Commercial Insurance Rates Rising: What Business Owners Need to Know

May 2022

American Property Casualty Insurance Association℠
INSURING AMERICA apci.org

0522 | 3482PRI

EXECUTIVE SUMMARY:

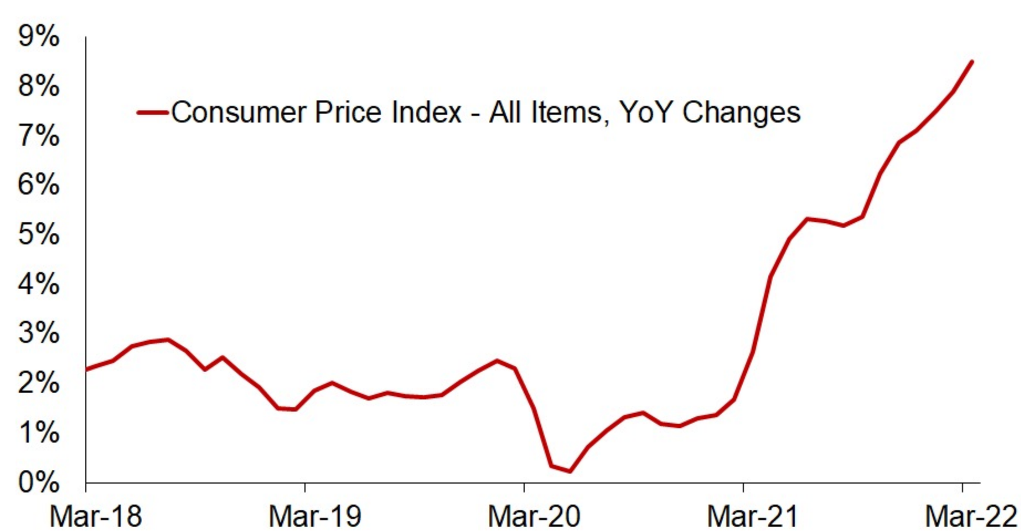
Skyrocketing inflation and legal system abuse have forced prices higher across society at the same time that losses in lines such as cyber insurance have also increased. As a result, just as many businesses are facing higher costs, insurers are facing significantly higher claims costs than in recent years – so much so that insurers' claims costs and expenses now are higher than what they collect in premiums in many cases. As a result, the insurance rates that insurers can offer to businesses have had to increase, including on some of the types of insurance frequently utilized by small businesses, including property, auto, liability, and cyber insurance. This document looks at the effect that significant cost drivers are having on insurers, businesses, and the insurance rates they are facing.

COMMERCIAL INSURANCE AND RECENT COST DRIVERS:

Businesses rely on insurance to ensure that a catastrophe, lawsuit or other unexpected event does not shutter their doors. Many business owners and executives may have noticed the price of their insurance increasing recently. This document helps explain why.

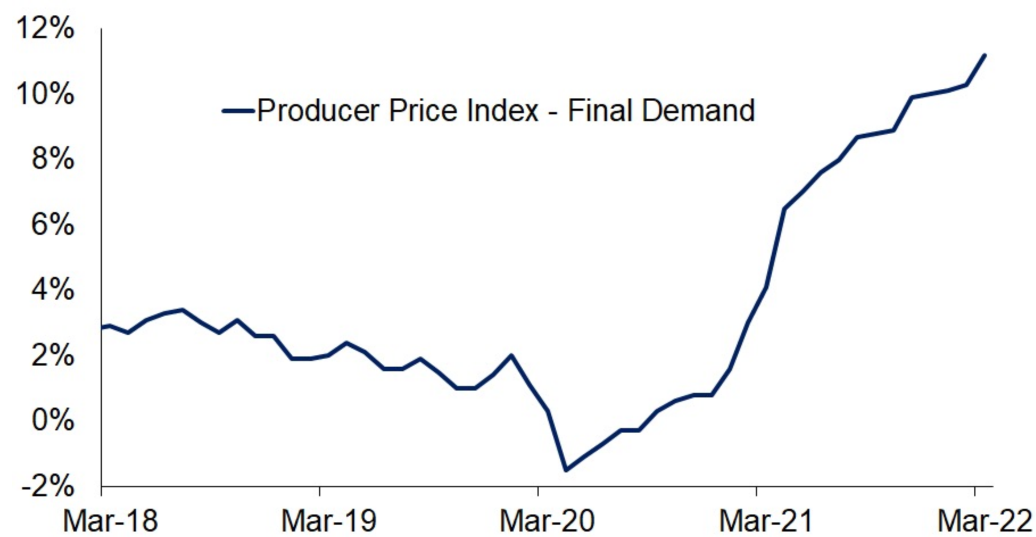
Just as with any business, insurers seek to manage expenses so that they do not outstrip revenue. But when external factors outside of an insurer's control send expenses dramatically higher, an insurer may have to increase rates when a policy is sold or renewed. Similarly, when the risks covered by an insurance policy grow, the insurer will have to increase rates to cover the expanded risk. Rapid increases in inflation and other developments over the last year have significantly increased the cost of claims that insurers have paid out to policyholders, leading to significant insurance losses. Insurers incurred losses and loss adjustment expenses increased by 17.8 percent in the third quarter of last year compared to the third quarter 2020.[1] This picture has forced insurers to increase rates to pay for higher losses and expenses.

