UNDER PRESSURE

Capitalizing on alternative risk solutions in the face of a hardening Commercial Property market

Steve McElhiney, SVP and Director of (Re)insurance

Artex

WHAT'S COVERED:

- Shaping the renewal story—data adequacy, claims history and analytics, and how they help to structure a productive (re)insurance discussion
- Risk retention with a captive — benefits of active loss control to achieve better than average loss results
- Supply chain disruption, delays and claims inflation — impact of the prevailing market on commercial property insurance placement

Market context: Q4 2022

The US insurance market continued to harden and transition, a trend that gathered momentum in 2020 and looks set to continue into the first half of 2023. That said, it is questionable whether market hardening will be at similar levels to what we have experienced to date. With the prospect of the US and other international markets entering a sustained inflationary phase, the resultant impact on supply chains including material and labor costs also need to be considered.

To a degree, this reflects a mix of factors including the residual impact of the COVID-19 pandemic and the insurance industry resetting reserves to buffer against a more challenging economic environment. In turn, certain lines of insurance may continue to harden with associated capacity constraints.

There appears to be a general consensus among (re)insurance company shareholders that both carriers and (re)insurers need to drive higher returns and deliver improved underwriting profits. Ongoing conversations with (re)insurance partners indicate that rate hardening seen throughout 2021 and 2022 may continue into the first half of 2023.

WHAT DOES THIS MEAN FOR COMMERCIAL PROPERTY?

A range of considerations generally apply in renewal and placement discussions, including the following topics:

- **The complexity of the business:** For example, third-party engineering may be required for industries such as chemical engineering, energy and power, and steel production, which generally have a complex risk profile. In those cases, there are broader impacts beyond general market hardening to take into consideration such as industrial fire and explosion risks, human safety concerns, and best practices around fire protection and related risk mitigation efforts.
- **Reallocation of capacity** in recent months has seen a number of global (re)insurers and insurance carriers moving out of industry classes and/or occupancies due to a variety of factors around loss experience and general risk appetite changes.
- **Industries with a higher or more complex risk exposure:** In sectors such as food production, mining and power generation, one option to respond to ongoing capacity and placement challenges is the formation of a single-parent captive to supplant previous insurance placements in the traditional market, and to access facultative (re)insurance as a risk transfer strategy.

  In some cases, arrangements have been in place for several years with a retained panel of carriers and a layered or syndicated placement through a single-parent captive on a facultative (re)insurance basis.

  Single-parent captives often elect to set up the captive within the US or offshore domiciles, although segregated cells — a captive where assets and liabilities are kept legally separate from one another — may also work in this context as well.

USING A CAPTIVE AS AN INFLATION OFFSET MECHANISM

When using a captive insurance solution to retain commercial property risks as part of an inflation offset strategy, it is important to sensitivity test pro forma financial projections on a planned basis to ensure the captive continues to offer a best-fit solution for the owner. In the current market context, this would generally factor in:

- **Account selection and capacity pricing**
  To offset current trading environment challenges, underwriters are becoming more selective over the mix of commercial property business they accept, and available capacity is being priced accordingly. The general expectation is that placement discussions are equipped with a robust renewal proposal backed by claims history and loss data.
- **Supply chain disruption**
  Although near-term disruptions following the COVID-19 pandemic are starting to ease out, there are still supply dislocations in the mix where we historically would have a clearer idea of material delivery schedules and labor lead times. Delayed start-ups have become more commonplace, but can be mitigated by having tight planning controls and material pricing frameworks in place.
- **Fluctuating markets and a turbulent trading environment**
  Inflation, interest rate hikes, geopolitical instability and a rise in the cost of living are converging at the same time, leading to a resetting of commercial property (re)insurance rates, which have been competitive for a long time.

  Given the currently expected market trajectory, it is increasingly unlikely that a return to softer markets, which we had seen prior to 2020, will reappear any time soon. From the standpoint of (re)insurance providers and traditional insurance capacity, the expectation has shifted the focus toward generating sustained underwriting profits and reduced loss ratios.

- **Interest rate increases**

  Following a sustained period of low (in some cases 0%) interest rates, the current pace of upward interest rate movement globally has placed additional pressure on underwriting performance to deliver the double-digit returns on equity expected by investors, where a combined ratio below 90% would be reasonable to expect.

