December 6, 2022

Market Segment Outlook: US Commercial Lines

Our outlook remains at Stable, as positive factors are countered by near-term concerns

AM Best is maintaining its outlook for the US commercial lines segment at Stable. Key factors supporting the outlook include the following:

- Sustained strong underwriting performance throughout the pandemic and amid the current economic volatility
- Sharply higher fixed-income re-investment rates, which will bolster profitability in virtually all lines, especially casualty
- Positive pricing momentum—though past its peak—throughout the segment, with the notable exception of workers' compensation
- Still favorable aggregate prior period reserve development, despite general tapering in reserve margins and segments such as commercial auto
- The diminishing impact of the pandemic on commercial lines insurers, reflecting in part almost universally favorable rulings on many business interruption coverage disputes

The segment maintains solid risk-adjusted capital, reflecting its generally conservative investment profile and hold-to-maturity strategy with respect to fixed-income securities, as well as its moderate and generally well reinsured catastrophe exposures, notwithstanding smaller premium rate increases and the impact of rising inflationary pressures on both property and casualty lines.

Near-term concerns include the following:

- Stubbornly elevated economic inflation, reflecting supply-chain disruptions and increased commodity and labor costs, primarily affecting loss costs in property lines
- Expectations of a commensurate rise in social inflation, including jury awards and litigation costs, affecting loss costs in casualty lines, in terms of both prospective underwriting and reserve margins
- Growing fears of an economic recession in 2023, including disruptions in important economic segments and workforce dislocation, with a potential impact on certain professional liability segments and other lines
- Pressure on risk-adjusted capitalization—despite continued strength—owing to sharply contracted equity market valuations and higher interest rates
- Increasing reinsurance costs and reduced coverage capacity in the aftermath of Hurricane Ian

Pressures on the US commercial lines segment have clearly increased in 2022, affecting both balance sheet strength and operating performance, although the impact varies by insurers and lines of business. The shock to equity market valuations, interest rate-driven mark-to-market devaluations of bond portfolios, and persistently high economic inflation and expectations of a commensurate rise in social inflation, are being felt by insurers across virtually all lines of business.

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The Stable outlook on the US commercial segment reflects AM Best's expectation that, on balance, the segment will remain profitable, its risk-adjusted capital will remain sound, and the segment will be resilient in the face of these near- and longer-term challenges. The outlook furthermore considers that the underlying outlooks for all but four of the lines of business in the segment (commercial auto, general liability, professional liability, and medical professional liability) also remain Stable, driven to varying degrees by headwinds and tailwinds discussed in this report, as well as unique, line-specific considerations.

Robust Underwriting Performance Across Major Commercial and Specialty Lines

Commercial lines insurers have reported positive robust underwriting results through the third quarter of 2022 and are expected to continue to do so, driven by strong net premiums earned on the heels of prior year rate increases and continued growth in net premiums written. With the notable exception of workers' compensation, year-to-date renewal rate changes have been strong. Segment earnings have also benefited from lower catastrophe losses for the commercial lines in 2022—notwithstanding the severity of Hurricane Ian in the third quarter—as well as from higher underlying underwriting gains and net favorable prior year reserve development. Favorable prior year reserve development has been driven primarily by better-than-expected loss experience in workers' compensation, sustaining a multi-year trend, partially countered by additions to reserves for asbestos, environmental, and other mass-tort prior year liabilities.

Although commercial insurers face a diverse underwriting landscape, companies are increasingly leveraging technology and innovative products to enhance underwriting and pricing decisions, with greater visibility into profitability at the account level. A more direct focus on loss control and claims management has impacted both frequency and severity. Despite ongoing structural challenges that can materially affect performance, the segment has benefited from improved technical pricing and is well positioned to meet both short- and long-term challenges.

