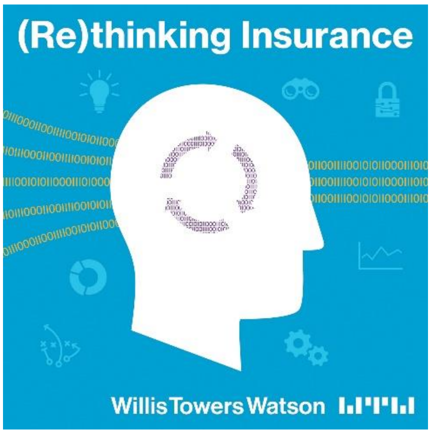

Episode 10: Inflation and its impact on the insurance industry

CHRIS BOZMAN: I think it's really hard to be a claims person these days, especially in liability lines with social inflation and now economic inflation. And I think the claims area is where successful insurers can probably differentiate themselves.

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SINA THIEME: Hello, and welcome to (Re)Thinking Insurance. I'm your host, Sina Thieme, and today, I'm delighted to be joined by my guests, Chris bozman and Klayton Southwood. Welcome both.

KLAYTON SOUTHWOOD: Thank you.

CHRIS BOZMAN: Thank you, Sina.

SINA THIEME: Chris, you're a managing director for our insurance consulting and technology practice in Philadelphia with over 30 years of insurance experience, mainly in the field of reserving M&A and capital. Klayton, you're a senior director for our insurance consulting, technology business in Bloomington in the US, with over 30 years of insurance consulting experience with a particular focus on pricing and reserving for auto and homeowner's insurance. And you're both mathematicians in background.

Today, we'll be discussing what everyone's discussing, namely how inflation impacts insurers. Before we get into that, though, I googled your name, Chris, and there's loads of great search results... from Instagram accounts of the boss, a musician's records on SoundCloud, a cyclist, the high school head coach of a varsity volleyball team. Is this the sort of result you wish one would find when Googling your name?

CHRIS BOZMAN: Well, it sounds more interesting than the real things that should be associated with my name. So that's probably somebody else.

[LAUGHTER]

SINA THIEME: Klayton, actually, when I googled your name, the search results that come up almost always end up with Willis Towers Watson or CAS. What did you wish one would find when Googling your name?

KLAYTON SOUTHWOOD: I would say, Sina, someone who enjoys helping my wife with her hobby farm.

[LAUGHTER]

SINA THIEME: All right, inflation. There's obviously robust economic growth in most developed markets now, mostly recovering to pre-pandemic levels, but inflation's really eating into that right, with 7.9% annual consumer price inflation rate in the US in February. We're seeing the highest inflation in four decades. Taking out food and energy prices, the inflation rate is still at 6.4%.

The Federal Reserve reacted with an interest rate rise of a quarter percentage point, bringing the target range to 0.5%. This is the first increase we've seen since 2018, and the Fed officials have already signaled this would be a series of increases this year and next year. And similar picture in Europe, really. Inflation is high there as well.

They're lagging the US cycle a little bit. In the euro area, the annual consumer price inflation rate was 5.8% in February 2022, with France and the Nordics being between 3 and 1/2% to 4 and 1/2%, Spain, Netherlands, Poland being between 7 and 1/2% and 8%. The only one that falls out a bit is Switzerland, where a comparably low at 1.9%.

On the other end of the extreme, there is Turkey with 54% of general inflation. And generally, the labor market isn't as tight as in the US yet maybe. Of course, the war in Ukraine is likely to further boost inflation with Russia being a key supplier of energy and commodities, right? So Chris, which types of inflation do you think insurers are impacted by most?

CHRIS BOZMAN: Yeah, thanks Sina. So when you think about first party lines and property damage, it's the cost of materials. We've seen spikes in lumber prices during 2021 in the US, auto parts increasing in price, and the labor costs to make the repairs have gone up as well. So we're already seeing that inflation.

