US Real Estate and Hospitality Market Update

SPRING 2023

Gallagher

Insurance | Risk Management | Consulting

Introduction

The marketplace for real estate insureds has changed significantly since the last quarter of 2022 and throughout the first quarter of 2023. A few examples include:

1. More insureds are finding that they need to utilize the excess and surplus lines markets to secure coverage. In 2022, surplus lines premiums tallied a record high of $100 million.[1]
2. Interest rates in the US are the highest we have seen since the 2008 financial crisis to combat persistently high inflation.[2] As a result, real estate insureds are facing decreasing market value of assets against simultaneously increasing replacement cost values of those same assets.
3. Florida passed sweeping legislation aimed at revitalizing its insurance marketplace.
4. Reinsurance and ESG are now prevalent topics in renewal conversations with insureds.

Throughout this report, we will expand on current marketplace conditions for real estate insureds and what can be expected going forward.

Continued property market turmoil should be expected throughout 2023. Above all else, insureds should focus on the adequacy of their replacement cost valuations. This is one controllable variable that will dramatically impact renewal results. Gallagher's South Central Region Real Estate Leader, Iva Giddiens has noted that in some cases, even a brand new building transitioning off of a builder's risk policy has been required to update replacement cost valuations. The chronic nature of inflation has meant that values declared at the inception of a project are no longer in line with present-day replacement costs. At the time of writing, US headline inflation stands at 5% YoY.[3]

For casualty lines of business like general liability and umbrella/excess policies, we are observing stability with more attractive renewal results available. Exceptions to this trend include insureds with risks located in historically strenuous legal environments or those with poor loss history, especially when the losses are related to serious injuries or violent crimes.

The management liability lines of coverage are seeing the most balanced renewal results compared to other lines of coverage. For Directors' & Officers' liability, Gallagher experts have observed flat renewals, as well as rate decreases occassionally proportionate to the size of increases seen in prior year renewals. The effects of the banking crisis remain to be seen as the marketplace continues to digest the fallout. Moderate tightening should be expected on employment practices liability and fiduciary coverages.

Lastly, even cyber insurance increases have begun to moderate on the heels of the improved cyber hygiene practices mandated by carriers.

UNDERSTANDING THE FACTS

1 PROPERTY

- Adequacy of declared replacement cost values is still the top priority of underwriters
- Inadequate values will be punished via higher cost, higher deductibles, and/or changes to terms and conditions

2 GENERAL LIABILITY

- Return to stable market conditions
- Exceptions include difficult legal environments and loss affected risks

3 UMBRELLA/EXCESS

- Stability and more capacity expected for best-in-class risks
- Multifamily assets are still very challenged, especially those with losses

4 MANAGEMENT LIABILITY

- D&O—flat renewals and decreases available in the marketplace
- EPL—higher self-insured retentions
- Fiduciary—higher self-insured retentions

5 CYBER

- Moderating market for those who have implemented proper controls and maintained good cyber hygiene

PROPERTY

Real estate insureds preparing for renewal should expect a materially different market than they encountered just one year ago. Insurers willing to offer terms last year may have an entirely different stance this year. Reinsurers upstream in the insurance supply chain are dictating changes that will be experienced by policyholders downstream. Regardless of asset class or geography, all insureds should expect difficult property renewals with increases in both premiums and rates. Insureds should be on the lookout for changes to deductibles or retentions, and altered terms and conditions.

Habitational risks have presented the greatest challenge in the property market, especially older wood frame assets. Many carriers are reducing their appetite and some have exited the market for habitational risk altogether. Gallagher's Great Lakes Region Real Estate Leader, Dan Kilberg expects that these market conditions will continue to deteriorate before they improve. Insureds with habitational assets must focus on proper maintenance of mechanical, electrical, plumbing and roof systems. Forgoing proper maintenance will lead to increased underwriting scrutiny and in some cases a declination to quote.

A CHANGING LANDSCAPE:

- Most insurance programs will require more carriers than they did last year to achieve the same limit capacity. This will come at a higher price.
- Restrictive coverage language like Occurrence Limit of Liability Endorsement (OLLE) and Margin Clauses are becoming far more common. They are no longer reserved for clients with perceived undervaluation.

REGIONAL NUANCES:

Southeast

- For named storm deductibles, we see Tier 1 wind deductibles increasing from 2%–3% up to as high as 5%.
- In South Florida, we are seeing Tier 1 wind deductibles increase from 5% to as high as 10%.
- In Southern Louisiana, we have observed Tier 1 wind deductibles increase from 5% to as high as 10%–15%.