Pricing Off Its Peak, Still Favorable Across Most Major Commercial Lines

Following a multi-year peak in late 2020/early 2021, premium rates for most of the major commercial lines remained robust through 2021 and continued to rise in 2022, albeit at a slower pace, with rate-on-rate pricing gains fueling commercial insurers' underwriting performance through the current year and into 2023. A notable exception has been workers' compensation, whose multi-year underwriting performance has been the strongest of the segment and whose premium rates are also the most tightly regulated, resulting in ongoing premium rate decreases in 2022—this despite continued favorable margins, reflecting both higher payroll and total pricing for the line, as well as still favorable reserve development from prior years.

Recent premium growth has been led by major accounts and specialty lines, followed by middle market and the more commodity-like small commercial account business. Financial lines have seen a modest decline, due primarily to sharp reductions in IPOs and M&A. Overall rates (excluding workers' compensation) have been up in the mid-single digits, while total pricing, which includes rates and exposures, have increased in the high single digits.

Because of the impact of the decline in workers' compensation rates (which will be offset partly by the impact of rising wages) and sustained increases in nearly all other lines, direct premiums written are expected to grow only modestly, in the mid- to high single digits.

If not for inflationary pressures, as well as the prospect of sharply higher reinvestment rates on fixed income securities portfolios, AM Best would expect further downward pressure on premium rates. However, early indications suggest that insurers are mindful of the multiple economic headwinds and crosswinds and that pricing strength may regain traction in response to rising costs

across the board and to the impact of heightened market volatility on capitalization and rising costs of reinsurance protection, especially post-Hurricane Ian.

Inflation Cutting into Margins and Pricing Increases in Property & Liability Lines

The most notable adverse trend facing US commercial insurers, and the economy overall, has been the persistent surge in inflationary pressures for both goods and services, as wage growth has lifted employment costs. The US Consumer Price Index (CPI) all goods urban index rose 8.2% as of third quarter 2022 from the same period in 2021, sustaining the 8.3% recorded for the prior rolling 12-month period, and a pace of inflation not seen in over 30 years. Notwithstanding US Treasury efforts to combat inflation with rising rates, insurer loss costs are likely to continue to rise, as ongoing supply chain issues and labor shortages continue to push up prices for a variety of consumer goods and the materials, as well as repairs or replacement of damaged property. Rising cost estimates will also be reflected in a reduction in the benefit of further reserve releases on business written in prior years, as those reserves were likely established under more benign assumptions.

Inflationary pressures are affecting not only the property lines. The general rise in claims demands, settlements, and judgments—social inflation—is highly relevant for casualty lines, as these trends not only impact future claims but also require continual re-evaluation of existing claims reserves. These lines—with the exception of commercial auto liability—benefited from the material favorable loss reserve development during most of the last decade. Over time, however, the extent of favorable development has declined, due in part to the rise in claims costs—particularly in general liability and medical malpractice, both of which have seen adverse development in more recent years. As public attention shifts from the pandemic and its impact back to other issues, AM Best expects to see a return of the negative trends in social inflation and associated issues, such as litigation financing.

Commercial insurers will therefore need to remain vigilant about inflation, in terms of both pricing and reserving and across both long- and short-tail lines of business. AM Best views the market as being reasonably disciplined; however, given loss cost inflation and likely slowing growth in exposures owing to uncertain economic conditions, casualty rates in most classes will need to rise at an accelerated rate—or the industry will fail to keep pace.

Capital Market Volatility Impacts Balance Sheets, but Higher Interest Rates To Fuel Returns

Inflationary pressures have affected commercial insurers' prospective underwriting and reserving margins, but the sharp increase in capital market volatility and rising interest rates through the third quarter of 2022 have significantly eroded the market values of their equity and fixed-income securities portfolios. Nevertheless, US commercial insurers' securities portfolios remain overwhelmingly invested in investment-grade fixed-income securities generally held to maturity (thereby significantly mitigating the likelihood of realized investment losses), and equity portfolios, though significant, are carried net of deferred tax liabilities, which helps dampen the impact of market declines on insurers' capital.

