacted by natural catastrophes. “We are seeing underwriters across the board look for price increases and deductible adjustments,” said one respondent from a midsized Southeastern firm. “Property is leading the pack.”

The difference between this and prior hard market cycles is:

- There is still plenty of capital in the marketplace. What has changed is the willingness to deploy it.
- There has not recently been significant new capacity emerge to counteract some of the firming.
- The focus of underwriters is on margin and return on capital. Rate pressure is increasing, and underwriting terms are being tightened.

We anticipate these trends to continue at least into early 2020 when we learn how the markets performed in 2019.

The California earthquake market is beginning to trend up, with average rate increases of 5% on clean accounts. Aggregation issues are driving the pricing uplift, so buyers are looking to parametric solutions as an option.

Dealers open lot (DOL) is a microhard market with several carriers getting out of this line of coverage completely. The average DOL rate increases are around 15%, but it isn’t uncommon for some clients to see increases of 40%-50%. With no new entrants in this space, maintaining capacity on current programs is a primary concern.

Similar to the US property market, global carriers are evaluating their deployment of capital in local markets which is impacting pricing and capacity for global property programs. Many insurers have isolated certain countries as underperforming and in some cases have elected to not renew or exit the market. In addition, local insurers are seeking to improve their underwriting performance and reduce their exposure, so stand-alone local policies may be particularly vulnerable without the support and leverage of a broader global program. For businesses with significant risk outside the US, a comprehensive program strategy that accesses capacity at a global, regional and/or local level can help mitigate some of the market dynamics.
As mentioned, some segments of the market are experiencing more challenging conditions than the overall property market. Those areas are discussed below in more detail:

**Construction**

With a strong US economy, the construction market continues to be active and so is the demand for builder’s risk coverage. In general, builder’s risk pricing has increased by 15%-20%, which is being driven by reinsurance contracts. As with the larger property market, carriers are focused on terms and conditions. Noncombustible commercial construction and heavy, industrial/petrochemical construction remain well capitalized and thus are seeing flat to 10% rate increases for builder’s risk.

Builder’s risk water-related losses (e.g., flood, water intrusion and mechanical/plumbing components) have followed an adverse trend with rising frequency and severity. This has resulted in increased policy deductibles in some cases. Proactive loss and quality control procedures remain impactful tools in managing these types of exposures.

The wood frame market remains distressed with multiple fire and water losses. Rates have continued to move upward with an average increase of 6%-8% over the past 12 months and more than 20% in the past 24 months. Capacity constraints in both the domestic US and London markets continue further upward pressure into 2020.

**Energy**

2018 was one of the worst loss years in downstream property, with claims totaling over $3.5 billion. It is reported that only three of the past 12 years have been profitable for the global downstream energy insurance market. Under these conditions, the pressure for the market to increase rates has become overwhelming. In addition, there is a reduction in capacity resulting in markets deploying less capacity per risk. Accounts with natural catastrophe exposure can expect even larger rate increases. We anticipate rate increases will continue in the downstream energy market until performance improves and new capacity enters the market.
Marine cargo and stock throughput

It’s been a little over a year since the Lloyd’s syndicates reset their standards of underwriting with a particular focus on cargo and excess stock insurance programs. Since then, it is estimated that there has been a 26% loss of Lloyd’s cargo capacity, and more closures are expected in 2020. The reduction in capacity and problematic risks are driving rate increases and making renewals more challenging in both domestic and international markets. As with the broader property market, carriers are also tightening terms and being more selective in how they deploy capital in this space.