Some of the increase in costs can be explained by inflation. In March of this year, the consumer price index (CPI) jumped 8.5 percent from a year earlier, the fastest 12-month pace since the early 1980s. Final demand producer prices moved up 11.2 percent for the 12 months ending in March. However, inflation in insurance claims has been rising even faster than CPI, outpacing increases in premiums.



Source: U.S. Bureau of Labor Statistics.

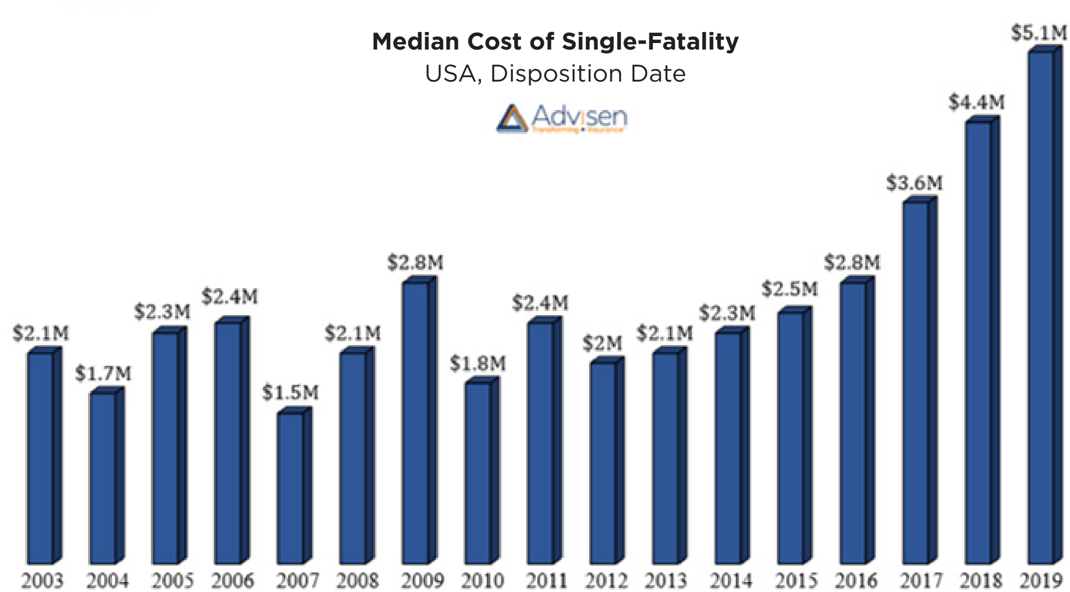
1 Property Casualty Financial Operating Results at 3Q 2021, APCIA and ISO, most recent available data as of May 2022.



