Historic Downturn Creates Headwinds

Reduced capacity and restricted risk appetites will endure longer in an economy hobbled by the COVID-19 pandemic

As expected, Canadian insurance companies that write predominantly commercial lines faced severe challenges through the first half of 2020. The actions insurers began to take in 2019 aimed at returning the industry to long-term sustainable profitability have been complicated by the sudden and precipitous economic downturn caused by the COVID-19 pandemic. As social distancing provisions forced businesses to shutter temporarily or reduce the scope of their operations, they turned to their insurers for premium credits and payment deferrals to help mitigate the impact of reduced revenues and cashflow. Insurers stepped up to provide these supports—putting pressure on their own revenues while also having to absorb the impact of pandemic-related claims across a number of lines of business.

Direct premiums written rose over 11% to $6.76 billion for the first half of 2020 compared to the same period a year prior, largely driven by rate increases. However, the industry recorded an underwriting loss of $244 million for the period and an overall loss of $5.1 million. The industry's overall combined operating ratio (COR) rose well above the trouble line to 106.1% for 1H 2020, with the majority of large commercial insurers in the red on this metric (see Company Results below).

The two areas for Canadian placements most impacted by current market conditions are property, across virtually all classes of risk, and directors & officers' liability (D&O). Other forms of liability insurance for most industries is still available, despite reductions in capacity. However, areas where insurance placements were already difficult before the onset of hard market conditions—such as certain classes of hospitality risks—are seeing dramatic increases from expiring premiums, if renewal terms are offered at all.

"Current pricing is approaching adequacy but does not yet translate into stellar [returns on equity] for the industry."

Albert Benmichol
CEO of Axis Capital Holdings

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.

Insurers have signaled that current market conditions will persist through the end of 2021 at the earliest. The silver lining in all these dark clouds is that there is insurance capacity that is ready to be deployed upon the return of sustainable profitability, which would allow pricing to stabilize. Additionally, unlike hard market cycles of the past, there remains plenty of reinsurance capacity available in the current market, despite the heavy losses reinsurers have absorbed over this period.

PROPERTY LINES

Market hardening has continued unabated in property lines as insurers continue to struggle with frequency and severity of claims across a broad cross-section of risk categories.

- **Residential Realty**

  This line continues to see significant rate increases and capacity reduction driven by ongoing frequency and severity of claims. Catastrophe events, such as the June hailstorm in Calgary which caused $1.2 billion in insured losses, also continue to impact this category.

- **Hospitality**

  There has been a considerable reduction in property insurance capacity for bars, nightclubs and other hospitality categories. The withdrawal of Lloyd's capacity for this sector in March has also made it very challenging to obtain any liability coverage for these risks.

- **Recycling and Chemical Plants**

  Capacity has reduced as an already limited pool of markets willing to write these risks has now shrunk. This has driven significant rate increases and deductible increases for these operations to mitigate claims severity issues. We are seeing renewal terms asking for three-fold to five-fold increases on expiring premiums.

- **Vacant Risks**

  The number of risks deemed unoccupied has risen sharply due to the impact of COVID-19. In the early days of the pandemic insurers were very understanding in extending 30-day unoccupied exclusions to 90 days, given that social distancing provisions prevented many owners from remaining on their premises. Several months later, the pandemic has forced many of these owners to shut their businesses entirely, turning their property into truly vacant risks. In consequence, coverage and appropriate limits can be difficult to obtain and rates are escalating.

- **Manufacturing**

  The manufacturing sector has also seen reduced capacity and rate increases for property insurance. On the brighter side, since the start of the pandemic certain manufacturing, wholesale and retail businesses have pivoted their operations to include personal protective equipment (PPE) products. Markets have for the most part accommodated these change with few exceptions.

"The COVID-19 crisis has exacerbated many underlying societal challenges, from poverty to racism, to the care of our most vulnerable people. Businesses and their employees have an important role to play in solving these problems and we intend to do our part to contribute to meaningful change."

Charles Brindamour, CEO of Intact Financial Corporation

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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.