Favorable accounts that fall within a desired risk profile are seeing average rate increases ranging from 2.5%-10%. However, clients that have experienced business growth should expect overall increases that could exceed 10%. Further, programs with a high concentration of static risks and exposure in CAT-prone areas (along with other areas that haven’t been profitable for carriers) can expect significantly larger increases in rates and retention levels. It is worth noting that the frequency and severity of fires at storage and processing facilities are increasing at an alarming rate, so insurers are viewing fire as a new “CAT” peril.
Real estate

Years of soft-market pricing, large catastrophe losses in 2017 and 2018, and low investment returns have pushed the real estate insurance market into a state of correction. With combined ratios well over 100%, carriers are reducing capacity, increasing premiums, raising deductibles and restricting coverage terms. In some cases, they are also exiting certain asset classes, primarily multifamily and hospitality. Several have left the space altogether.

The distinguishing characteristics of this market include the following:

- While many carriers are hanging on to their well performing legacy business, new business is under heavy scrutiny.
- Minimum retentions of $50,000-$100,000 are becoming more common.
- Valuations are being closely scrutinized.
- Flood and earthquake limits are under pricing and/or capacity pressure.
- Due to increased claim activity, many markets are mandating a water damage deductible of $100,000 or more.
- Shared aggregate CAT real estate programs (i.e., REAPA, CIBA, PRMA, etc.) continue to be very selective on renewals and more so on new business.
- Carriers remain mindful of convective storm activity in Texas, Oklahoma, Colorado and into the plains and Midwest. Pricing continues to be a challenge in these areas, and carriers are pressing for both higher rates and percentage wind/hail deductibles. In addition to rate increases, there are additional costs coming from buying down deductibles to comply with loan requirements and carrier scrutiny around increasing replacement cost valuation.
- Many markets have restricted the percentages of subsidized, student or elderly housing, while others have ceased writing accounts in certain states all together (including California, Florida, Louisiana and New York).

Another rapidly growing concern in the multifamily marketplace is crime. Multifamily clients should take significant and purposeful steps towards expanding the scope of security awareness programs. Real estate owners and managers will need to provide comprehensive information on risk controls and risk management strategies when placing coverage associated with these exposures.
CASUALTY

The firming umbrella and excess casualty market is the lead story when it comes to challenges in the US casualty marketplace. While commercial auto continues its streak of 32 straight quarters of rate increases, the umbrella and excess casualty market is changing rapidly. Conversely, workers’ compensation remains the one area within casualty that’s competitive with decreasing to flat rates in most cases.

The umbrella/excess markets have abruptly shifted to a renewed focus on profitability and pricing adequacy. As a result, carriers are demanding higher attachment points, reducing capacity and increasing premiums. This is creating pressure on the entire tower of limits, not just the lead layer. While these actions are affecting the majority of clients, national accounts and clients with substantial fleets are experiencing the most significant impacts. The marketplace generally agrees that this is a phenomenon that will persist for the next 12-24 months.

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<th></th>
<th>Commercial auto</th>
<th>Workers’ compensation</th>
<th>Commercial property</th>
<th>Umbrella</th>
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<tr>
<td>Second quarter 2018</td>
<td>8.2%</td>
<td>-2.9%</td>
<td>2.2%</td>
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In response to the legal dynamics hindering profitability (see page 10 of the December 2018 Lockton Market Update), carriers are drafting exclusions at a rapid pace for a wide cross section of exposures that are subject to mass tort litigation. These include sexual misconduct, opioids, cannabis, traumatic brain injury (TBI)/chronic traumatic encephalopathy (CTE), glyphosate, wildfires, assault and battery, and on-premises violent acts. 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.

Coverage exclusions, structural changes and premium increases may be deemed insufficient to address underwriting concerns. In these instances, nonrenewal positions are being taken. We have observed a higher volume of nonrenewal actions both in the lead layer and from excess carriers subscribing to more rigorous minimum pricing discipline than in prior years.
While the above updates apply to many industries and types of businesses, here are a few exceptions or industry-specific issues in the casualty space.

Construction

In general, casualty coverage within construction has followed the broader casualty trends. A few areas of note are:

- Increased frequency and severity for construction-defect related allegations, automobile, and bodily injury losses under New York’s labor law standards have resulted in increased underwriting scrutiny.
- The professional liability market is following the trends noted within the overall casualty space with significant increases on any risks that are loss challenged. Capacity remains available but with an increased cost. Loss-related issues are also placing significant pressure on retentions for professional liability.
- Contractors pollution liability is one area experiencing rate decreases in the single digits.

