2022 U.S. Property Market Outlook

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Over the past few years, insurance companies in the excess and surplus (E&S) commercial property insurance market have been on a self-improvement regime. Companies have remodeled their portfolios by shedding unattractive risks, raising premium rates, lowering coverage limits and adjusting policy terms.

On the surface, this hard work appears to have paid off. Many see the overall commercial property market stabilizing in 2022 but with some challenged pockets, such as southern Louisiana and the Florida condo market.

In recognition of commercial property insurers' improved books of business, A.M. Best revised its outlook from negative to stable for the U.S. commercial property market in late November 2021.

Yet profitability in the E&S commercial property market remains elusive for many companies.

"The E&S property market is complex and dynamic," explained Wes Robinson, National Property president at Risk Placement Services (RPS). "Increased rates, tighter terms and conditions, and greater clarity around COVID-19 should pay off in 2022 for the carriers. However, there seems to be greater uncertainty around catastrophic events, and that leads insurers to be more conservative in their capital deployment."

For 2022, Robinson believes many insureds will see their rates moderate; however, he noted, "There will be plenty of exceptions, especially around catastrophe-exposed risks and/or loss-affected accounts."

"Expect the unexpected" could be the market's mantra.

"We are operating in unprecedented times. Many of the losses that we've seen are ones that we never could have predicted," said Christa Nadler, an executive vice president at RPS. "It's hard to anticipate what the next thing is going to be."

A BUMPY ROAD BACK

In 2022, the commercial property market is still feeling the effects of the COVID-19 pandemic on a number of fronts.

The Omicron variant has made many companies change their plans to bring employees back to the office. Canceled in-person conferences and events will impact hotel occupancy rates, at least in the first quarter and possibly longer.

On a national scale, the civil unrest and riots of 2020 didn't repeat last year, but concerns about those occurrences lingers, in part due to the outsized losses of 2020's events.

According to Verisk, a data analytics company, the average insurance industry loss stemming from a riot or civil unrest occurrence over the past 70 years was approximately $90 million. In contrast, protests triggered by the George Floyd murder trial in 2020 exceeded $2 billion.[1]

Ongoing underwriter concerns about civil unrest and rioting are now reflected in commercial property coverage terms.

For an increasing number of insureds, especially those with property in urban, downtown locations, their policy now excludes damages related to strikes, riots and civil commotions.

And for those who have all-risk commercial property coverage, the policy language around these events has become more restrictive.

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Changes in how an occurrence is defined have been introduced in tandem with the tightening of civil unrest policy language. For example, insurance companies are looking for ways to aggregate multiple events into one, moving beyond the common standard that different losses can be combined into a single occurrence only if they took place within a 72-hour period.

"Insurance companies often find themselves in a situation where they pay claims for damages that they never intended the policy to cover," noted Raul "Rep" Plasencia, executive vice president, RPS. "Once this occurs, endorsements become longer and policy language becomes more specific."

While COVID-19-related claims have had minimal impact on the commercial property insurance market, the pandemic itself has impacted that sector in other ways.

Rising prices for building materials, notably lumber; supply chain issues; and labor shortages have made it more expensive to repair and rebuild properties. This has put additional pressure on the undervaluation issues that already plague the commercial property market. These pandemic pressures will likely persist during the first and second quarters of 2022.