West

- The California Earthquake market has started to harden.
- In December, the California Earthquake Authority (CEA) did not renew a portion of its reinsurance program. The CEA commented that it "continues to face challenges due to exposure growth and inflationary pressures combined with the decline in the amount of risk transfer available to CEA and an increase in the price of the risk transfer still available."[4]

East

- Recently we have observed a few carriers rating risks that fall in Zone X or "Non-Special Flood Hazard Areas" of "moderate-to-low risk" as though they fall in "Special Flood Hazard Areas" or "high-risk areas." This is due to their proximity to a flood source.

South Central

- Named Storm and Wind/Hail percentage deductibles are increasing from 1%-2% to 2%-3% minimums. In North Texas, we are observing 3%-5% minimums along the coast.

CASUALTY

From a national perspective, the casualty market has reached a level of stability for both general liability and umbrella/excess lines of business. Underwriters evaluating real estate insureds will look favorably upon deeper information related to historical loss performance. An ideal submission should include 5-7 years of loss history for general liability and as much as 10 years of loss history on the umbrella. Insureds with proper risk management controls in place will be able to use this depth of information to demonstrate themselves to the market as a superior risk.

For office, industrial flex, and retail assets, we are observing a more stable renewal environment. Renewed capacity within the first $25 million excess layers has offered increased competition. Insureds who have multiple lines of coverage with one carrier would be wise to have an open dialog with underwriters and leverage relationships to seek pricing efficiencies.

Unfortunately, habitational risks are continuing to face the greatest challenges. Rate increases for primary general liability layers persist and capacity is still challenged for umbrella coverage. Additionally, those with poor loss experience and/or in difficult legal environments will face further challenges and may need to seek Nonadmitted options. Any losses that involve serious injury or violent crimes will further limit the available options.

MANAGEMENT LIABILITY

Management liability lines of coverage have emerged on the other side of the bell curve. We observe stable markets with plenty of capacity from existing carriers and newer market entrants interested in real estate risks. Barring changes in exposure and/or loss experience, flat renewals and rate decreases can be expected.

1. **Directors' & Officers' Liability**
   - Gallagher experts have observed flat renewals, as well as rate decreases occasionally proportionate to the size of increases seen in prior year renewals.

2. **Employment Practices Liability**
   - While rate and premium are not experiencing significant upward pressure, real estate insureds should expect to see underwriters pushing for higher self-insured retentions. This is particularly true in coastal geographies with higher costs of living and thus elevated wages. A trend of increasing loss severity is beginning to develop.

3. **Fiduciary Liability**
   - The primary concern for underwriters evaluating exposures related to fiduciary responsibilities is claims related to "excessive fees." As such underwriters are responding by mandating higher self-insured retentions to minimize frequency losses.
   - Premiums remain relatively low even though rate increases are making their way into renewals.

4. **Crime**
   - The marketplace for crime cover is stable. However, it is important to note that the frequency of social engineering fraud remains high. Special attention should be paid to what limit the insurer is providing for these exposures and negotiations related to increased limits may be warranted.

5. **Cyber Liability**
   - In recent memory, underwriters have demanded specific controls to even offer cyber cover. The result has been a reduction in claims and a normalization of the cyber market for those who had implemented these controls.
   - One study from a leading provider of cyber access management control systems found a 61% decline in year-over-year numbers of firms who fell victim to ransomware attacks.[5]

ESG

As we mentioned, the growing importance of corporate Environmental, Social and Governance is something that will be part of the risk landscape for insureds going forward. While corporate ESG strategies are still taking form, the environmental portion of ESG has seemingly been the easiest for firms to grasp.

Gallagher's Lisanne Sison, Managing Director of our ESG practice has said that pressure is mounting for organizations to address environmental risk in three key areas:

1. **Physical Risk**
   - The effects of climate change have resulted in more severe catastrophe losses such as floods, wildfires and drought. Named storms such as Hurricane Ian are bigger, slower, and drop more precipitation.
   - This presents a risk to physical assets and increases the cost of insurance.

2. **Transition Risk**
   - As real estate insureds make efforts to transition to greener materials and operations, this transition comes with its own risks. Some firms may be looking to newer and unproven technologies that are hard for underwriters to get their arms around.

3. **Liability Risk**
   - Investors and regulators alike are taking a stance on ESG disclosures. This presents pressure for management to ensure that their operations align with forward-looking ESG objectives and stated goals.
   - Lawsuits from climate activists for failure to meet stated targets or alleging "greenwashing" may present additional challenges.