BUSINESS INTERRUPTION EXCLUSIONS STAND UP

Coverage exclusions within property policies for business interruption (BI) losses stemming from the pandemic have so far withstood legal challenges in the U.S. Additionally, lawmakers in several states have yet to follow through on any actions that would mandate coverage to be provided as they indicated they would do in the early months of the pandemic.

Likewise, the only business interruption coverage grants that have been seen in Canada have been around the lack of a specific exclusion or the activity of a specific sub-limit for outbreak/pandemic. Canadian policy wordings for this exclusion are closely modeled on those in the U.K., and a recent test case there upheld the validity of those exclusions. Consequently, most carriers are less concerned about their BI exposure on existing wordings and have taken action to revise or add exclusionary language to renewal wordings where deemed necessary.

An unfortunate by-product of this state of affairs is that insurers are now often unwilling to follow certain wordings of a lead insurer on a subscription policy in which multiple insurers share the risk. This has made an already difficult subscription task even more challenging, as insurers scale back appetites and the need to structure policies on a subscription basis has increased substantially over the last year.

LIABILITY LINES

Escalating losses across a broad spectrum of liability products continue to drive rate increases and capacity reductions. Additionally, the deepening economic crisis is likely to drive more claims activity in some categories as businesses fail and some individuals in desperate financial circumstances resort to moral hazard and fraud to survive, a phenomenon observed in the economic downturn of 2008-2010.

A further complicating factor for liability lines, which are often calculated based on a company's revenues, is the sudden turn to a shrinking pool of premium caused by the slumping economy. Businesses that have been forced to temporarily shutter, reduce operations or close entirely have sought premium credits or dropped some coverage to reflect their new circumstances, while others have canceled policies entirely.

Here are a few highlights:

- **Errors & Omissions (E&O)**

  Pricing for this line is increasing, which has been impacted by declines in revenue during the pandemic from factors such as a drop in construction activity. Premium discounts based on declining volume of business for insureds are exacerbating the rate increases.

- **Directors & Officers (D&O)**

  Business failures caused by the pandemic are expected to drive heavy losses for D&O lines. Rate increases and capacity reductions are prevalent, resulting in the need to restructure programs and limits. Customers in the energy sector, for example, are currently facing challenges procuring new D&O programs or renewing existing ones due to plummeting commodity prices and liquidity concerns. These factors have increased the risk of bankruptcy or restructuring under the Companies' Creditors Arrangement Act (CCAA).

  In response to these circumstances D&O insurers require more time to assess accounts and are asking for things like:

  - Additional information on employee layoffs, return to work procedures and COVID-19 controls for employees and the public
  - Thorough financial details including pro-forma budgets and projections, details on banking and debt covenants, expense reductions, and government support programs accessed.
  - Preparation, review and potential calls with underwriters may be required. Attention to timelines and strategy is critical for optimal renewal results.

- **General Liability**

  Insurers have reduced appetite and capacity for primary layers of general liability, thus forcing down the limits for the primary layer—i.e. the portion of policy that will pay out first—from $5-$10 million down to $2-$5 million.

  Losses developing into the umbrella and excess layers have also resulted in insurers looking to reduce their exposure by pushing their attachment points higher, which has dramatically reduced the pool of insurers interested in providing excess liability over limits below $5 million. That reduced pool of insurers has caused a significant spike in premiums across the more hard-to-place/higher hazard liability classes.

  In addition, general liability insurers are more frequently reducing or excluding coverage for losses like pollution and product liability, forcing companies to purchase separate specialty lines. Canadian businesses with either locations or sales outside Canada are seeing this even more substantially than those with primarily Canadian exposures.

"We expect the claims and reserves we have booked in the first half of 2020 to cover the majority of our ultimate COVID-19 losses. While the impact on our earnings is significant, it remains manageable as our operations continue uninterrupted, all our businesses are performing well and our capital position allows us to take advantage of attractive opportunities in an improving market."