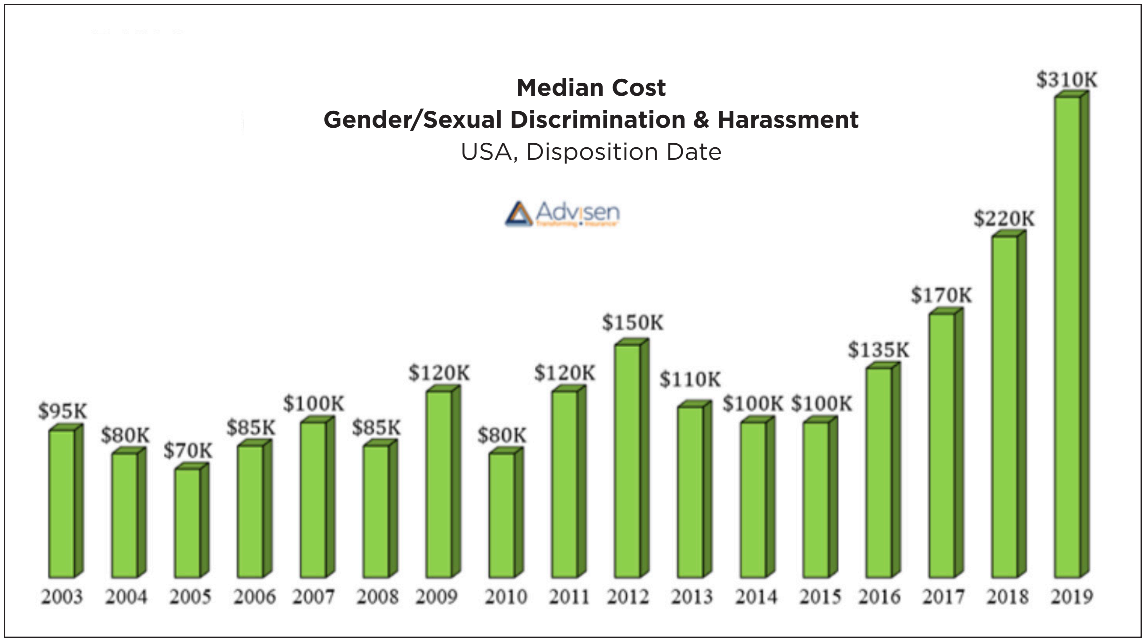
Source: U.S. Bureau of Labor Statistics.

Legal system abuse, sometimes called social inflation, is also driving insurance losses and costs higher, which in turn increases premiums for policyholders. Changes in laws are encouraging more lawsuits and jury awards increasingly do not reflect logical conclusions or precedents. Jury decisions can be influenced by emotions, state and local laws or procedures, and plaintiff bar tactics. In recent years, practices like third-party litigation funding – investment by hedge funds and other third parties in lawsuits in return for a share in the awards – have played a significant role in litigation abuse.[2]

The ever-increasing impact of litigation abuse can be seen in many areas. Examples include the cost of an event in which one death and no other injuries occur, and the cost of gender/sexual discrimination and harassment cases.[3]



2 Insurance Information Institute, https://www.iii.org/insuranceindustryblog/author/jeff-dunsavage/.
3 https://www.advisen.com/tools/fpnproc/fpns/articles_new_1/P/362243669.html?rid=362243669&list_id=1.



These increased costs for insurers can be seen clearly in the "combined ratios", which represent claims and expense costs as a percentage of premiums. The combined ratio for insurers measures whether the insurance company is earning more revenue from its collected premiums relative to administrative costs and the claims it pays out. A combined ratio over 100 percent indicates that claims payments and associated expenses are higher than total premiums collected from policyholders. After three years of combined ratios[4] around 99 percent, preliminary estimates of 2021 suggest that the property and casualty (P&C) insurance industry's commercial lines combined ratio is at almost 101 percent, meaning insurers paid more in claims and expenses than they collected in premiums.[5] Liability lines and commercial multi-peril lines of insurance, which are frequently purchased by smaller businesses, are expected to have combined ratios higher than this overall combined ratio.[6] U.S. P&C insurers faced an $11.3 billion net underwriting loss in third quarter 2021.[7]

IMPACT ON SMALL BUSINESSES

The lines of insurance that a smaller business might utilize depend on the particular nature of the business, but can include commercial auto, general liability, commercial property, cyber, and others. Often, some of the types of insurance that small and medium-sized businesses need will be combined under a single policy, called a commercial multi-peril policy.

While insurance costs are affecting businesses of all sizes, smaller businesses can experience these changes in a unique way that creates particular challenges. A recent survey from the Council of Insurance Agents and Brokers (CIAB) found that in the fourth quarter of 2021, medium-sized businesses experienced an average increase in insurance premiums of 10.6 percent, and small businesses faced an average increase of 6.3 percent.

