Exploring the Consequences of Inadequate Program Limits in Commercial Property Insurance

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"The broader marketplace is seeing underinsurance and/or situations where the limits procured are inadequate for the loss scenarios. Sometimes the exposure values reported understate the actual exposures that exist at the time of loss. That can be a function of inflation, and it can be a function of supply chain disruption."

"On the business income side, we see supply chain as more of a driver. It is taking longer to get replacement parts; it's more expensive; there are labor shortages, and that makes it more time-consuming in terms of reinstalling, testing, and things of that nature. All of that is feeding into a situation where policy limits may be inadequate for the loss scenarios."

"Having the right information to describe the risk you have and the coverage you're trying to buy puts you in a better position. It doesn't necessarily mean it's going to be easy or less costly, but it gives you better than market treatment, and you'll have more options for your consideration."

"Organizations that don't have the required information are relegated to the excess and surplus lines market, which is looking for a much higher rate online. We're still competing in a marketplace where there is a finite amount of capital, and that capital will find its greatest rate of return, whether it's the money they take in or the exposure they take on."

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Navigating inflation, soaring rebuild costs, and lengthy periods of business interruption in an increasingly challenging insurance market.

INTRODUCTION

Property insurance buyers have dealt with the most challenging property market in decades. A confluence of factors, including inflation and heightened claims experience, is restricting capacity for commercial insurance and reinsurance at a time when demand for coverage is increasing. At the same time, insured values have steadily risen. Inflation and an increasing frequency and severity of claims are impacting restoration timelines and overall loss costs.

Property replacement costs increased by an average of 45% between 2020 and 2023, compared to average inflation of 15% over the same period, according to research by Insurance Information Institute.[1] Against this backdrop, some insurance buyers are struggling to secure adequate limits to protect them against property damage and business interruption losses. Often this is due to the buyers inability to determine adequate limits at commercial viable price levels.

The current headwinds call for a holistic and creative response. Among the tools in the toolbox are risk engineering, up-to-date valuation appraisals, increased risk retention, and alternative risk transfer solutions. Whereas once these were strategies that were mainly used by large corporate institutions, there is increasing buying sophistication within midmarket companies, driven by the confluence of challenges.

This whitepaper considers the difficult commercial property market through the lens of the insured. It highlights the importance of selecting the appropriate policy limits and considers how this can best be achieved in the current climate. There is a growing evidence that insurance buyers with detailed and transparent risk information are more likely to achieve better-than-market results at renewal.

THE MAKINGS OF A PERFECT STORM

The difficulties experienced in the property insurance market were symptomatic of a pronounced supply-and-demand imbalance. Industry capital contracted, and underwriters pulled back capacity and reassessed their appetite for natural peril risk. These dynamics were seen around the country, but they were particularly pronounced in states with high exposure to natural catastrophe perils, such as Florida and California.

The roots of the hard market can be traced back to 2017 and 2018, when insurers with significant property catastrophe exposures began to address the high frequency of losses they were experiencing.[2] More claims were coming from severe weather events, such as severe convective storms (SCSs) and wildfires, and many of these have fallen within primary insurer retentions, rather than being passed onto the reinsurance market.

According to Gallagher Re, 2023 saw the global private insurance market cover $123 billion worth of direct physical damage and net-loss business interruption as a result of global natural perils."[3] What has changed is the dominance of insured loss costs from secondary perils with SCS remaining the costliest global peril. Claims from SCS have accounted for 57% ($71 billion) of losses in 2023, with events in the US alone resulting in insured losses of $60 billion.

The market is seeing significant growth in the number of these billion-dollar-plus claims events each year. According to NOAA figures, the 1980–2022 annual average was 8.1 events (adjusted for inflation). In comparison, the annual average for the five years between 2018 and 2022 was 18 events.[4]

2023 came to a close with 28 confirmed extreme weather events in the US, with losses exceeding $1 billion. These included one drought event, four flooding events, 19 severe storm events, two tropical cyclone events, one wildfire event, and one winter storm event.

From a insurer perspective, both sides of the balance sheet are seeing losses. Volatility in the wider financial markets has reduced how much industry capital is available to insurers. Meanwhile, rising interest rates impact the relative attractiveness of insurance as an asset class. A drop in industry capital impacts how much exposure insurers are able to take on, based on what their minimum solvency capital requirements dictate.