Healthcare

As with other liability coverage, the legal landscape is having a direct impact on the healthcare segment of the casualty market. The frequency of larger jury verdicts is impacting future settlement values, and tort protections continue to be challenged in several venues. This is creating a shift in the market that we expect to continue in the foreseeable future.

- Medical professional liability rates are being adjusted for deteriorating combined ratios and exposure growth. Rate increases of 5%-25% appear to be the new normal, regardless of location, while challenged venues are experiencing even larger increases. The marketplace change is creating an influx of submissions for underwriters around the country, so the renewal process must start early to get ahead of increased underwriting scrutiny and questions.
- The senior care segment of the market has moved from “transitioning” to “firm”. Overall capacity has shrunk, rates continue to increase by more than 25%, and retentions are likely to increase as well. Certain venues have experienced a significant reduction in underwriting capacity.
- Healthcare operations that have exposures connected to the manufacturing, prescribing, dispensing or distributing of opioids continue to be subject to additional underwriting. This could include sublimits and/or opioid exclusionary language in liability policies.
Transportation

The transportation segment is experiencing more pronounced firming than the overall casualty space.

- Excess capacity continues to flee the market. Attachment points are increasing and/or limits are being reduced. Some players are exiting the transportation area altogether.
- Depending on hazard class within transportation, there may not be enough carrier capacity to fill out the desired liability limits.
- Carriers at all layers are drastically increasing rates. Inside the first $20 million, rates are increasing at double digits. Above $20 million, premiums can be two to five times expiring rates.
- The working layer for loss activity continues to increase.
- Legal dynamics are especially affecting transportation and driving some of the trends mentioned above:
  - Catastrophic jury verdicts and settlements continue to occur at an unprecedented rate. High excess carriers are dealing with multiple occurrences in layers where little to no activity was expected.
  - Third-party litigation funding continues to be a trend in the transportation sector. This enables parties to continue to litigate or arbitrate cases even if they have run out of funds to do so.
Mitigating the changing casualty market

While much of the casualty market is challenged, there are actions that can be taken to put businesses in a better position heading into their renewals. Lockton consults with our clients to help them define their risk profile and tell their story about what makes them a differentiated and desirable underwriting risk. This may include examining a company’s total insurance program and leveraging highly desirable policy renewals alongside somewhat challenged ones to potentially provide carriers with a more balanced and appealing underwriting opportunity.

Liability underwriters continue to have interest in a company’s product quality and safety controls as well as in their contractual risk transfer diligence. Furthermore, they are now seeking validation that these practices are having actual positive impacts on the company’s loss experience. For example, a fleet operator that can point to an improved loss trend correlated to a telematics investment and implementation will be more favorably viewed than those that simply “check the box” and self-identify as telematics users.

Clients with international operations may be able mitigate some of the US market dynamics by leveraging their multinational programs. Attracted by historically low loss ratios, the casualty market outside the US remains competitive with plenty of capacity. For clients with significant exposure outside the US, higher limits or expanded coverage terms and conditions may be available through non-US markets. Tapping into these markets could enable clients to take advantage of the more favorable conditions and international capacity for the benefit of their US programs.
For most companies, cyber risk remains the most difficult risk to understand, quantify and mitigate. Cyber risk is extremely dynamic and has continued to evolve over the past several months. Fortunately, the insurance solutions have evolved as well.

Cyber risk landscape

Ransomware has grabbed most of the headlines recently. In the first half of 2019, more than 50 cities were attacked, with Baltimore and Atlanta being the biggest ones. Some cities paid the ransom; others have not. One well-respected firm reports that ransomware was up 118% in the first half of the year. In addition to attacks growing in number, their sophistication has grown. This has led the ransom demands to increase. Prior to 2018, seven-figure ransom demands were unusual, but today, that is no longer the case.