THE CLIMATE-CAT CONNECTION

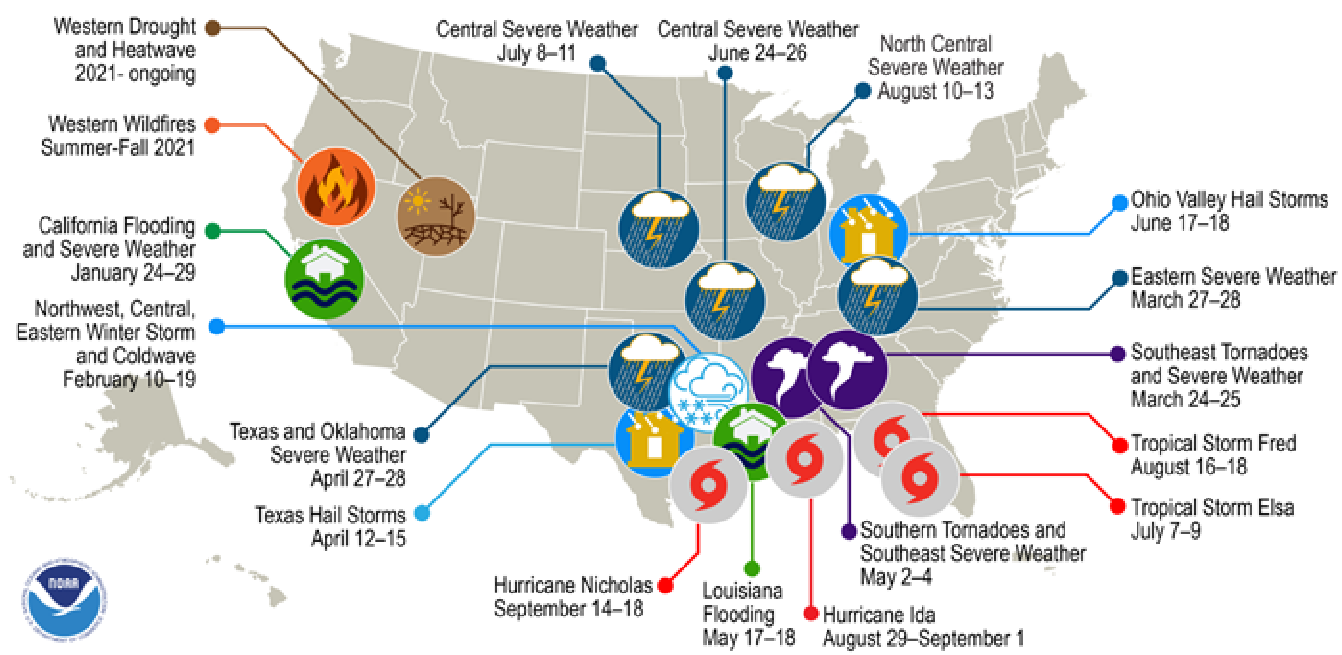
Every year the correlation between rising average temperatures and the frequency and severity of wildfires, tornados and other weather-related events becomes clearer. Weather and climate disasters in the first nine months of 2021 alone generated more than $100 billion in property and infrastructure damage.[2]

"Climate change is now a strategic concern for many reinsurers as well as commercial property owners," observed Robinson.

While 2022 may or may not prove to be more severe than 2021 in terms of catastrophes, insurers' general expectation is that the warming trend, which is driving the frequency and severity of these events, will continue.

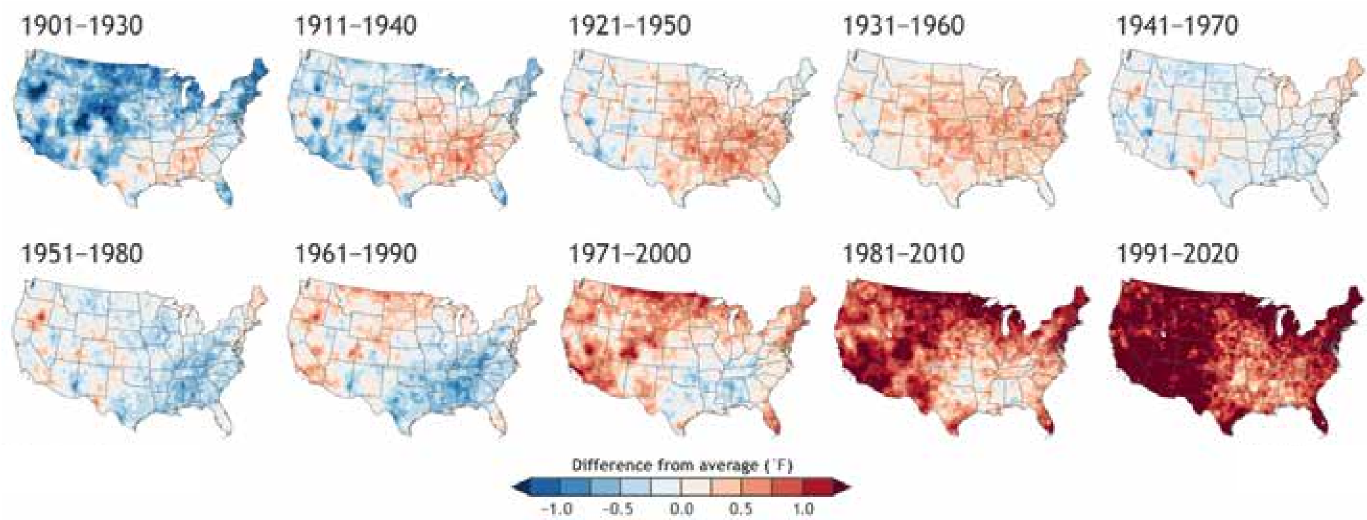
In May 2021, the National Oceanic and Atmospheric Administration (NOAA) released an update of its Climate Normals report, an analysis of U.S. weather patterns over a 30-year period. This latest version is based on 1991–2020 weather patterns. A comparison of the 10 periods in the collection shows how the average U.S. annual temperature is rising.