But when you think about third party lines and bodily injury as well as worker's compensation, it's really the wage and medical inflation that are the threats to those lines, and we haven't seen those tick up significantly yet. We're starting to see wage growth in the US, so there, I think the concern is more in the future, what's going to come in the next 12 to 24 months.

And if we do see increases in wage and medical inflation, what will the duration of that be?

SINA THIEME: Right, and claims inflation I think we define as the change in per claims costs in a specific portfolio. So apart from price and wage inflation, what are other factors or claim cost drivers? Maybe Klayton, if you want to take that first.

KLAYTON SOUTHWOOD: Yeah, I mean, there's a lot of stuff going on at least in the United States, and especially in personal lines. I mean, you've got the fairly well documented supply chain issues around COVID that are driving up, as Chris mentioned, lumber costs for property insurance repairs and the cost of parts for auto repairs. There's a lot of other stuff that's really driving the inflation, especially in auto around improvements in technology that seemingly will a long term basis help with loss cost and lead to overall increases in safety and reduced claim frequency, things like adding all kinds of sensors to vehicles.

In the short term, that's actually causing more strain, because the cost of repairs of all the automated sensors, the cost to run diagnostic scans to make sure that the electronics were fixed correctly in an accident. The cost of doing the recalibration of all the cameras and things like that. The body shops are just-- they're challenged to get the staff to know how to work on these repairs.

They're challenged to get the parts in. The manufacturers, I think, long term need to be doing a better job-- when they're putting these equipment on the cars, they're thinking about the improvements in safety. They're not thinking about the cost to the insurer to repair. So a lot of times, they're putting this equipment in spots where you end up having to replace the entire bumper rather than having to make a simple swap out of a piece of equipment.

So I think it's going to be the insurers having to work with the car manufacturers, in the case of auto, to think about better ways of building the vehicles so they can include this technology, but it's not so expensive to deal with when there was an accident.

CHRIS BOZMAN: I think when you think about claim cost inflation beyond the economic inflation contributors, social inflation is something that's come up in the US in liability lines that's a big driver. So that's been grabbing the headlines for a few years. So when we think of social inflation, we really think about higher insurance payouts not driven directly by economic inflation, and it's really the playing of spar that's driving a lot of this.

Perhaps other factors like anti corporate sentiment becoming more entrenched in the US driven maybe by wealth inequality, and we see changes in tactics used by the plaintiff bar to try to take advantage of that. And litigation funding, which has become a big alternative investment in recent years, where third party capital can actually back litigation and help finance it, which is driving larger awards. So we're seeing that in the US, and that was in the absence of economic inflation, and I think a big question will be, to what extent does that continue, even maybe increase as economic inflation increases.

And that's a bit of an unknown as to whether social inflation will be exacerbated by higher economic inflation. So social inflation is a big one. I mean, other drivers of claims costs beyond economic inflation would be changes in utilization. So that's potentially a big issue, say in workers compensation, where more treatments or different types of treatments for medical care could drive the costs up.

Actually, during COVID, we saw probably some drops in utilization as some workers' comp claimants probably skipped physical therapy sessions, for example, to try to stay at home during the height of the pandemic. So that will likely reverse itself and go back to more normal levels going forward.

SINA THIEME: Right, and maybe one aspect we haven't touched on that much yet is around demand search and shortages in labor. I don't know, Klayton, if you want to pick that up.

KLAYTON SOUTHWOOD: Yeah, I mean, that's definitely an issue, Sina. I mean, we saw that especially as COVID started to come on in the US with issues around the ability of people to continue to work in property insurance, getting into people's homes to make repairs. That definitely became an issue. Like I said, the body shops have been in auto have really been struggling to just find the people with the qualifications. Back to the discussion on technology.