The silver lining for commercial insurers, given their medium- to longer-term liability durations, is that operating performance will strengthen significantly as free cash flows and maturing fixed-income portfolios roll over into sharply higher interest-rate bearing bonds. Over the past decade, insurers have had to generate more substantial underwriting profitability to offset the impact of persistently low interest rates. The current rate environment, however, will play well into their generally shortened portfolio durations, allowing commercial insurers to finally achieve the portfolio yields they've waited for years to return. Insurers' new challenge will be to avoid sacrificing underwriting pricing adequacy and to keep their attention on maintaining adequate risk-adjusted returns.

Impact of Pandemic Subsides as Litigation Uncertainties Resolve and Claims Trends Normalize

The effect of the pandemic on the performance of the commercial segment has been modest across most lines of business. In some lines, the decline in loss frequency more than offset any increases in severity, with commercial auto and workers' compensation being cases in point. Meanwhile, litigation related to denial of coverage for business interruption claims has almost universally been resolved in favor of insurers, with many cases dismissed without proceeding to trial.

Thus, the segment's normalized combined ratio, which eliminates the effect of catastrophe losses and loss reserve development, improved broadly in 2021, although some of the improvement in the loss ratio was countered by a deterioration in the expense ratio because of suppressed premium growth and by higher costs associated with property lines, including commercial auto physical damage.

With the return of court dockets to full productivity—notwithstanding a push to release the case backlog—and a sustained period of significant return-to-workplace activity, AM Best expects that claims trends will return to historical levels, although the "new normal" will not necessarily match pre-pandemic trends.

Emerging Classes of Potential Litigation Merit Continued Vigilance by Casualty Insurers

Emerging Materials & Technology

In addition to well-established areas of litigation, the emergence of new sources of liability is an ever-present exposure for commercial casualty insurers, particularly in light of evolving legal and social attitudes toward dietary and other substances, the implementation of new chemical and materials technologies, genetic engineering research, and other trends. Additional concern appears warranted with respect to potential long-term liability costs related to (1) herbicides and pesticides in use over the course of multiple decades, (2) "nutraceuticals" such as dietary supplements, and (3) "forever chemicals" in commercial household products and industrial production facilities that could lead to bodily harm or impairment of real property asset values or affect drinking water—all of which may present fertile ground for mass tort litigation in the years ahead. The emergence of 5G technology has already prompted significant concern in digital/national security as well as aviation with respect to flight safety, an area of potentially incalculable exposure.

Climate-Related Exposures

Commercial insurers also face challenges in assessing the nature and scope of exposures relating to climate risk. The variability in the commercial lines' reported results in recent years is largely a reflection of the variability in catastrophe losses each year. The segment has been subject to an increase in the frequency of more severe events, driven not just by climate risk but also by demographics and rising costs to repair and replace damaged property. The effects of these factors on the segment are material and will persist over the long term. To be successful, companies have adapted by innovative use of technology and product design, as well as adopting firm underwriting objectives and incorporating assessments of these risks in their enterprise risk strategies. The segment's ongoing core underwriting and overall operating profitability, which contribute to steady risk-adjusted capital strength, reflect the resilience of the companies in the market.

Litigation Financing

Also worthy of note is the evolution of litigation financing, in which third-party investor groups (often private equity firms or hedge funds) provide up-front financing to plaintiff attorneys involved in personal injury and liability litigation in return for a share in the ultimate jury award or settlement. Litigation financing has become a significant factor in mass tort litigation and often results in costly verdicts.

Commercial Lines Insurers Remain Strongly Capitalized To Absorb Impact of Headwinds

In AM Best's view, notwithstanding the growing headwinds brought on by rising inflationary pressures, increasingly volatile capital markets, and some attrition in the segment's pricing power, the US commercial lines segment remains solidly capitalized on a risk-adjusted basis. This view considers the segment's generally conservative investment profile and hold-to-maturity strategy with respect to its predominantly investment-grade fixed income securities portfolios and limited equity exposures, as well as its consistently sound aggregate reserve position and enhanced risk management discipline across underwriting, claims, and actuarial disciplines—which are essential to navigating a highly dynamic market environment. Finally, the reinvestment of new cash flows at sharply higher rates than current portfolio yields should provide a strong tailwind for both long- and short-tail commercial lines.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
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We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

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