U.S. 2021 BILLION-DOLLAR WEATHER AND CLIMATE DISASTERS



A map of the United States plotted with 18 weather and climate disasters each costing $1 billion or more that occurred between January and September 30, 2021. Map by NOAA NCEI; Climate.gov.

U.S. ANNUAL TEMPERATURE COMPARED TO 20TH CENTURY AVERAGE



NOAA Climate.com Data: NCEI

WILDFIRES

Those rising temperatures and resulting drought conditions lay the groundwork for wildfires. Since 2000, the U.S. has experienced an annual average of 70,600 wildfires, which burned an average 7 million acres a year.[3]

Another trend that will continue to drive wildfire property damage is the increasing number of people who choose to live and work in high-risk geographies, such as the woodland-urban interface, areas where buildings are adjacent to flammable foliage.

Policyholders with wildfire exposures should anticipate average 2022 rate increases in the 10%–20% (or more) range, as well as material changes in terms and conditions. E&S property capacity will likely contract in wildfire-prone markets in California.

Wildfire activity has also increased in the Pacific Northwest and Colorado. Though the exposure may not be as severe as in California, large property owners and insurance companies that offer coverage in these regions see this as a growing and increasingly unpredictable concern.

"Currently, the underwriting community really doesn't have proven underwriting tools to aid in risk assessment," said Stephen Adair, senior vice president at RPS. "This will push insurance companies to be very conservative, resulting in reduced line sizes and higher pricing."

An insured's willingness to proactively engage in fire prevention does make a difference.

David Novak, area president at RPS, provides an example of a Northern California condo complex that included detailed information about its wildfire mitigation efforts in a renewal submission. This included their participation in the NFPA's Firewise USA® program and the installation of warning sirens, as well as tree maintenance and weed abatement.

"From a selection perspective, most underwriters are trying to pick the risks with the best chance of surviving a loss, and those factors include fire mitigation efforts by an insured," noted Novak.

> **Reinsurers also find it challenging to predict natural catastrophic risks, let alone those that fall outside of traditional parameters.**

COSTLY CATS

Two of the most expensive natural catastrophic events of 2021 both happened in the United States. Hurricane Ida cost $64.5 billion in damage, out of a total of $105 billion in estimated damage for the entire U.S. 2021 hurricane season.[4]

Ida was so costly because of its larger-than-average geographic reach—another climate-related change in catastrophic storms. The hurricane, which made landfall in southern Louisiana in September 2021, then traveled northward, triggering flash flooding in New York, New Jersey and Connecticut.

Louisiana, in particular, has been hit by a series of natural disasters over the last two storm seasons. Prior to Ida, five named storms made landfall in that state in 2020.

"Insurance companies are struggling with how to profitably write business in southern Louisiana," noted Adair. "We are seeing several markets cut back their capacity, increase client retention levels and increase their premiums in order to even provide coverage."