Data breaches continue to plague companies. Over 4.1 billion records were breached in the first half of 2019 alone, which represents a 54% increase over the same period in 2018. The number of incidents also increased by 52%. Not surprisingly, the healthcare sector experienced the most breaches. Other notable affected sectors include retail, finance and insurance, information technology, and public administration.

Looking forward, companies need to be concerned about an increased regulatory burden. California is leading the way. On Jan. 1, 2020, the California Consumer Protection Act (CCPA) will be in effect. The CCPA broadens the scope of information that will be subject to legal protections. It also creates new obligations concerning how information is collected, managed and disposed of. The CCPA is something that companies need to prepare for now.
California’s internet of things security law will also become effective on Jan. 1, 2020. This law requires manufacturers of connected devices sold in California to ensure that reasonable security measures are built into those products. Whether measures are reasonable will be based on the nature and function of the device as well as the information it may collect, maintain or transmit.

The new laws in California seem likely to spur other states to enact similar statutes.

**Cyber insurance marketplace**

The cyber insurance marketplace remains vibrant. There have never been more insurers offering more different cyber insurance solutions than there are today. Competition is strong, and this has helped keep premiums down and spurred innovation.

Cyber insurers are eager to cover companies that can show that they take cyber risk seriously and that they manage it well. Companies in that position can sometimes achieve premium decreases year over year. Companies that are less prepared for cyber incidents can find coverage, but the cost may be higher and options more limited. Solutions for small- to midsize companies (typically with annual revenues under $250 million) have the greatest number of choices. There are a number of cyber policies (including some created by Lockton) that provide state-of-the-art coverage at excellent prices, and they don’t require strenuous efforts by the company in the underwriting process.

While it’s currently a buyer’s market for cyber insurance, we could see some firming in premiums over the coming year. Insurers have paid some significant losses over the past year in connection with some significant data breaches. Likewise, they have been hit by the huge volume of ransomware attacks. For large companies with over $1 billion in annual revenue, some of the larger global insurers are starting to seek single-digit rate increases on cyber and technology errors and omissions renewals. This may lead insurers to reconsider pricing for primary policies and, even more likely, excess policies. Insurers have seen, once again, that large cyber incidents can easily exhaust an entire cyber program, which makes it difficult for them to rationalize significantly discounting excess layers. Nevertheless, it is possible that competition will force rates down in the future; this is something Lockton will continue to monitor closely.
Over the past few months, insurers have taken steps to clarify what policies cover losses resulting from cyber events. Lloyds, and, most recently, AIG have stated that future policies must affirmatively cover cyber losses or must exclude them. Other insurers are likely to follow suit. Lockton feels this is a positive development. Some believe that having a policy be silent about whether cyber losses are covered is a good thing because it allows an insured to argue that coverage is available. However, such silence could be, and frequently is, a basis for a coverage battle that the insurer and the insured don’t want. Clarifying the availability of cyber coverage brings certainty for all parties involved.

We’re also hearing that General Data Protection Regulation (GDPR) regulatory actions are and will continue to increase in frequency. Early signs show that many of these actions may result in settlements versus fines or penalties. This increases the likelihood of insurability. While this is good news for policyholders, some insurers may find themselves unprepared for these losses, leading to sublimits or increased pricing for the coverage.

Cyber policies themselves have continued to evolve. The insurance industry is no closer today to having a standardized cyber policy form than it has been in the past. While this makes it more difficult to compare policy forms, this lack of standardization benefits companies that are clear on what they want to cover.