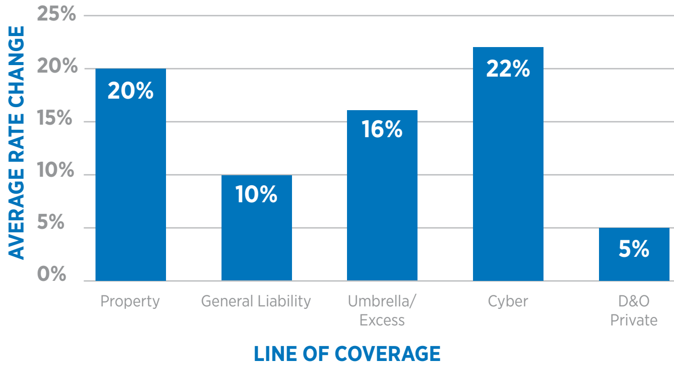
REINSURANCE

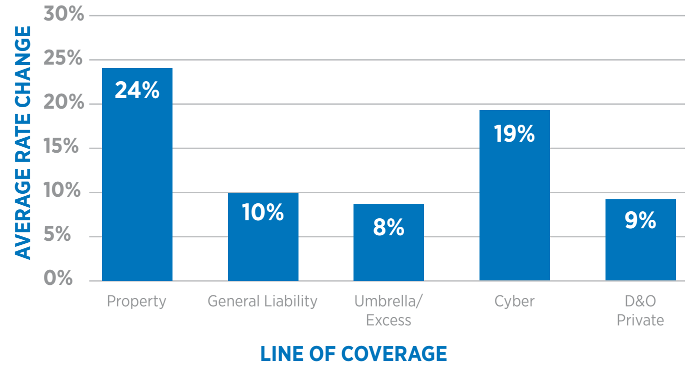
As the ink dries on April 1 reinsurance renewals, real estate insureds should take note. The reinsurance renewal results experienced upstream in the insurance supply chain often signal future market conditions that will be passed down to policyholders. Gallagher Re's James Kent noted that the latest renewals "reflected a continuation of the discipline shown by reinsurers at January 1, but with greater determination that pricing and contract improvements are applied across all territories and to all business lines."

Property reinsurance renewals saw increased premiums and deductibles for primary insurers. Additionally, reinsurers sought to limit their exposure to "secondary perils" which refers to perils other than earthquake and hurricane. Renewal pricing was up across the board and most extreme for catastrophe-exposed accounts with losses.

While renewals for general liability were less strenuous, the impact of nuclear verdicts (judgments awarded in excess of $10 million) continues to strain liability lines. Reinsurers looked particularly hard at prior year loss development and loss trends. Primary insurers will heavily scrutinize insureds with similar adverse characteristics to limit drags on their portfolio of clients. Loss-free accounts saw the potential for flat renewals, although most received moderate single to low double-digit increases.

"Please note that the following rates represent entire regional average rate change metrics for the most recent completed quarter. They do not account for variables such as asset class, loss experience, increases/decreases in exposure base, etc. These should be used as bellwethers for where the marketplace has been and individual renewal expectations should be discussed with your broker."



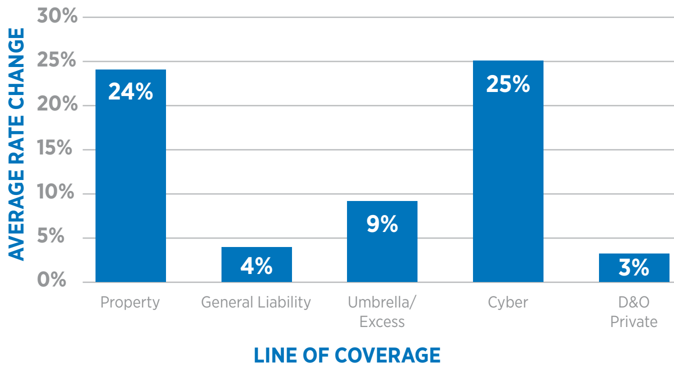


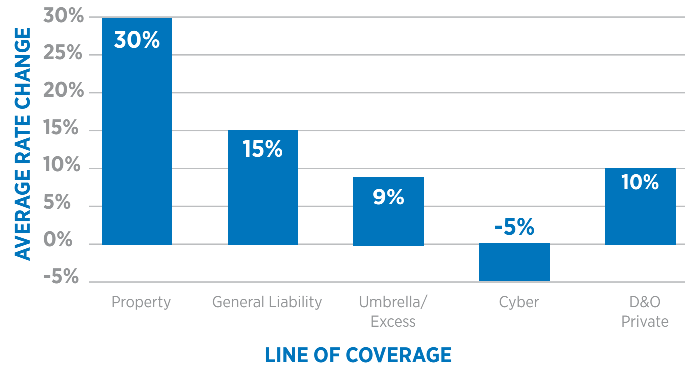
West

Arizona, California, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming

Northeast

Maine, Vermont, New Hampshire, Connecticut, New York, Rhode Island, Massachusetts, New Jersey, Delaware