UNMODELED RISKS

Winter Storm Uri was among the five most costly catastrophic events in the world in 2021, with estimated property damage losses of approximately $15 billion.[5] It is also another example of the type of unanticipated catastrophic event that brokers refer to as a shock loss.

"The problem with Uri was that none of the insurance companies had ever priced property in Texas for a significant winter ice storm, let alone a storm that caused the state's power grid to fail," explained Novak. "Insurance companies price for hurricanes in Houston, and tornadoes and hail in Dallas, not for one of the deadliest and costliest winter storms we've ever seen."

The series of tornados that swept through Kentucky and five other states in December 2021 triggered another highly unusual loss event, particularly with regard to its timing.

According to Fitch Ratings, historically December is the least costly month of the year in terms of convective storm damage. Estimated losses from these tornados are at $5 billion.[6]

Reinsurers also find it challenging to predict natural catastrophic risks, let alone those that fall outside of traditional parameters. Analysts at S&P Global Ratings have stated that reinsurers could be underestimating their exposure to natural catastrophe risks by 33%–50%.[7]

THE RIGHT DATA

As underwriters continue to embrace technology, artificial intelligence data, particularly third-party data, is playing a larger role than ever before in evaluating risks and making pricing decisions. Satellite and drone imagery, public records and natural hazard data are just a few of the data sets carriers frequently employ in their underwriting decisions.

The use of artificial intelligence and external data hasn't turned out to be the magic bullet that many believed it would be, as evidenced by many E&S commercial property insurers' struggle to achieve profitability. The more unpredictable losses are, the less useful this data becomes.

"Everyone looks at the various analytic tools with a high degree of skepticism," noted Novak.

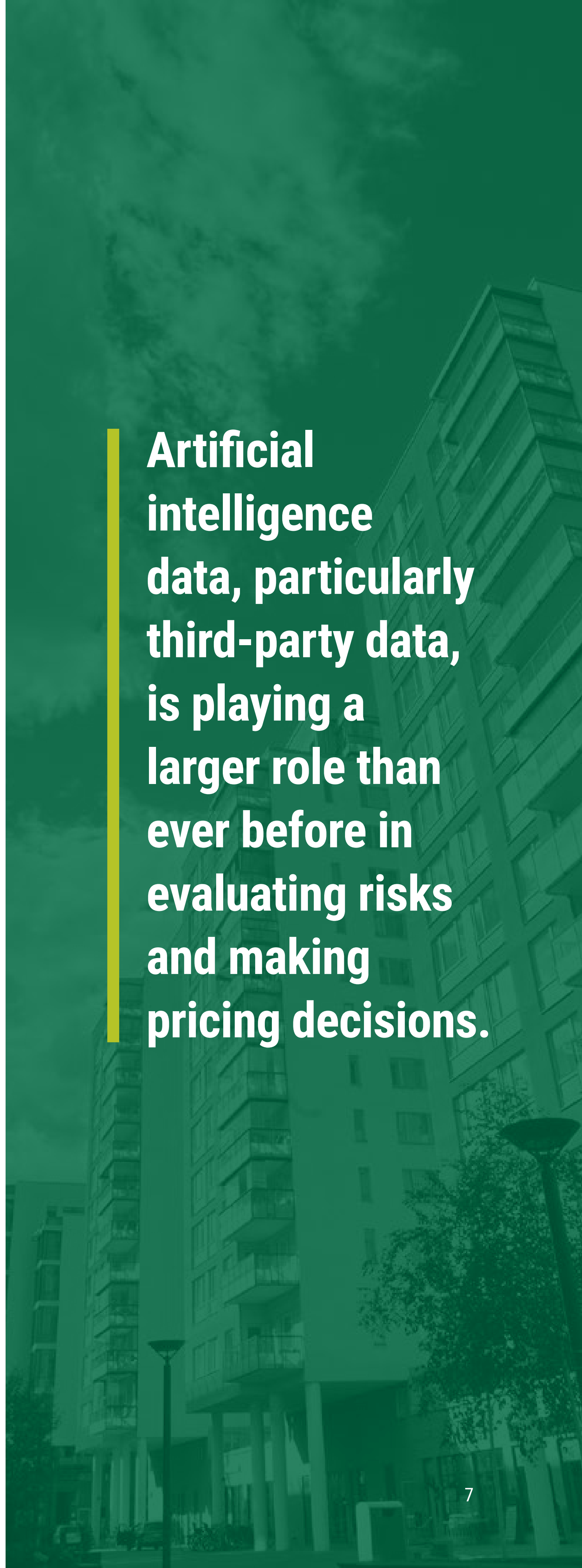
Information that is specific to an insured may prove to be the path to better underwriting decisions. But relevancy is key.