  Although current interest rate movement has provided a temporary cushion and relieved some of the pressure, it is reasonable to expect that 90% combined ratios will almost certainly remain as the performance bar for (re)insurers and carriers in order to generate the returns required by their shareholders.

THE INSURANCE INDUSTRY IS ADAPTING TO SHIFTING HORIZONS AND A NEW MARKET NORM

Looking for alternative risk placement strategies for commercial property insurance in the current market is a common strategy in renewal discussions with captive owners, insurance carriers and (re)insurers. It's a complicated scenario where, in some cases, industry analysts applying the same broad brush across the board can influence the direction the conversation takes. Ultimately, a lot of it depends on variables such as the buyer, their loss history, the industry or industries they operate in, and what occupancy they are in.

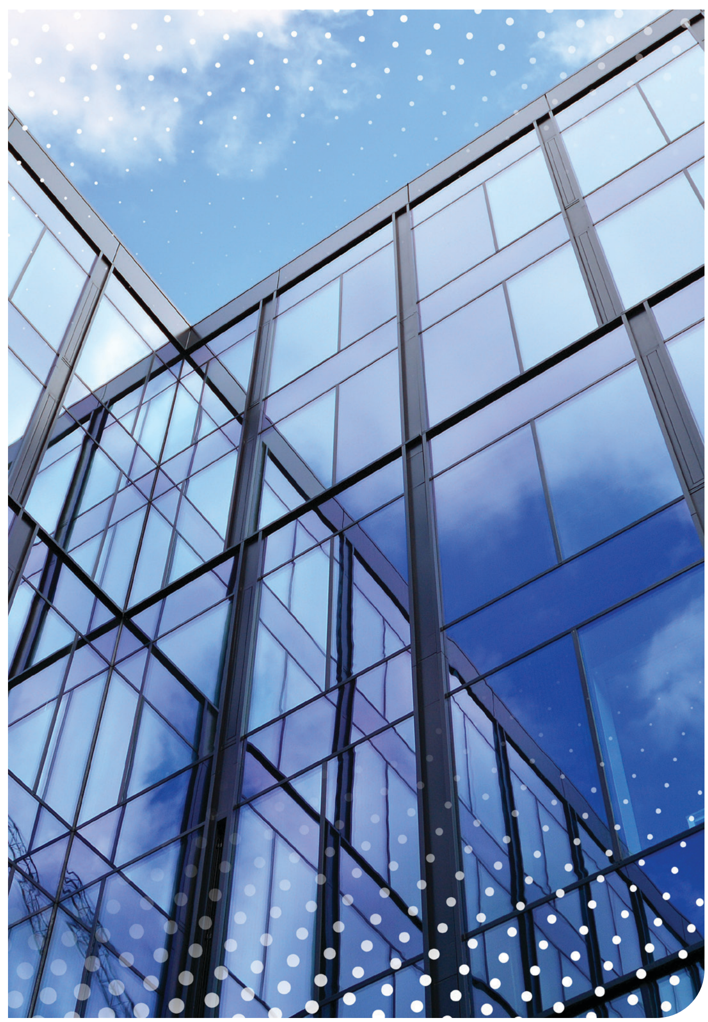
A steady rise in litigation, up by almost 50% since 2017, and the severity of the settlements across multiple casualty risks has led to increased focus on cause and impact (lessons learned) of loss events of various types. From a property perspective, there is a requirement for a deeper examination around loss control, fire protection and third-party engineering processes given industry losses across risk classes.

Ongoing structural change within the insurance industry and carrier operating models is a reasonable expectation. In multiple markets internationally, exhaustive underwriting seems to be the mantra of the day, including a deeper level of scrutiny of a client's insurance portfolio and their claims loss history.

Steve McElhiney, SVP and Director of (Re)insurance at Artex, expands further on this point,

"Insurers are more frequently drilling into the drivers of potential loss, particularly in industry niches where claims losses are generally expected to be higher.

As one example, you may have a company that is operating in a tougher risk class such as steel productions, but within that class you might have an outlier in the mix with extremely low losses and a well-controlled risk management framework. Those types of companies have generally been good candidates for moving out of the traditional insurance market and using a captive to access (re)insurance directly."