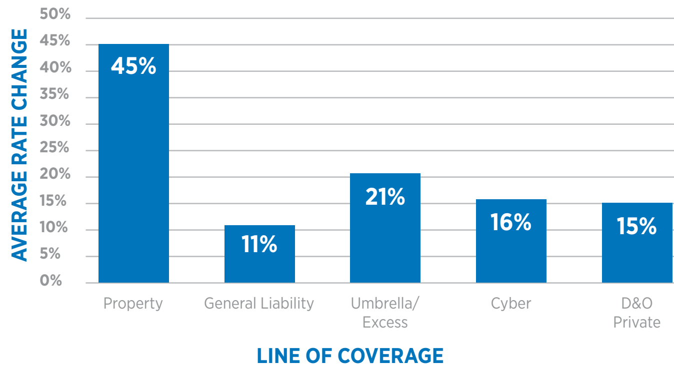
Great Lakes

North Dakota, Minnesota, Wisconsin, Michigan, Indiana, Ohio, Pennsylvania

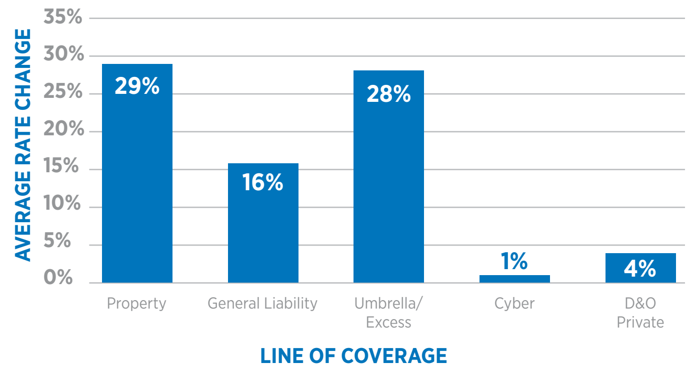
Midwest

South Dakota, Nebraska, Iowa, Illinois

Southeast Region Rate Change Q1 2023



Mid-South Region Rate Change Q1 2023



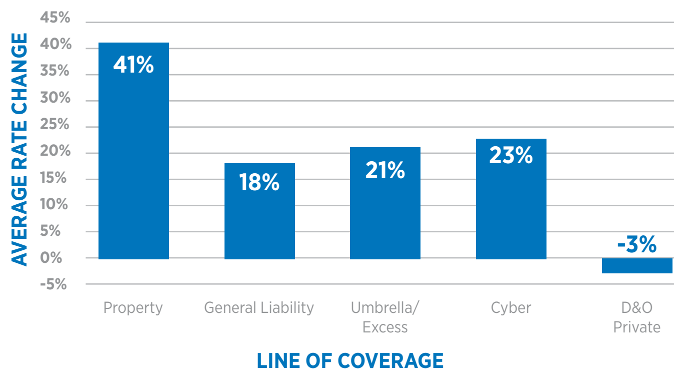
Southeast

North Carolina, South Carolina, Alabama, Georgia, Florida

Mid-South

Maryland, Virginia, West Virginia, Kentucky, Tennessee, Mississippi, Arkansas, Louisiana

South Central Region Rate Change Q1 2023



South Central

Missouri, Kansas, Oklahoma, Colorado, New Mexico, Texas

AJG.com **The Gallagher Way.** Since 1927.

[1] https://www.insurancebusinessmag.com/us/news/professional-liability/meeting-the-increasing-complexity-of-eands-insurance-422608.aspx

[2] https://fred.stlouisfed.org/series/FEDFUNDS

[3] https://www.bls.gov/news.release/cpi.nr0.htm

[4] https://www.theinsurer.com/news/cea-reduces-risk-transfer-cover-to-8-2bn-at-1-1/

[5] https://www.prnewswire.com/news-releases/delinea-2022-state-of-ransomware-report-reveals-that-attacks-are-down-61-from-the-previous-year-and-ransom-payments-are-also-on-the-decline-301717452.html

The information contained herein is intended for discussion purposes only. This publication is not intended to offer legal or governance advice, or client-specific risk management advice. Any description of insurance coverages is not meant to interpret specific coverages that your company may already have in place or that may be generally available. General insurance descriptions contained herein do not include complete Insurance policy definitions, terms, and/or conditions, and should not be relied on for coverage interpretation. Actual insurance policies must always be consulted for full coverage details and analysis.

Insurance brokerage and related services to be provided by Arthur J. Gallagher Risk Management Services, Inc. (License No. 0D69293).

© 2023 Arthur J. Gallagher & Co. | GP44429