Useful information includes how often a roof is inspected, maintenance protocols and year-over-year capital expenditures on maintenance and loss control.

COVERAGE CHALLENGES

Unless there is a significant shift in behaviors, several adverse trends will likely carry over into 2022.

When carriers lower their limits, insurance programs for larger and/or more complex risks require an increasing number of carriers and more layers of coverage. As claims grow in size, those in the middle, the buffer layers, feel the squeeze.



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"As carriers become more conservative about their limits, program layers are becoming thinner," explained Robinson. "Losses are now going into layers that they've never reached before. And there's not enough premium in those buffer layers to compensate for those losses."

Because of this situation, Robinson forecasts that buffer layers will see greater premium increases than primary layers in 2022.

LATE REPORTING

Late reporting of claims has increased over the past few years. This is particularly an issue when a claim is filed after a policy has been renewed, as the new rates won't truly reflect the insured's loss history.

Late reporting often occurs when there's property damage that the insured has not yet discovered—often roof damage from hail—or does not realize is covered by their commercial property insurance. When they find out down the road that it is a covered loss, they will file a claim.

In another common late-reporting scenario, insureds don't file a claim because they think that the repair costs will be less than their deductible. But then they come to find out the repair is more costly than anticipated and exceeds the deductible.

This frequently occurs when the cost of labor and materials is rising rapidly. This results in a claim being filed weeks or even months after the property damage occurred.

VALUATIONS

For several years, underinsured property has been the scourge of the commercial property insurance market. With inflation running at 7% as of December 2021, its highest level since June 1982, the gap between what a property is insured for and the cost to rebuild it could grow significantly in 2022.

The Champlain Towers South condominium building, a 12-story building in Surfside, Florida, which partially collapsed in June 2021, serves as a cautionary example of what can happen when a structure isn't insured to its current valuation.

The condominium association had purchased a $31.4 million property policy for a building where 136 condo unit values ranged from approximately $400,000 to nearly $3 million.[8]

"The methodology underwriters use to establish replacement cost is decades old," said James Rozzi, area executive vice president, RPS. "For example, the assessment tools have not kept up with rising labor costs. This discrepancy can add up quickly, even during periods of relatively low inflation. They also don't take into account statutory changes that could affect replacement costs when code upgrades are triggered."

With rising commercial property values predicted for 2022, this issue will continue, even if inflation does moderate as many predict. Underwriters will increasingly ask for justification, such as an appraisal, for properties where values have remained static for several years.

RIPPLE EFFECT

While the lawsuits associated with the Champlain Towers South condo collapse will take years to settle, its impact on the Florida insurance market will be felt in 2022.

RPS' Plasencia warns that older condo buildings may find it impossible to purchase property coverage for full insurable limits. And those buildings in Southern Florida that don't pass a county-mandated 40-year recertification process may find that they cannot buy property coverage.

"Will there need to be legislative changes to once again make these properties insurable?" he questioned.

Plasencia believes that the impact of this tragic event will extend to other coverages as well. For example, a structural engineer's decision to work on buildings similar to Champlain Towers South could become a risk factor in underwriting their professional liability coverage in the South Florida market.