Cyber risk changes so frequently that a form that is a year old probably needs to be revised. Lockton recently launched a new version of our High Compliance Plus policy form. The form is used with London insurers and is regarded as the broadest cyber policy form in general use. Lockton has also developed a version of the High Compliance Plus form called CyberForce that can cover property damage resulting from a cyber event. Very few policies provide such coverage. Lockton account teams work with our clients to evaluate their options and help secure appropriate coverages.
SURETY

The surety industry continues to act as a broken record with significant revenue and relatively low losses. Through the first two quarters of 2019, the surety industry booked $3.48 billion in revenue, a 10.5% reduction from the same period in 2018. While down, this still represents one of the largest first-half results in the history of the surety industry. Reinsurance remains robust and inexpensive, helping sureties support record backlogs for many clients.

As a whole, the industry experienced an 18.2% direct loss ratio. While historically speaking this is still solid, several notable sureties are showing elevated losses. Despite the robust economy, construction company failures are occurring with examples from Canada, the Northeast, Texas and Florida. Ongoing concerns regarding availability of labor, ownership transitions and overextension of contractors continue, which are factors we will continue to monitor.

Fueled by new entrants attracted by healthy margins, the commercial surety market remains extremely soft. Sureties are heavily investing in technology on the commercial side with the hope of creating efficiencies in the bond request/execution process. International has also become a focus for commercial underwriters as they look to expand their offerings for clients and grow their revenue.

While on the surface everything appears rosy, angst over an anticipated downturn in the US economy and ultimately the construction market is starting to creep into underwriters’ heads. In the short term, we do not anticipate any significant changes to underwriting, rates or capacity. Companies with strong credit profiles will continue to benefit from a soft surety market. However, we may be seeing the very early signs of changes on the horizon. Lockton will continue to be proactive and communicative with our clients to address any marketplace changes that occur.
EXECUTIVE LINES

Since the April 2019 Lockton Market Update, the directors and officers (D&O) market has continued to firm. Public companies are seeing particularly challenging trends with rate increases for primary policies averaging over 20%. In addition, carriers are forcing higher retentions, as many are requiring a minimum attachment point of $2.5 million, and many carriers are cutting back on capacity. The private side is more stable with firming trends isolated to a handful of carriers that have recently experienced very high loss ratios, but overall, rates are inching upward in private company D&O as well.

Excess carriers are not only following the primary increases for public companies, but they are also increasing rates on their excess coverage, compounding the total premium change. Recent data shows that excess carriers are seeking average premium increases in the high 30% range, but the range varies widely with many insureds seeing much larger increases.

This market deterioration is due in part to the rise in claims frequency, settlements and unresolved cases. The frequency of claims has been at record high levels the past three years. Litigation is generally taking longer, resulting in inflated defense costs. In addition, more cases continue to be filed in state court, creating more uncertainty in outcomes. 2019 is trending toward 400 securities class-action claims, following similar numbers from 2017 and 2018. Fewer public companies also means less premium for carriers and a higher likelihood of getting sued.

PERCENTAGE OF PUBLIC COMPANIES FACING A D&O CLAIM

Source: Cornerstone Research
D&O for initial public offerings (IPOs) is facing a very hard market as capacity has narrowed considerably, particularly for “unicorn” companies or private companies with a valuation over $1 billion. Premiums have skyrocketed, and attachment points are typically $5 million to $10 million. In the first half of 2019, 14 companies with recent IPOs (since 2017) were hit with at least one D&O claim.

The employment practices liability (EPL) market is stable with the exception of an increase in sexual harassment claims, in part as a result of the #MeToo movement.

The crime market continues to see a large increase in claims mostly because of the increase in social engineering fraud. However, kidnap, ransom and extortion are being impacted by hacking and ransomware risk, and many carriers are forcing a cyber insurance policy to respond.

Due to these market conditions, renewals are taking longer. The renewal process should begin well in advance of expiration. We recommend a minimum of 120 days, and communication needs to be continual throughout the process. We expect these trends to continue into 2020.

For additional details on recent claim trends, see Lockton’s EPL and D&O white papers.
CLOSING

By implementing our suite of capabilities for each client, Lockton is poised to help our clients navigate this challenging environment and deliver the best possible outcomes. The current market conditions are changing frequently, so please contact a member of your Lockton team for up-to-date information.