Despite receiving substantially more premium for the risk they are assuming, the level of claims activity continues to test the profitability of the industry. According to AM Best, the US P&C industry delivered an improvement on 2022's combined ratio of 102.6% with a final figure of 101.6% for 2023.[5]

INSURERS PULL BACK CAPACITY

The majority of such losses continue to be absorbed within insurance company retentions rather than being ceded onto reinsurers. The impact on the balance sheets of primary insurers has led to a reevaluation of the attritional impact of a large frequency of billion-dollar-plus losses. Some insurers have substantially withdrawn their capacity or will only participate in the higher layers of a property program.

At the same time, demand for reinsurance has grown as insurers seek to pass on more of the risk. Gallagher Re's April 2024 1st View report notes that reinsurance capacity is returning, but only for the top end of programs. Primary insurers are still retaining more losses than they did before due to the "radical redistribution of risk between primary and secondary markets in property catastrophe and specialty segments during 2023."[6]

In addition to demanding increased pricing and deductibles, policy terms and conditions have tightened, and multiyear coverages have largely disappeared. The frequency and severity of significant weather claims are continuing to influence how insurers price and underwrite such exposures moving forward.

Insurance buyers are facing more challenging questions at renewal. Programs that were previously placed with one insurer are being coinsured and carved up between multiple insurers, even within the midmarket space. Underwriters are removing blanket occurrence limits of liability and applying limits per location, in addition to other measures. Where underwriters are not satisfied with the information contained within renewal submissions, declinations and non-renewals are more frequent.

As a result, demand for loss prevention surveys and risk engineering services grew substantially as insureds — in partnership with their brokers — sought to gather more detailed information on construction, occupancy, and exposure. The sophistication of risk management within the midmarket space has grown substantially over the past five years, with insurance buying strategies evolving to include captives and other alternative risk transfer solutions.

KEY DRIVERS OF INADEQUATE COVERAGE LIMITS AND UNDERINSURANCE

The impact of inflation on property values and other assets is a common source of underinsurance. As discussed, this is being exacerbated by the challenging insurance market and lack of reinsurance capacity for primary and lower layers. In the overall marketplace, organizations are not able to buy what they previously bought and, in some cases, what they need to buy. Prices have increased due to inflation, so insurance becomes a matter of availability and affordability. This can lead to inadequate coverage limits.

From a business income perspective, insurance buyers frequently underestimate how much time it will take to recover from a claim, clear and remove debris, replace damaged machinery, undergo rebuild and repair, and get back to business as usual.

Inflation is again an exacerbating factor, adding to the cost of building materials such as lumber and steel. Meanwhile, issues around transportation and logistics (including fuel costs) increase how much time it takes to secure materials and labor, lengthening the restoration time needed.

According to Zurich North America, there was an "unprecedented increase in construction cost inflation" between January 2022 and January 2023, with an average increase of 12.9% for the year.[7] Cost increases ranged between 7.6% and 21.2% according to region, with labor shortages (particularly in the skilled labor market), supply chain issues, and the knock-on impact of the war in Ukraine cited as key drivers for the increasing cost of materials.

As a result of these issues, indemnity periods in business income policies are frequently underestimated. Buyers typically seeking business income protection for a 12-month restoration period rather than the 18 or 24 months they are more likely to need in the event of a loss. As business income limits are based on the estimated restoration period, claims based on a 12-month restoration period are proving increasingly insufficient.

Inflation and the hardening insurance market are not the only sources of inadequate coverage limits. There are other reasons why policy limits may be inadequate or why there may be gaps in cover — due to policy exclusions, for instance.

After a loss occurs, it is too late for insureds to discover that they lack adequate coverage or that their restoration periods for business interruption are too short. Buying the right policy limits helps lower the total cost of risk for an organization and will mitigate surprises in the event that a loss occurs.

Small businesses make up the backbone of the US economy, but a recent survey by Hiscox revealed that three-quarters are significantly underinsured. Over 70% do not understand what business insurance covers. This can leave business owners financially and legally liable for costs beyond insurance limits.[8]

Inadequate policy limits can result in policyholders receiving only a portion of the funds they need to cover the cost of a claim. In the worst-case scenario, insureds may go out of business. This can happen regardless of whether the insured has suffered a full or partial loss. When a partial loss occurs, insurers apply the condition of "average" to the claim settlement, effectively reducing the claims payment by the percentage of underinsurance.

"Previously, single insurers were willing to commit significant capital to a risk that usually resulted in a lower cost. The only time that individual carriers are not writing an entire risk is because they can't or they won't. As a general rule of thumb, the more insurers and layers you have in a program, the higher the program cost, and you end up with a less efficient transaction."