REINSURANCE AND RISK TRANSFER

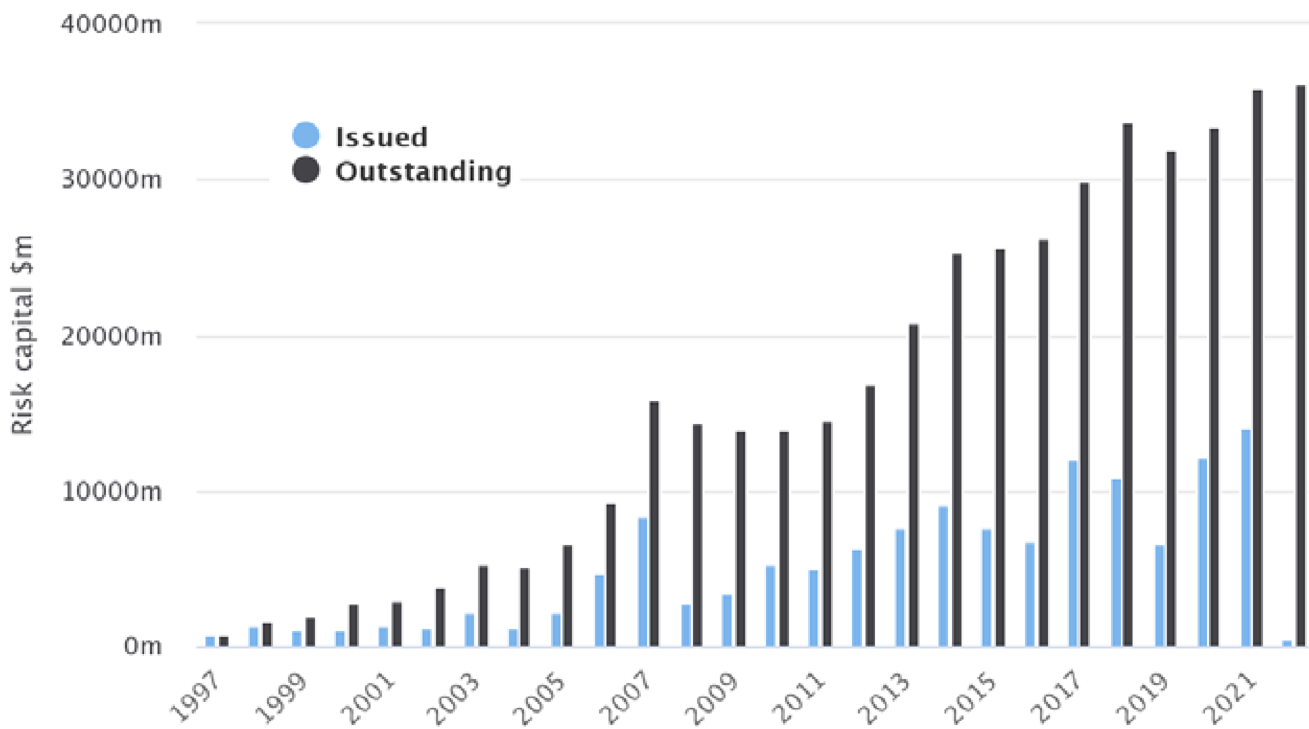
E&S commercial property carriers have another year of increased reinsurance treaty costs to look forward to. Analysts at Fitch Ratings are predicting that property reinsurance rates will rise by as much as 10% in 2022.

Given the losses stemming from natural catastrophes, improved pricing isn't enough of an incentive to keep many reinsurers from cutting capacity. Retrocessional pools being less active in taking on risk from reinsurers is another source of stress impacting E&S property market capacity.

With rising reinsurance rates and shrinking capacity, alternative risk solutions have grown in popularity. In 2016, total insurance-linked securities market (ILS) issuance was $6.8 billion. For 2021, it is estimated to have more than doubled to $14 billion.[9]

Yet, even the ILS market is beginning to feel the impact of higher-than-anticipated catastrophic losses. After several years of underperformance and increasing amounts of trapped capital—funds that are frozen until the final cost of a loss is determined—investors are beginning to move money out of that market in search of better returns. This turn in the ILS market is reducing aggregate retrocession capacity, according to Gallagher Re's January 2022 1st View report.