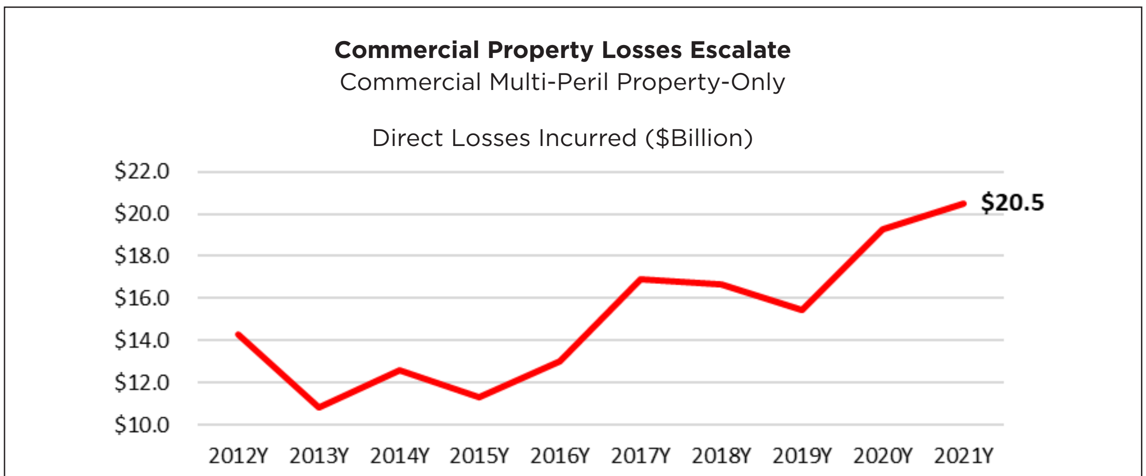
Below, we look at how the types of insurance that small-and-medium sized businesses utilize have been affected by inflation and other trends that have made them more expensive.

4 Claims-related losses and all expenses as portion of premiums collected.
5 A.M. Best: Best's Market Segment Report-- P/C Industry Maintains Solid Capital Despite Increased Challenges in 2021; February 24, 2022.
6 *Ibid*.
7 Property Casualty Financial Operating Results at 3Q 2021, APCIA and ISO, most recent available data as of May 2022.

COMMERCIAL PROPERTY

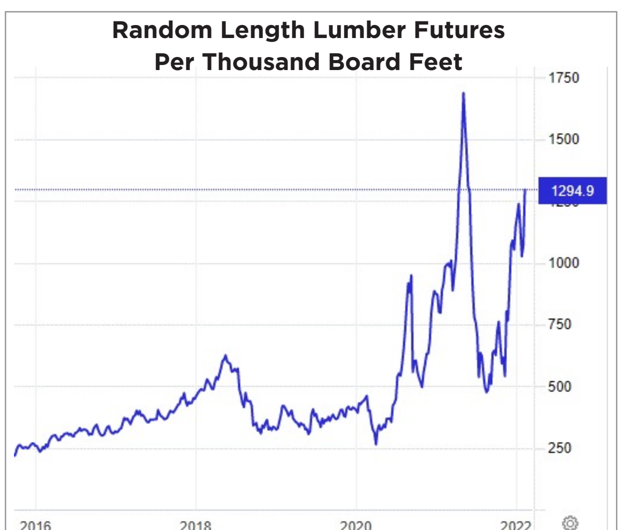
When the cost of the materials that have to be purchased to make repairs to a business following an insured event increase, the cost of claims for an insurer increase as well. That, in turn, means the insurer may have to charge more for commercial property policies when they are purchased or renewed. The cost of the materials and labor needed to reconstruct homes and businesses have skyrocketed amid ongoing impacts from the COVID-19 pandemic, such as supply chain constraints and shifts in demand for housing, which are continuing to affect overall supply and demand challenges. From December 2019 through December 2021 the price of construction materials rose by 44.1 percent,[8] with some lumber prices in mid-2021 up 400 percent. These have contributed to significantly higher underwriting losses.

Cost increases have a direct impact on claims costs for property-related insurance coverages.



Source: S&P Global Market Intelligence .

Lumber has been among the most affected materials, in terms of cost and longer lead times to secure materials.[9]



Source: Trading Economics, as of Feb. 11, 2022

8 U.S. Bureau of Labor Statistics from Federal Reserve Bank of St. Louis (FRED): **https://fred.stlouisfed.org/series/WPUSI012011**.
9 **https://www.usatoday.com/story/money/markets/2021/06/23/home-building-lumber-prices-renovations-delayed-amid-covid/7768522002/**.

Natural disasters can also have a significant effect on commercial property policies, claims, and premiums. When more natural disasters strike (i.e., frequency increases) or when those disasters do more damage (i.e., severity increases), the cost of claims on an insurance policy can go up significantly, which means that the price an insurer can offer for an insurance policy may also increase at purchase or renewal.