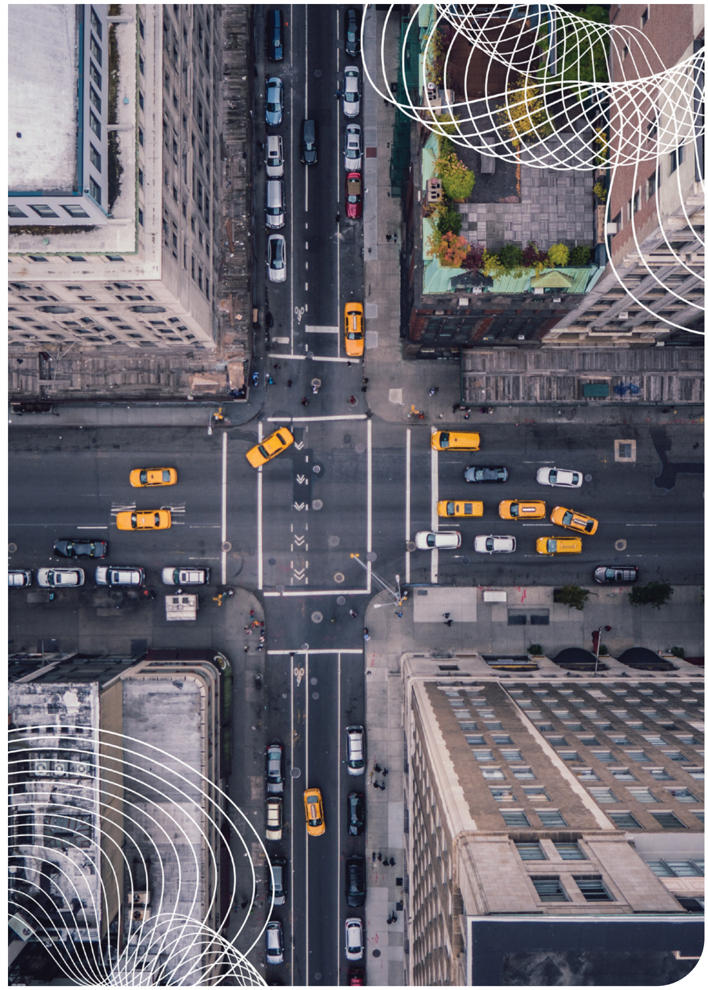
This wave of change is translating into a number of outcomes:

- **A heightened sense of the critical importance of analytics and data adequacy:** This places increased pressure on brokers and insurance advisors when preparing submissions with renewed emphasis on providing deep, granular information within a tight set of parameters (particularly around catastrophe exposures).
- **Orphaned business is being shopped around,** which reflects a narrower market than that seen historically.
- **Where third-party engineering projects** need to be undertaken, insurance underwriters are generally questioning the overall strategy and looking for a comprehensive loss control plan to be implemented, which is reviewed and updated frequently.
- **A notable shift in commercial appetites** in some of the larger global carriers, with new management coming in and tightening up their risk parameters. As one example, whereas historically a carrier may have supported a $500 million commercial property traditional placement on a 100% underwriting basis, we are now seeing coverage limits being reduced and in some cases the carrier not renewing.

  This includes carriers issuing non-renewal letters six months ahead of placement discussions, which can load significant pressure on to the insurance advisor and client.

BE AN ACTIVE PARTNER DURING PLACEMENT AND RENEWAL DISCUSSIONS

From a client, broker or captive owner standpoint, getting more involved in the renewal and submission discussions helps deepen their understanding of the risk process, including taking an active interest in loss control and the strategy around it, and being more involved in the placement process generally. Speaking directly with underwriters is leading to a shift in the client/broker/underwriter dynamic in recent months, which is paying dividends in some cases.



Turning to the decision of a client opting to use a captive insurance structure carries a range of benefits from having direct access to their (re)insurers and carriers, including the following:

- A syndicated placement approach offers stability of risk capacity.
- (Re)insurers tend to have a favorable view of commercial property risks being managed using captives because of the well-controlled nature of the spread of risk. Commercially, it makes business sense for (re)insurers to retain these accounts for a longer time period, which offers a positive alignment of interest between the captive owner and their insurance markets.
- Retain risk within the captive where the client is incentivized to have active loss control and achieve better than average loss results.