CATASTROPHE BOND AND ILS RISK CAPITAL ISSUED AND OUTSTANDING BY YEAR



Source: www.Artemis.bm Deal Directory

SEGMENT OVERVIEW

Habitational Real Estate

The commercial residential market has another tough year ahead of it, especially for buildings that are wood-frame construction. The majority of insureds should anticipate premium rate increases in the 15%–20% range with hurricane-exposed properties seeing rate increases that are even higher. Many insurance companies are raising wind and hail percentage deductibles on Midwestern properties.

In many ways, habitational could be a poster child for the commercial property market's undervaluation challenge.

Older buildings, which will need to be rebuilt to higher code standards than those that were in place when the original structure was constructed, often create claims that exceed the policy's replacement cost coverage. RPS' Novak notes that the losses underwriters model for a property are inevitably lower than the actual losses sustained.

The challenge for underwriters is to differentiate the better risks in a poorly operating class.

"Agents that work with habitational property owners need to make sure that they're highlighting in their submissions anything the insured is doing that makes them an above-average risk," advised Novak. "The quality of the information is really key."

Hospitality

Insurance rates in the hospitality sector are determined to a larger extent by the individual property than they are in other segments.

Amenity-filled resorts typically have more complex needs, which require a multilayered insurance program, compared to an extended stay property with less frequent turnover and fewer amenities. Resorts are also more likely to be located in hurricane- and flood-prone locations along the Atlantic and Gulf coasts.

Many hotel and resort owners used the pandemic downtime to refresh and upgrade their properties.

Those that have done so will want to provide their brokers with detailed information about these improvements, as they could have an impact on property valuations. Certain upgrades, such as a newer and more extensive sprinkler system, could also positively influence rate.

In 2022, hospitality may be one of the few pockets of the commercial property market where well-performing accounts may see a rate decrease. The predicted range of 0%–10% rate reduction rates compares favorably with 2021's average 5%–12.5% increase in premium for hospitality accounts that had performed well.

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More favorable rates doesn't mean that this sector isn't without its own challenges. Since Hurricanes Irma and Harvey in 2018, many insurance companies trimmed capacity or even pulled out of the hospitality market and have yet to return.

"Any rate reductions in the hospitality sector will be hard to come by and rare as carriers cut back capacity in the excess layers," stated Rozzi.

Schools and Public Entities

Several factors make schools and public entities an attractive and stable sector for E&S commercial property insurers. Schools and municipal buildings are typically well constructed. These insureds don't acquire new properties in a different geographic region and are not active buyers and sellers of buildings. Valuations are typically more realistic than they are in other market segments.

How well a school system or public entity will do in the E&S property market in 2022 will depend on a number of factors beyond loss history.

These include the insured's location and the reasons why they left the standard market. For example, many schools and public entities have a need for either a manuscripted policy form or custom coverage, which are more available in the E&S market.

While these properties are typically well built, deferred maintenance has become an issue due to lower tax revenues and the impact of COVID-19.

As insureds continue to defer maintenance, insurers become more concerned about a potential loss. Recently admitted carriers have lost their appetite for older buildings in the Northeast. In the Midwest, where convective wind is a concern, a lack of updates to a roof can make a significant difference in property policy terms and costs.

On average, a clean account should anticipate a 5%–15% increase in premiums on renewal in 2022, though some of these accounts could be looking at multiples of that if they are moving from the standard market to the E&S market.

Construction and Builders' Risk

The pandemic-induced combination of labor shortages, supply chain issues and rising material costs hit this sector hard in 2021. The result is that many projects are running behind schedule. As a result, it is increasingly common for a Builders' Risk policy to expire before a project is completed.

With these current market conditions, a good strategy for developers is to purchase a Builders' Risk policy for a longer term than they anticipate needing just to account for these pandemic-related delays.

If not, they may need to purchase an extension policy that costs more than the original one. And in some situations, the original carrier may decline to offer an extension.

A sector trend that should continue will be the repurposing of older structures, often turning an out-of-date office building into a habitational or hospitality property.