Economic Losses	Injured Losses	
$169 Billion	**$92 Billion**	**U.S. Total**
$75.0 B	$36.0B	Hurricane Ida
$23.7 B	$15.0 B	February Polar Vortex
$9.0 B	$4.3 B	Drought
$5.1 B	$4.0 B	Mid-December Tornadoes
$3.4 B	$2.6 B	TX and OK Hail

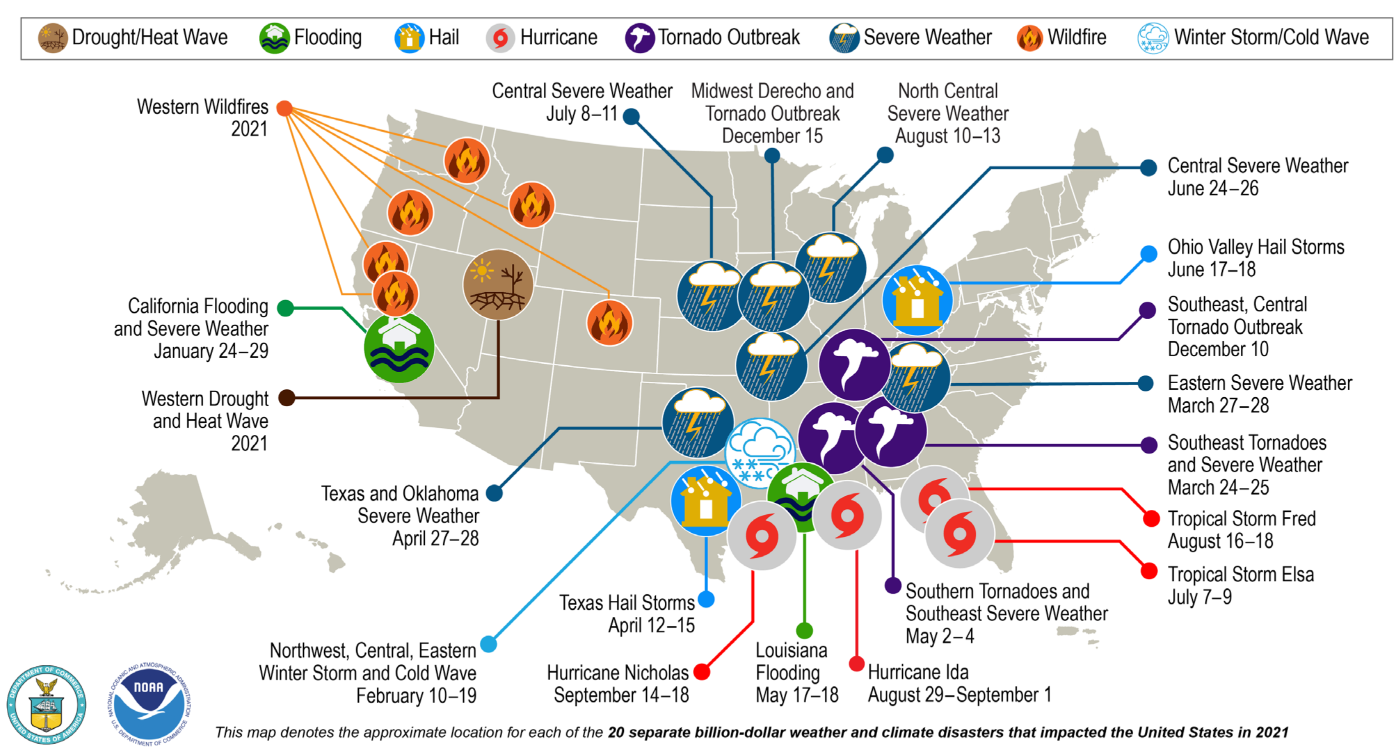
Source: Aon 2021 Weather, Climate and Catastrophe Insight

This past year, 2021, was the seventh year in a row the U.S. suffered at least 10 catastrophes causing over a billion dollars in insured losses.[10]

Globally, 2021 was the fourth most extreme catastrophe loss year[11], led by Hurricane Ida that was the fourth costliest global insured loss event since 1900.[12] The United States incurred natural catastrophe losses in 2021 were more than double the 20-year average.[13] Building in high-risk areas can also affect commercial property policies, claims and premiums. Population and building growth in hazard-prone areas would exacerbate the effects of climate change leading to more frequent and severe catastrophe losses.

According to National Oceanic and Atmospheric Administration (NOAA) data, the number of billion-dollar events in 2021 was second only to 2020, which shattered the record with 22 separate billion-dollar events, and pushed the most recent 5 year annual average up to an unprecedented 17.2 events (2017–2021, CPI-adjusted).