As a lot of this new technology has come on board, the manufacturers are requiring that their own proprietary hardware and software be used for things like the scanning and the recalibration, and it's an expensive prospect for the body shops, especially the independent shops who aren't part of large networks to be able to afford this equipment, to train the people, and to pay the wages for the specialized knowledge that you need to repair this make and model of car versus that making model of car. It's all different, and it's a big strain.

I don't know what the long term impact on this is going to be, but we are seeing some consolidation in body shops, because the independents are having to sort of sell out to the larger shops or go out of business because they can't afford the upgrades in the equipment, and that's going to create further strain on the market with less capacity and less options for the insurance carriers and the consumers to have the repairs done. So it's something that we're really going to have to keep our eye on over the coming years just to see how this all shakes out.

I mean, hopefully, at least the supply chain issues related to COVID will ease soon, and that will maybe save some strain on the system, but just the overall push towards advancements in technology is going to, I think, cause some long term strain. The other thing in that regard, Sina, is electric vehicles. As those start to come more on board, that's a whole other issue that the carriers are going to have to deal with in terms of cost of repair.

I was at the conference earlier this week, and there was a lot of talk around just all the technology in these vehicles that a lot of people don't even use but is incredibly expensive to repair and when an accident occurs. So it's like, what's the trade off between pushing forward with including all these nice features if they're not going to get a lot of use and are incredibly expensive to deal with when they have to be repaired?

SINA THIEME: Right. So I guess auto and homeowners are the obvious lines of businesses that are impacted. What are some other lines that you think are majorly impacted too?

KLAYTON SOUTHWOOD: I think, to some of the points that Chris made, I think we're going to see similar issues in a lot of the commercial lines. I think we're seeing a lot of issues. For example, in commercial property, you've got the same issues-- some of the same issues that impact homeowners around supply chain issue and cost of lumber. I think you're going to continue to see upward trend in a lot of the liability coverages, both personal and commercial. I mean, Chris made the point about litigation finance.

I think that's an important one, because what we're seeing, especially in bodily injury, be it bodily injury or GL related injury, claimants who would otherwise be inclined to settle to get cash are not as inclined to settle anymore because they've got the litigation finance companies backing them and supporting them and encouraging them to continue on. So it's extending cycle times of claims, it's increasing the cost and duration and frequency of lawsuits. That's a major issue that the industry is going to have to wrestle with and figure out the best way of counteracting the impact of all the litigation financing that's come online and seems to be getting ever more popular as the days go by.

SINA THIEME: And that's going to have a real impact on reserve adequacy, right? I don't know, Chris, do you want to comment on of other areas that could be impacted as well?

CHRIS BOZMAN: Reserve adequacy is a big issue, and it's something we're thinking a lot about and our clients are thinking a lot about. So actuaries have been dealing with a pretty benign inflation environment for a long time now. Reserving actuaries can look at historical development and assume that that is likely to continue as a default. I mean, there's been other complications along the way, but by now, we really have to give a lot of thought to how changes in inflation will impact the development of reserves.

And that thought has to be given at a very granular level, at a line of business level. You have to think about the inflation in the experience period you're using in your projections and what the likely inflation will be going forward. And also whether inflation after the time the claim occurs impacts the ultimate cost of the claim or whether it really doesn't.

So for some lines, it's obvious, like workers' comp, medical costs. If there's medical cost inflation after the claim occurs, that will impact the payments that the insurer has to make. Contrast that with workers' comp indemnity, where unless there's cost of living adjustments in a particular state, the indemnity is really key to off the wages at the time that the claim occurred. And in other lines are less clear, like general liability.

It's probably somewhere in between those extremes. So insurers really have to think through all of those issues and consider making explicit adjustments to the reserves for the potential for higher inflation.

SINA THIEME: And do you think that should be done sort of indirectly during the reserving exercise or should it be done via scenario tests or how would you approach that?