"I see lots of submissions for rehabbing and repurposing buildings," observed Rozzi. "In the long run, this is a good thing and results in a structure that is a better-quality risk. However, that rebuilding process is challenging to insure."

It is increasingly common for a Builders' Risk policy to expire before a project is completed.

FRAME CONSTRUCTION SOARS HIGHER

Safety concerns and local building codes have traditionally limited how high a wood-frame building can be built—typically five or six stories high. Now mass timber, an engineered wood product, is making it possible for this type of construction to be used in a building two or three times as high.

Builders and developers are interested in mass timber as a low-carbon alternative to concrete and steel. They also like how it makes buildings more energy-efficient. The material has performed well in fire testing and exceeded the two-hour fire resistance rating.

From an underwriting perspective, the jury is still out on this material and how it will perform in a real-world fire or catastrophic event.

Another concern is how mass timber will affect business interruption claims and the cost of rebuilding a structure. As a relatively new material, mass timber is only manufactured by a limited number of companies in a few locations. Quickly obtaining a large quantity of this material could prove to be a challenge.

The tallest mass timber building in the world is scheduled to be completed in 2022 in Milwaukee. The Ascent will be a 25-story mixed-use building with more than 250 apartments.

Industrial and Processing

This diverse group of commercial properties, which includes plastics manufacturing plants, food processors, foundries, woodworking facilities and recyclers, continues to face challenges.

From 2020 to 2021, this market experienced drastic changes as standard market carriers pruned their books of business. This move pushed more industrial property owners into the E&S market.

For 2022, insurers will be looking harder at their accounts that have been paying below-market rates. Property owners in this situation could still see substantial deductible and premium increases, though some tough classes of business may fly under the radar and retain below-market rates.

On renewals, insurance companies will be paying more attention to an insured's willingness to follow loss-control recommendations, such as updating an older sprinkler system. In a sector hit hard by the COVID-19 pandemic and supply chain issues, the cost of implementing these upgrades may be prohibitive for certain property owners.

Given the challenges of obtaining coverage in this sector, some retail insurance agents are now engaging engineers to do reports on their client's properties in hope of putting them in a better negotiating position.

"When we're equipped with better data and a good story to tell, we can put together a better program for the insured," Nadler explained.

THE ROAD AHEAD

The E&S property market will continue to grow in 2022 for a number of reasons. Standard market insurers should continue to cull accounts to improve their performance, so demand for an E&S product will rise. Additionally, there is still constriction in the E&S property market in certain geographic areas and asset classes, so there will be pressure on rates and terms there.

Often it is a hard business decision that pushes a commercial property owner into the E&S market. Nadler provides an example of an industrial property owner whose current insurance company advised them to change their flammable storage process.

"That's a significant expense," she noted. "It could come down to it being less expensive to pay a higher premium in the E&S market than to address their storage issue. And when the property owner has the time and resources to invest in changing their process, then they may be able to move back to the standard market."

It is a common occurrence for insureds to move in and out of the E&S market. For example, as a result of the December 2021 tornados, many Kentucky commercial property accounts could enter the market in 2022.

As we enter the third year of the pandemic, more and more commercial property owners may be facing these tough business decisions and challenging insurance renewals.

The E&S commercial property market will be ready to assist them in finding solutions.

CONSIDERATIONS FOR AGENTS

As rates continue to rise, retail insurance agents will continue to have more tough conversations with commercial property clients, particularly those insureds who live in the growing number of areas prone to damage from convective storms, hurricanes and wildfires.

Robinson reminds these agents that the E&S commercial property insurance market is vast and can quickly change.

“It is vitally important we start the renewal process early to be prepared for the unexpected with a backup plan,” he advises.

Working with a knowledgeable and experienced wholesaler is also critical in the E&S market.

Commercial property wholesalers have a specialized focus in their coverage line and deep relationships with E&S insurers. This specialization allows them to pull knowledge from their volume of transactions to bring the best product to the table.

“Creativity is always an integral part of a wholesaler’s value,” noted Plasencia.

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ABOUT RISK PLACEMENT SERVICES

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For more information, visit RPSins.com.

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