U.S. 2021 Billion-Dollar Weather and Climate Disasters



*This map denotes the approximate location for each of the **20 separate billion-dollar weather and climate disasters that impacted the United States in 2021***

Source: **https://www.ncdc.noaa.gov/billions/**

10 National Oceanic and Atmospheric Administration (NOAA) is part of the U.S. Department of Commerce.

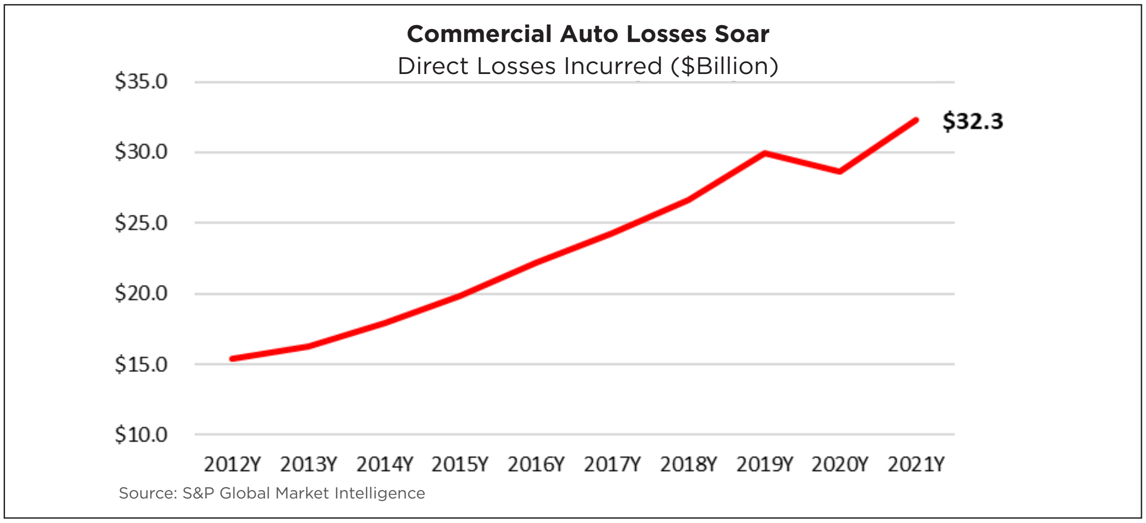
11 **https://www.reinsurancene.ws/global-insured-losses-topped-100bn-again-in-2021-aon/**.

12 Aon 2021 Weather, Climate and Catastrophe Insight.

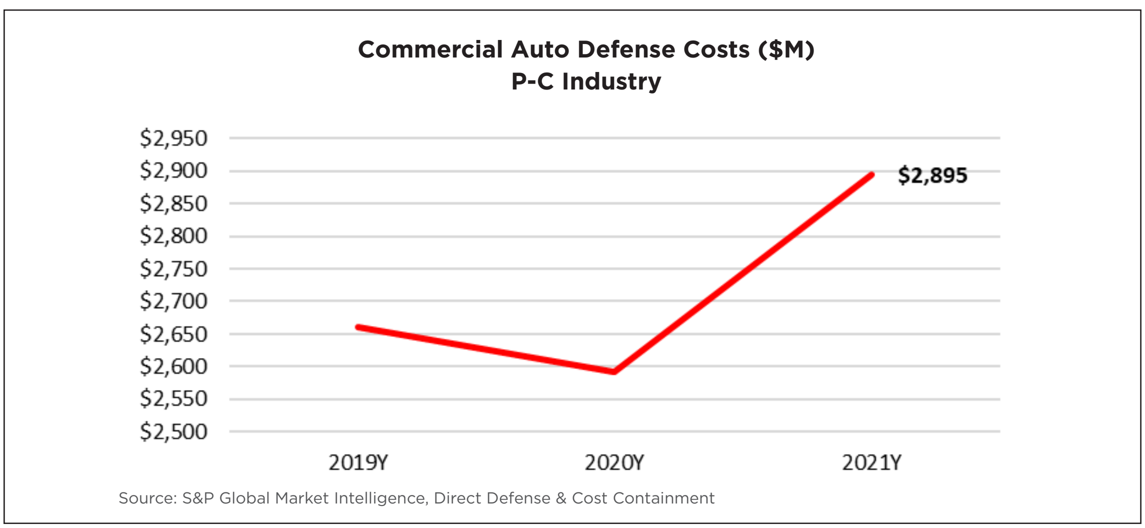
13 *Ibid.*

COMMERCIAL AUTO

Except for a slowdown in 2020 due to the impact of the pandemic, claims costs for commercial auto continue to increase, in part driven by legal system abuse.



The frequency of attorney representation in commercial auto claims has been increasing, and the relative costs of resolving claims are significantly higher for claims with attorney representation, including taking considerably longer to resolve for consumers.[14] P&C industry commercial auto defense costs largely exceed pre-pandemic levels.