CHRIS BOZMAN: I think insurers are going to have to think about this as part of the reserving exercise. I mean, scenario and sensitivity tests are very helpful, they provide insight to management and to boards in terms of what could happen to reserves in a high inflation environment. But now we're in one, so it's not really a scenario test anymore, it's more this is a central estimate consideration. So I think actuaries, as part of the reserving, need to be thinking about this.

Like I said, it's not easy and it takes time. And reserving actuaries are already pretty strapped for time. But this is something that needs to be thought about now.

SINA THIEME: And it should be thought about in the overall context of impact on the asset side as well, impact on discount rates, impact on the entire business strategy, right?

CHRIS BOZMAN: Absolutely.

SINA THIEME: In a more holistic context. I guess, Klayton, do you want to talk a bit about your thoughts on how inflation could impact premiums and claims and future underwriting years and/or the business strategy?

KLAYTON SOUTHWOOD: Absolutely. I mean, I guess the question comes down to what do you do with the current inflationary environment in terms of the pricing of your products. In the near term, a lot of carriers are just going to take rate increases to try and offset the increased claim cost, but I think long term, it's really important to think from a business perspective about the steps you're taking to properly manage the business. I mean, if you think you're on the homeowners side, with the surge that we've seen in replacement costs of homes and the price of homes in the real estate market, the way it's been the past couple of years, there are tools that carriers need to be really thoughtfully applying.

I mean, making sure that homes are properly insured to value. Making sure they're replacement cost estimation tools that you have and utilize are appropriately measuring the exposure that you have with the homes that you're insuring. Making sure that you've got inflation guard provisions in your rating algorithms to pick up that increase in cost that's taking place. The other thing that I think carriers are going to have to do is just think really smartly about underwriting strategy and things of that nature, too.

So I mean, there's only so much that you can do from a price perspective. I mean, one of the challenges that carriers have in the US right now, especially in the auto market with claims inflation going up and needing to take rate increases, your regulators are looking back to 2020 and saying, did you really give back enough premium? You made a lot of money during COVID. Yeah, you gave back some.

I mean, the industry gave back several billion dollars at least in personal lines auto, but was it enough? And you had these outsized profits, and so I mean, I think regulators get it. The carriers need the rate, but on the other hand, they're looking at consumers who are really struggling, even in the face of increasing wages with the rate of inflation is the way it's been, it's a a struggle, and so the regulators are getting concerns expressed by consumers, and it's that balancing act.

So I think it really behooves the carriers to look at other strategies beyond price. As I mentioned, things like smart underwriting and really trying to control the level of exposure that you have in your book.

SINA THIEME: Chris, anything to add?

CHRIS BOZMAN: I agree with all those points. I think on the claim side, a good claim strategy is important in terms of thinking about the impact of inflation, on settlements to try to keep that under control. I think it's really hard to be a claims person these days, especially in liability lines with social inflation and now economic inflation. And I think the claims area is where successful insurers can probably differentiate themselves in trying to extract the best outcomes for the organization, while still serving claimants appropriately. I guess the other thing I think companies need to think about is on the capital side, what does higher inflation mean for the, say, the capital allocations to different lines of business and also the total amount of capital.

So in capital models, I mean, some companies have been kind of modeling an inflation impact separately but not all. And I think it's certainly a best practice to try to spike out inflation, because you can look at the liabilities and the asset. Impacts at the same time, and it also may impact the way you think about diversification of different lines of business. So lines of business that historically were thought to diversify with each other, if they're susceptible to the same economic inflation, then maybe that diversification isn't what was previously thought.

So that's another important area where I think companies should be looking and focusing, and it really impacts what they think the capital that's needed is to run their business and therefore how they should be pricing their products.

SINA THIEME: Do you think there's anything on the underwriting and product design side that insurers can do to react to inflation?

CHRIS BOZMAN: Well, I think, as Klayton indicated on property, getting total and short values right I think is really important, and that's been a struggle, I think, in the past. And inflation guard, for example, is part of that. Those are the main things. Limits, watching limits, watching attachment points, increasing deductibles, and making sure the pricing-- if you're writing excess-- is reflective of the trends we're seeing.