COMMERCIAL PROPERTY REQUIREMENTS AND RISKS ARE BECOMING HARDER TO PREDICT

Fluctuating asset values, particularly in the current market where commercial property values are moving outside of a traditional trend model, carry a degree of unpredictability. Pricing arbitrage is one option that can potentially help smooth out market and asset value fluctuations.

One advantage of a captive solution is the ability to retain risk. In a hardening market period, including where you have a mix of other market factors at work, a company has the option to appreciate the retention within the captive to offer better loss results going forward. This enables you to capture underwriting profits in the captive and the ability to vary retentions over time based on market performance.

(Re)insurers are focusing more squarely on the impact of inflation. (Re)insurers are placing increased scrutiny on rebuilding costs and project completion timelines. Historically, 12 months would have been a reasonable expectation for a rebuild project, whereas in the current market, we are seeing projections of up to two years to reinstate commercial property following a claim. Cargo and logistics disruptions, material shortages, and spiraling costs spiking dramatically within relatively short periods of time has led to growing concern from underwriters and (re)insurers.

A general shortage of skilled labor is emerging in the US in line with other parts of the world where we are seeing longer wait times to get the right people on board to remediate property following a claim. It remains likely that longer tail claims losses will continue for the foreseeable future.

Scheduled property valuations and asset reviews can make a difference. Companies managing large and/or complex commercial property portfolios are strongly recommended to conduct regular valuations to ensure that coverage levels remain in line with current market values. Insurers and (re)insurers are looking more closely at this information, and working with an appraisal firm with a trusted market reputation puts a renewal discussion on a stronger footing.

Regular valuations consider more than what needs to be done today or in the near term. It also factors in pricing risk and underinsurance, margin clauses or, worse still, non-insurance. Taking a holistic view of a property portfolio helps to ensure that nothing falls through the gaps due to the lack of regular appraisals and valuations.

WHAT IS THE ROLE OF THE RECENCY AND ADEQUACY OF VALUATIONS?

Property reconstruction timelines generally carry a material impact to business continuity plans which, in the current market environment, presents an increasingly complex risk scenario to project against. Business disruption periods have steadily increased over the past 18 to 24 months, aggravated further by the impact of inflation, interest rates and the cost of labor.

(Re)insurers examine these risks when assessing placement, and carriers will consider both the current inflation position (currently at around 10%) and the impact if the rate of inflation continues in an upward trend to say 15% – 20%. There is a lot of uncertainty to factor in, as well as a degree of variability, when it comes to mapping out predictive outcomes and what that would mean from a loss perspective 9 to 12 months from now. Many are hoping that the current inflationary trend will be a short-term issue and that we will start to see gradual improvements in the latter half of 2023 or early 2024. We will continue to monitor this situation.

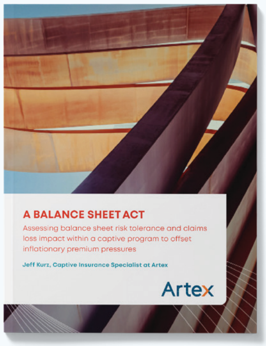
What does this mean specifically for Commercial Property placement? We expect to see evolving inflationary pressure on commercial property rates. Carriers remain concerned about the millions of dollars they are providing in terms of market capacity and considering what happens if the current trend continues.

What is the commercial impact? Are they going to be paid for that risk? That's a very different dynamic than what we've seen over the last 5 to 10 years. It has become the No. 1 conversation topic in the past 12 to 18 months, and we expect this to continue for the foreseeable future.

WE BELIEVE IN FINDING YOU A BETTER WAY.

As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science — where creative thinking meets expertise and superior outcomes are made. Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital.

FURTHER INSIGHTS



A BALANCE SHEET ACT

Assessing balance sheet risk tolerance and claims loss impact within a captive program to offset inflationary premium pressures