An example of the litigation explosion is seen in growing injury claims involving commercial autos and trucks. From 2017 to 2018 the average size of trucking verdicts grew by 483 percent.[15] Claims for injuries in crashes involving commercial vehicles have also contributed to nuclear verdicts, with awards in excess of $10 million growing from $300 million in 2011 to nearly $1 billion in 2018 and 2019.[16]

14 Milliman, Trends in Attorney Representation: US Commercial Automobile Insurance, January 2022.
15 Fox Business, https://www.foxbusiness.com/lifestyle/nuclear-verdicts-trucking-exponential-pace.
16 The Geneva Association, Social Inflation: Navigating the evolving claims environment.

A considerable percentage of total insurance cost increases does not relate directly to crash experience. While underwriting losses do continue, much of the cost increase experienced by motor carriers is associated with economic externalities (e.g., general inflation and rising healthcare costs), limited high-severity crashes, expanding litigation and loss of coverage capacity in the commercial auto insurance market.[17]

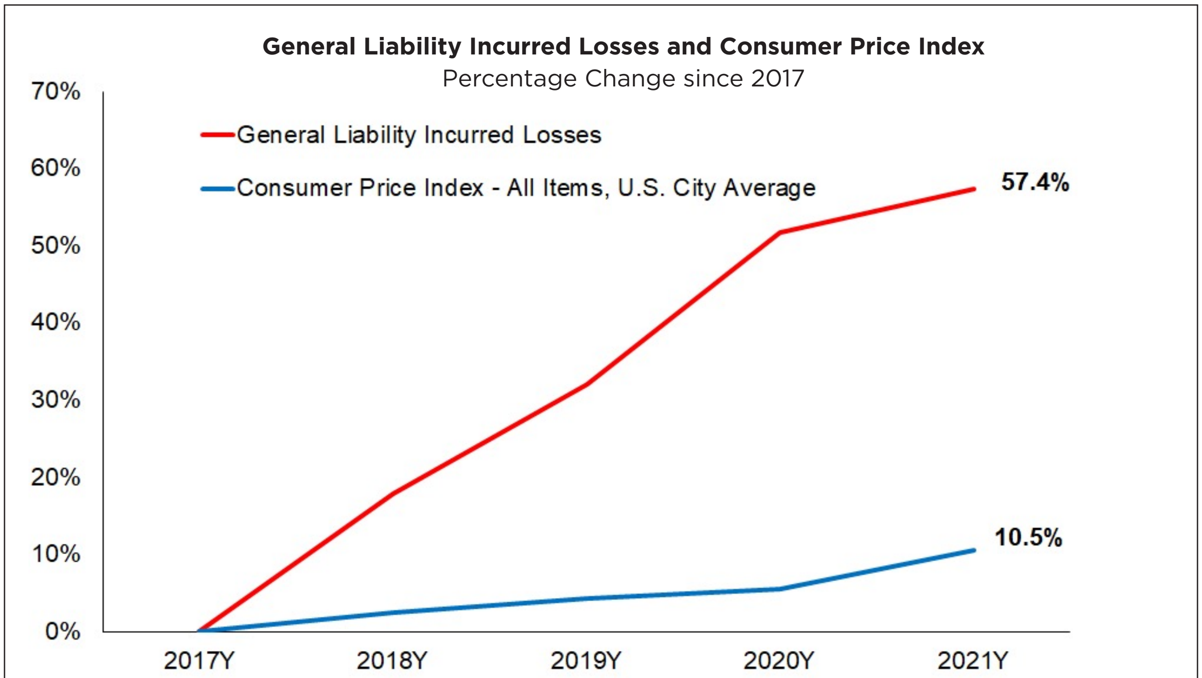
Crash severity has been on the rise in recent years, a factor which increases the cost of claims as well as the likelihood of litigation. Average vehicle speeds were higher during the COVID-19 pandemic in particular due to lower traffic levels, and they have been linked to higher crash severity.[18]

Technological advances in motor vehicles have also contributed to increasing costs associated with repairing them; electronics now make up 40 percent of the cost of a new vehicle.[19] These higher cost parts can make claims more expensive, which in turn makes claims more expensive for an insurer, potentially leading to higher premiums.

GENERAL LIABILITY

General liability insurance is affected by many of the same lawsuit trends that affect commercial auto policies, including the number of large "nuclear" verdicts in lawsuits. When lawsuits against insured businesses become more likely to lead to large verdicts, the cost of the insurance policy that covers those verdicts may increase, as well.

P&C industry incurred losses for general liability have skyrocketed more than 57 percent since 2017.