"Previously, most middle-market companies could buy insurance relatively efficiently, and in many cases, they would buy it from a single insurer. But as loss exposures increase, coupled with the pullback in the marketplace capacity and inflation, the market has seen some of the greatest pain in this segment."

"This is a marketplace of the haves and the have nots, and the haves are the ones with the best information and the longest lead times, who can equip their representatives in the marketplace to do their best work."

"There's nothing that replaces good-quality, reliable information, which reduces underwriting uncertainty. That then allows you to get better than market results."

James English
Regional Vice President
Property Practice Leader

Great Lakes and Midwest Region, Gallagher

> "It is no longer about renewing a program. It's about how the program got built, and is that still relevant, or does the insured have an interest in pursuing something that historically they may not have done? This used to be a conversation that was reserved for the largest insureds, but it's now relevant for most insureds."
>
> "It puts an emphasis on brokers readiness to have these conversations and create opportunities in the underwriting marketplace."

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Why highly protected risks have the edge

Knowing what limits to purchase can save organizations significant costs in the long run by avoiding inadequate limits and ensuring that businesses can get back up and running as quickly as possible when a claim occurs. Working with agents and brokers, insurance buyers should stress-test how their property and business interruption policies would respond in different scenarios and identify gaps in coverage before a loss occurs.

Having adequate insurance coverage in place provides extra cushion for additional costs arising from inflation, longer lead times for assessing more complex losses, sourcing of labor and/or construction materials, debris removal, and site preparation. It will also factor in additional expenses, such as the increased cost of working as part of an organization's business continuity plan.

Awareness of the problem is the first step to avoiding underinsurance. Insureds may be unaware that the actual replacement costs of their facilities may have risen substantially. Taking proactive measures (e.g., on-site replacement cost property appraisals and replacement costs valuation indices) do not necessarily mean the cost of **your** insurance will increase substantially.

Communications from agents and brokers to clients often stress why insurable property value estimates and the limits of business income insurance may be too low in the current economy. Further, clients should be aware of how inflation and other macroeconomic issues are impacting repair and reconstruction costs, and regularly undertake property appraisals to determine appropriate replacement cost exposure values.

Even when appropriate limits are selected, underwriting appetite may be difficult to obtain and/or prohibitively expensive. At a time when there is a finite amount of capital available in the commercial insurance market, tactics are changing and the appetite for risk-sharing and risk retention solutions is growing. Alternatives may need to be sought to secure the depth and breadth of coverage required by lenders and other stakeholders.

These market challenges have created opportunities for brokers, agents, and insureds to be more creative in the options pursued at renewal and consideration of all those alternatives.

Making necessary investments to improve their risk profile can take buyers into the realm of highly protected risk (HPR), putting them in the best position to secure the coverage they need from insurers. Insurers continue to state that they are more likely to offer competitive rates to insureds that invest in loss prevention and are proactive about keeping their property values up-to-date.[9]

Buyers that can demonstrate this investment in detailed and transparent renewal submissions are likely to be viewed as HPRs. This is especially true if the insured has some skin in the game through a higher deductible or self-insured retention. In the challenging insurance market, underwriters view such insureds as partners and therefore more desirable risks.

BECOMING AN HPR

Businesses described as HPRs prioritize an enterprise wide approach to risk management and, in the process, are able to moderate their loss expectancies. They are subject to a lower than normal probability of loss as a result of low hazard occupancy or property type, resilient construction, installation of fire protection equipment, and a keen focus on risk mitigation.