Jeff Kurz, Captive Insurance Specialist at Artex

NATCAT STRATEGIES

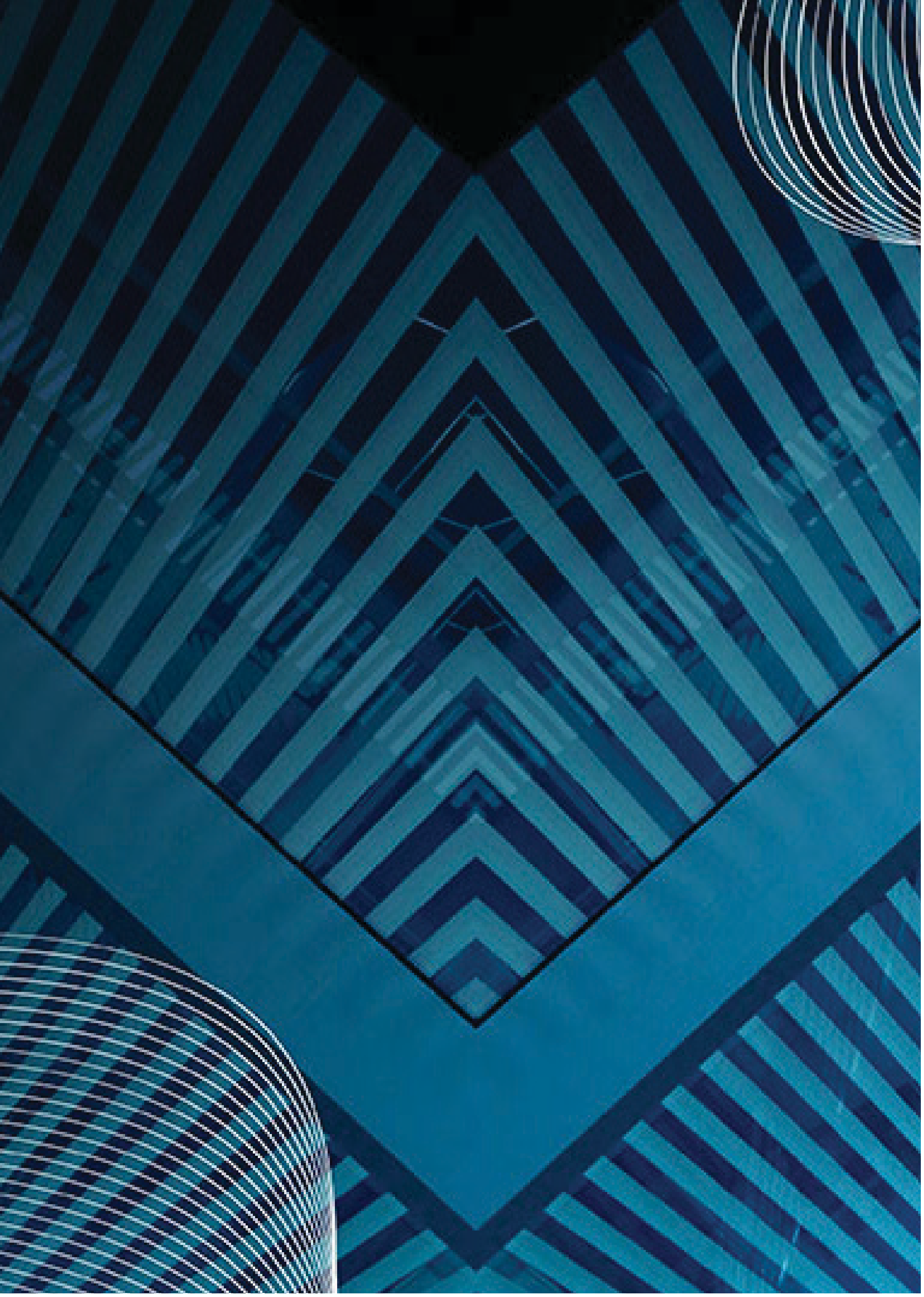
Structuring commercial property risks in natural catastrophe zones and offsetting extreme weather event exposures using alternative risk strategies

Steve McElhiney, SVP and Director of (Re)insurance

STEVE MCELHINEY

SVP and Director of (Re)insurance

Steve heads (Re)insurance for Artex Risk Solutions with his Dallas-based team by way of the 2019 acquisition of EWI Re, Inc., where he was CEO as well as serving as chief risk officer for Contran Corporation and president of their Vermont captive. Steve is a senior vice president and global director of (Re)insurance for Artex globally. Steve's insurance industry experience spans more than two decades with several global insurance groups such as Allianz, Transamerica, Argo Group and Overseas Partners RE. He has served in the roles of CFO, corporate treasurer, (re)insurance executive and board member. In 2021, he was named to the Captive Review Hall of Fame.



Artex

artexinfo@artexrisk.com

PHONE: +1.630.694.5050

PHONE: +44.(0).1481.737100

artexrisk.com

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