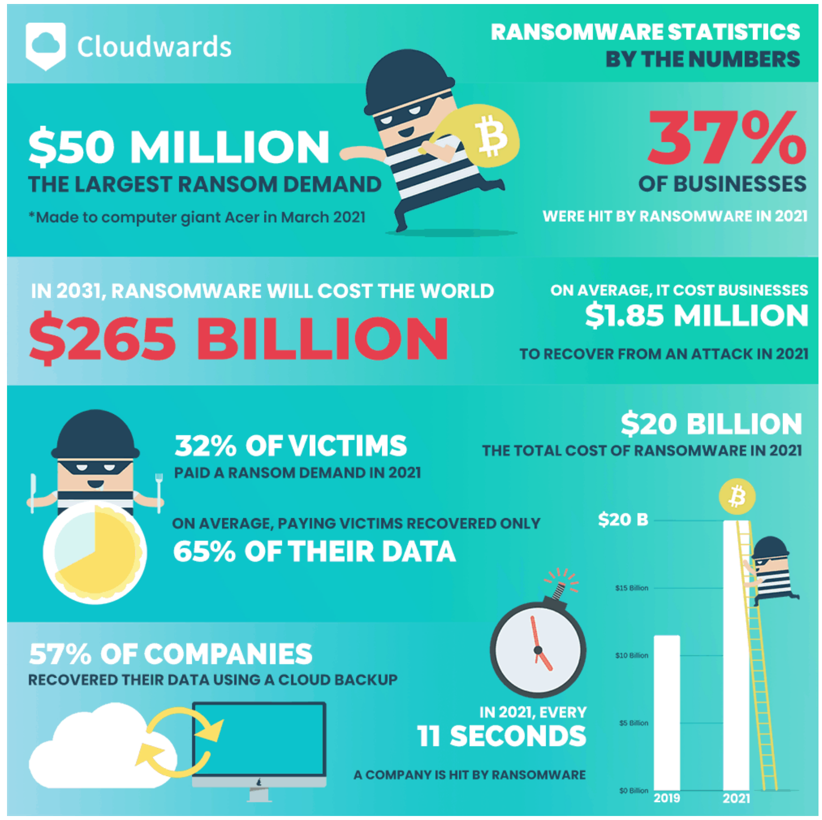
Source: S&P Global Market Intelligence and Bureau of Labor Statistics

17 ATRI, The Impact of Rising Insurance Costs on the Trucking Industry, February 2022.

18 National Highway Safety Administration: Continuation of Research on Traffic Safety During the COVID-19 Public Health Emergency: January – June 2021 (October 2021).

19 *Ibid*.

CYBER



Given the increasingly digitally-connected world, which has further expanded since the pandemic, companies of all sizes are vulnerable to cyber-attacks. This can be particularly true for smaller businesses that may have limited IT security and personnel budgets.

Ransom payments have frequently exceeded $1 million and the resulting costs for business interruption or data exfiltration increased claim payouts. A related development is the growth of “Ransomware as a Service” (RaaS) operations. Like “Software as a Service” (SaaS) operations, organizations with names like REvil and Darkside are offering to sell or rent sophisticated ransomware tools to less sophisticated gangs who use them to perpetrate the actual extortion, expanding the number of sources of ransomware attacks and making it more difficult to identify those behind the attacks.

The massive growth in ransomware attacks increased the 2020 loss ratios (prior to expenses) for stand-alone cyber policies by more than 50 percent, and the corresponding combined ratio was estimated at more than 100 percent.[20] This trend is expected to have continued in 2021.

The response and replacement costs associated with responding to a cyber incident are rising, as well. From forensic and legal experts to deal with the incident to the rise in ransomware demands, the costs to respond to a cyber intrusion are rising quickly.

INCREASING COSTS ARE AFFECTING THE WHOLE ECONOMY

Inflation, legal system abuse, and cyber-attacks are causing a ripple effect throughout the economy, and insurers and small businesses are being significantly impacted. As claims and other costs have recently increased dramatically, insurers are under pressure to raise rates on a wide range of types of insurance policies. Those policies include some of the types frequently utilized by small businesses, including property, auto, liability, and cyber insurance. Insurers and agents are looking for ways to reduce costs while still meeting all obligations to policyholders, but the most significant drivers of insurers’ costs are out of the hands of the insurance industry. As a result, small and medium-sized businesses may be seeing their insurance rates increase when they buy a new policy or renew a policy, even if they have not made claims in the preceding year.

20 Aon: US Cyber Market Update – 2020 US Cyber Insurance Profits and Performance; June 2021.