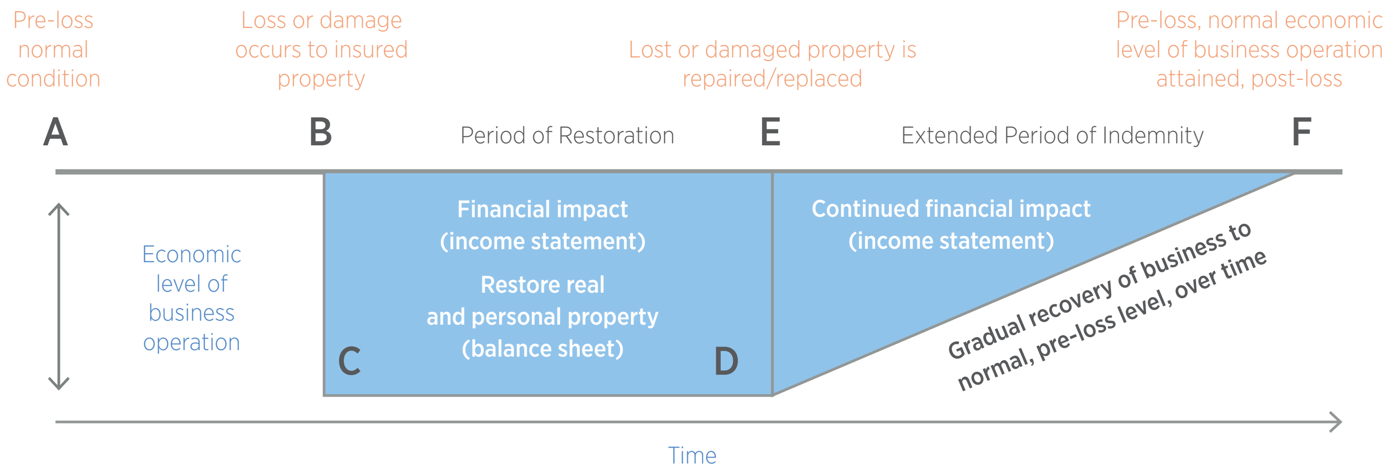
HPRs typically have a management commitment to loss prevention, invest in regular risk engineering surveys, and comply with loss prevention recommendations from their insurers and/or qualified third parties. Gaining HPR status involves more than adhering to building codes or adding sprinkler systems. It means the construction and protection of a location are adequate for that location's current occupancy and exposures. Should the occupancy or building structure change, it may introduce a new set of potential hazards, requiring further investment in additional loss prevention.

BUSINESS INCOME: SELECTING THE RIGHT INDEMNITY PERIOD

Customers often choose the proper limits for B–D, but they are missing E–F. Not purchasing E–F causes an underinsured exposure, and most are not aware of the additional exposure until after a loss occurs.

Policy language varies by insurer and insurance program, so it is important to read your policy to understand how your coverage applies.

What is a business income or time element loss?



A	Pre-loss condition; "normal" economic level of business operation
B	Loss or damage occurs to insured property
B–C	Economic level of business operation: reduced, due to loss or damage to insured property
C	Period of restoration begins
C–D	Reduced or suspended economic level of business operation during period of restoration
D	Period of restoration terminates when loss or damage to insured property has/or should have been repaired/replaced; however economic level of business operation has not returned to "normal" pre-loss, level
E–F	Extended period of indemnity after period of restoration ends, when economic level of business operation returns normal pre-loss level
D–F	Economic level of business operation returns to normal pre-loss level gradually over time
F	Normal pre-loss economic level of business operation attained, post-loss

CONCLUSION

Because of the highly nuanced nature of this market, it is imperative that you are working with an insurance broker who specializes in property insurance. Gallagher has a vast network of specialists that understand your industry and business, along with the best solutions in the marketplace for your specific challenges

About the author

James English is an industry-recognized subject matter expert in property insurance, having earned his EMBA from a highly ranked program. He is also a guest speaker, publication contributor, adjunct faculty for MBA courses and professional development leader with a 30-year record of accomplishments at three of the four largest global insurance brokers. James has decades-long trading relationships with the vast majority of leading global property insurers and reinsurers. Clients have collected more than $500 million of paid property insurance claims on programs that he placed.

James specializes in using risk analytics to develop and execute programs that transfer unacceptable levels of risk from some of the largest organizations in the world to the global insurance marketplace. He has worked with more than 100 distinct clients over his career, including insurance placement and service for all industry sectors except petrochemical. James also has experience working in corporate finance, accounting, and risk management, which affords him a distinctive perspective and the agility to communicate and connect with executives and leaders at business partner organizations.

James is responsible for developing and executing Gallagher's strategy for property insurance and related insurance coverage lines in its Great Lakes and Midwest regions, and supporting Gallagher's global strategy for property insurance and related coverage lines for all industry sectors.
His responsibilities also include client retention; product, market, and business development; peer review of client programs; and the identification, recruitment, training, development, mentoring, and retention of broker colleagues.

James earned his bachelor's degree in business with a finance concentration from Western Michigan University and his executive MBA from Michigan State University (MSU). From 2013 to 2018, James served as an adjunct professor for The University of Olivet's MBA in insurance and risk management. James has completed multiple courses toward a Chartered Property Casualty Underwriter designation and currently serves on the MSU EMBA Alumni Board.

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