Christian Mumenthaler,
Group CEO of Swiss Re

INSURANCE 101

Attachment Point: A coverage threshold, or limit, that determines when excess insurance (or reinsurance) is activated. The attachment point may be dictated by a deductible or a layer of primary insurance. E.g. if a reinsurance policy has a deductible of $500,000 than the attachment point is $500,000. If an excess liability policy has an attachment point of $10 million, that means the first $10 million of a loss are paid out by the primary insurance layer or by the insured through self-insurance.

Cyber Liability

Uptake for cyber risk products is increasing in Canada as more businesses in more sectors come to appreciate the risks and their vulnerability to them. The pool of premium has doubled since this time last year but remains small at $150 million. Consequently, cyber insurers have been experiencing heavy losses on this line as claims have spiked since the beginning of the pandemic. The massive shift to work from home arrangements has given hackers new opportunities to exploit open ports in poorly secured networks and increase the frequency, scope and efficacy of phishing attacks, such as emails that ask recipients to click a link to receive their COVID-19 test results.

Insurers continue to expand and improve pre-breach resources businesses can use to better manage the risk and prevent claims. These include employee training and security assessment tools that are included in the cost of the premium. Companies that take advantage of these resources will tend to receive more favourable renewal terms from insurers than those that don't use them.

COMMERCIAL AUTO

Premium volume for commercial auto was down slightly in the first half of 2020 compared to the same period a year ago. This was due in part to a drop off in vehicle traffic caused by the pandemic. However, that does not mean that market conditions for this line are softening. Claims severity remains an issue for most insurers, as exemplified by Lloyd's markets which had a loss ratio approaching 120% in this area.

Two area that face considerable challenges are worth highlighting:

- **Buses**

  High-profile incidents like the Humboldt Broncos crash and the Columbia Icefield tour bus rollover along with other incidents that may not make the headlines have created challenges in securing excess umbrella liability coverage for any bus-related risk.

- **U.S. Exposures**

  Insureds that have vehicles that drive anywhere in the U.S. are also seeing capacity reductions and dramatic rate increases on expiring premiums due to factors such as social inflation driving up claims costs.

HERE'S WHAT YOU CAN DO

The current hard market cycle will have an impact on every customer in the country, regardless of their prior claims history. At the same time, insurers are struggling to meet the demands of the current market, especially as the need to renew existing policies on a subscription basis has driven a significant increase in submissions. There's no easy way to say it: insureds need to be prepared for rate increases and expect the unexpected.

In the meantime, here are three things you can do to help us obtain optimal renewal results for you:

1. **Help us tell your story**
   In the current market, insurers are no longer willing to "make assumptions" or proceed without basic underwriting information. Our focus on the fundamentals of insurance can help you tell a better and more complete story around claims, operations, loss control/risk management activities, and risk quality.

2. **Consider your broker's market access**
   Clients with favourable loss histories may be tempted to consider "shopping" their business when faced with rate increases upon renewal. Doing so in the current market conditions is extremely risky. A new broker may not have access to the same breadth of markets that we do here at Lloyd Sadd. Another important consideration is what services a broker can offer beyond simple risk placement. Our services allow you to improve your business's operational profile to an underwriter over a longer term.

3. **Address prior claims history**
   Be prepared to outline what changes your company has made with regards to operations, experience, risk control and procedure changes. Respond (with evidence) to loss prevention recommendations in a full and timely manner. Engage in physical inspections.

COMPANY RESULTS

Mid-year 2020 Combined Operating Ratios (COR) for several key commercial insurers. A number greater than 100 indicates a loss (see Insurance 101).								
	AIG	114.4	*Arch*	167.9	*Chubb**	105.3	*CNA*	103.9
	Allianz	116.9	*Berkley*	98.9	*FM*	127.4	*Northbridge~*	100.0
	Liberty	93.2	*SGI*	90.5	*SovGen*	101.6	*Travelers~*	111.2
	*Aviva***	95.5	*RSA*	93.3	*Intact***	97.0	*Zurich*	127.2

* These companies write substantial personal lines business as well
~ Includes results of personal lines portfolio
** Includes results of significant personal lines portfolio

LET US HELP YOU MANAGE YOUR RISK

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