So if you're attaching in $1,000,000, $1,000,000 certainly doesn't offer the protection that it did even a few years ago. So pricing actuaries need to be thinking about that very carefully.

SINA THIEME: So Chris, another way to potentially react to inflation could be alternative ways of transferring risk, like parametric insurance, which would ensure quick payouts, no ambiguity, therefore no legal risks. What do you think is that real potential for the person market as well?

CHRIS BOZMAN: Well, we've seen that to some extent in the reinsurance market with industry loss warranties, for example. So those are time tested in that market, although they're not always completely straightforward, because there can be are arguments about the trigger of what the industry loss is, what's included, what's excluded. But in theory, it should be straightforward. But on the direct side, I don't really personally see that as a solution.

I think there's probably too much basis risk for a policyholder to take on and the insurance product does not work so well for an individual or a small business if there's a lot of basis risk.

SINA THIEME: Right. For anyone who is interested in parametric insurance, we actually did a separate session with Dr. Simon Young on this as part of the (Re)Thinking Insurance podcast as well, so listen to that if you're interested.

CHRIS BOZMAN: I think, for the most part, insurers are in a situation where it is going to be difficult to hedge inflation. But understanding it is the first step, of course. And when you think about things like reserve risk, one solution could be to go out and buy an adverse development cover from a legacy market or something like that. So we may see companies looking for those options.

Of course, the legacy markets are smart as well, and we'll be thinking about the potential for inflation in their pricing of those covers. But we may see a little more activity because of that if companies are really trying to control their reserve risk.

SINA THIEME: Yeah, thanks, Chris. Yeah, I agree. Before we close off, I think I would want to know from both of you if you think the current inflation discussions are a bit of an unnecessary panic or is it an actual issue for insurers that will persist in the near future? Klayton, do you want to start?

KLAYTON SOUTHWOOD: Yeah, yes. I'm happy to go. I mean, I think that, at least for the next couple of years, we're going to have this. I mean, I think it's going to take a while to get over the supply chain issues we've seen, I think, as things like litigation finance more fully matures. As I mentioned before, the increasing levels of technology in vehicles, it's going to put more and more strain on parts prices. It's going to put more and more strain on labor rates.

So yeah, I think some of the supply chain issues related to COVID ease in 2022 and probably into 2023 would be my personal guess. We're going to see some easing, but I think there's just some systemic things going on in the industry that are going to be more long term and that are going to cause carriers some headaches if they don't really stay out in front of it.

CHRIS BOZMAN: Yeah, I don't think there's a panic that at least isn't warranted. I think this is something companies need to be thinking about and it's appropriate to be thinking about, and there's a range of scenarios, right? So most economists think that the fed through increasing interest rates will be able to bring inflation under control and the supply chains will kind of work themselves out.

But there's other scenarios that are not as favorable that are possible. So a wage price spiral. I'm not saying that will happen, but it's possible. The geopolitical situation adds a lot of uncertainty, especially around energy prices. That's obviously very uncertain.

So companies need to be thinking about these things. It's really challenging, especially coming out of COVID, because as actuaries trying to make sense of all of this, they're dealing with distortions due to COVID as well, which is already making projections difficult and we're layering in inflation on top of that. So there is a lot to try to think through, but I think it's right for companies to be raising this as an issue, and most of the companies we talk to, I think, are appropriately concerned and focused on this issue.

SINA THIEME: Great. Thank you so much for your time and your thoughts on the topic, Chris and Klayton.

CHRIS BOZMAN: Thank you.

KLAYTON SOUTHWOOD: Yes, thank you, Sina.

SINA THIEME: Thank you for listening to this episode, and I hope you find this interesting and useful, and if you did then join us on future episodes of (Re)Thinking Insurance.

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