

BUSINESS INSURANCE

How insurers, brokers, policyholders can reduce the effects of social inflation

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Social inflation is a term we hear a lot today about what is driving up the cost of insurance. Simply defined, the term means more losses and more expensive losses. We will discuss what causes this and how policyholders, brokers and insurers can mitigate the effect.

Social inflation relates to many claims. This article will focus on the most common property claims relating to fire, windstorm, water and hail, and liability claims related to bodily injury such as slips and falls and construction accidents.



So why have we missed the mark when it comes to anticipating losses?

- **Inflation.** Losses on a liability policy written today will be typically paid three to five years from now, or 10 years or more on complex claims. While we try to estimate what the future cost will be for medical inflation or general inflation, insurers have underestimated inflation trends, and there is “sticker shock” from the value of a claim as compared with what a similar claim would settle for a few years earlier. Also, a more generous societal view on compensation or expansion of the definition of tort liability is typically not contemplated in pricing.
- **Higher verdicts and runaway verdicts.** Bodily injury claims must pay for medical liens and legal fees and must be sufficient to compensate the claimant for their injury; however, expectations have risen in terms of what is needed to adequately compensate an injury. Juries by their nature empathize with victims, but excessive verdicts ultimately go into the loss cost pool and drive up premiums.

For property insurance, there are increased construction costs and increased frequency and severity of regional exposures, such as sinkhole losses in Florida and hail losses in Texas and Colorado.

- **Litigation funding.** Claimants and/or lawyers are being paid up front by litigation financing firms to proceed with a case. With interest charged on the funds advanced and other costs, traditional settlement values leave little money for claimants because they have huge interest bills and have spent a good part of the money they received. This creates a natural incentive not to settle, thus driving up settlement values and legal costs. The very high interest rates charged by the lenders will ultimately be reflected in premiums.
- **Bad faith.** Depending on the state, expansive plaintiff-oriented definitions of bad faith will materially increase the cost of claims since the demands are often over and above the policy limit or expected settlement value. Claimants and their plaintiff attorneys will use bad faith allegations to gain leverage over an insurer and win payments on questionable or exaggerated claims. This has been pronounced for hail claims in Texas and Colorado, which has adversely affected the availability of this coverage in those areas.

In addition, in certain jurisdictions, plaintiff attorneys have been successful in broadening the standard for when someone is liable, such as through vicarious liability.

Real or anecdotal?

Rating agency A.M. Best Co. Inc. commented in a June 2020 report that “Social inflation (broader interpretations of contract language and more plaintiff friendly juries) has helped drive unfavorable loss frequency trends for liability claims, particularly for umbrella and excess casualty business.”

Skeptics of the insurance industry might say insurers are using the concept of social inflation as an excuse to raise prices. However, statistics showing claims costs are rising are compelling.

For example, calendar year loss ratios, per Schedule P in insurers’ annual financial statements, for the general liability line increased 15 points from 2013 to 2018. If we look at the average of 2011-2013 as compared with 2016-2018, the increase is 12 points. This is meaningful and would be a function of more losses — both frequency and severity, prior year reserve inadequacy and lower pricing. From the data, we see increased losses and price decreases — which fell 7.5% cumulatively 2015-2017 — are the largest drivers.

From a severity point of view, there are numerous data sources showing the existence of social inflation.

For example, the Insurance Services Office’s recent “General Liability Trend Data and Analysis” shows an increase in severity for the Owners Landlords and Tenants classification of 60.4% for bodily injury (indemnity only) and 79.6% for property damage from year-end 2013 to June 30, 2019, which is roughly a 9% annual increase for bodily injury and 11% for property damage.

In addition, the Schedule P line for “Other liability — Occurrence” from 2013 to 2017 showed an increase in severity of over 40% as compared with prior historical periods. This reflects all claims, whether they were settled, litigated or resulted in a jury verdict.

Meanwhile, Jury Verdict Research stated in a recent report that “median jury verdicts are more than 2½ times what they were seven years ago.” This is consistent with a white paper from Swiss Re Group Ltd. that noted that the median of the 50 largest verdicts doubled from 2014 to 2018. This is also consistent with a report from the Insurance Information Institute that noted that average awards for all lines increased 83% from 2013 to 2017.

All the data is pointing the same way, although not identical in result.

Pricing and loss costs will ultimately become synchronized for the most part. However, we have had convulsive dislocations over the past many decades, such as the liability crisis in the early 1980s, ongoing issues with medical malpractice insurance and huge property underwriting losses following the Sept. 11, 2001, terrorist attacks.

Current social inflation is more akin to the 1980s liability crisis, with the value of the claims, both in terms of frequency and severity outpacing our expectations.

What does it mean?

The insurance industry cannot pay losses without ensuring a reasonable return over the long term. On a short-term basis, the industry will take it on the chin, but on a long-term basis the cost will come back to the policyholder in the form of higher premiums, higher deductibles, more restrictive coverage, avoidance by insurers and less availability of limits, and migration to the excess and surplus lines market with considerably higher pricing and more restrictive coverage.

What can be done?

By the insurance broker or agent:

- Educate your policyholder and manage expectations.
- Understand the market and develop long-term relationships with insurers that are comfortable with your client’s business at a reasonable premium with reasonable terms and conditions (i.e. they do not overreact by erratic pricing or withdrawing from classes of business).

- Explore risk mitigation strategies with your client and discuss with your insurers why this makes a difference to justify better pricing.
- Make sure your client has taken sufficient steps to be categorized as a “best-in-class” risk.

By the policyholder:

- Understand what is driving up rates and explore risk mitigation strategies such as effective safety programs, good maintenance of property, leases that properly transfer risk to other parties, and sufficient security. Make your business a best-in-class risk.
- Choose insurance agents or brokers who understand your risk profile and can place your account with insurers that understand your business and will give you credit as being a best-in-class risk.

By the insurance company:

- Understand what is driving up loss costs. Avoid risks with poor risk profiles relative to premium.
- Increase price, increase deductibles and tighten coverage, as warranted.
- Identify and prioritize writing best-in-class risks.
- Communicate to your producers what you believe are best-in-class risks.
- Make sure that your policyholders have above-average loss control for both their property and liability exposures.

Social inflation is insurers’ problem in the short term but will ultimately become a problem for policyholders. Therefore, it is good practice by policyholders and brokers to understand the underlying causes of loss cost drivers, to mitigate such exposures and be presented as a best-in-class risk by their broker or agent to the insurer.