Anticipating Future Claims Costs:

The Impact of Inflation on Property & Casualty Insurance

BDO

Surging inflation rates are impacting insurers' portfolio values, income and returns as the market grapples with inflation numbers not seen in decades. In September, inflation declined slightly to 8.2%, but core inflation — when subtracting food and energy — rose to a 40-year high of 6.6%. As prices on goods and services have rapidly climbed to new heights, consumers and business leaders await the effects of the Federal Reserve's changes to monetary policy and interest rates.

All industries are impacted by this level of inflation, and the property and casualty (P&C) insurance sector is no exception. Outside of the impact to investment portfolios, inflation also affects insurers' liabilities; for insurers, the impact of inflation can vary by industry sector and risk type.

P&C professionals who monitor key trends can better anticipate risks and potential losses to prepare for what is to come. Inflation is expected to ease further, especially after the Fed has repeatedly increased the target federal funds rate. However, the rate of inflation is unlikely to come down and reach the Fed's 2% goal during 2023. Federal Reserve Bank of Cleveland President **Loretta Mester said in June** it "will take a couple of years" for inflation to reach 2% again. P&C insurance carriers should prepare to weather the inflationary storm for some time still. Fortunately, there are several important steps they can take, particularly by applying data analytics to claims and pricing.

CLAIMS COSTS ON THE RISE

The recent increase in claims costs stems from a confluence of factors. In the P&C sector, one reason relates to advanced automotive technology being more expensive for insurers to cover. Another reason is the uptick in extreme weather events and damages. For example, covering property damage claims was more expensive, in part, due to the spike in prices of building materials.

Supply chain issues related to the pandemic also contribute to inflation. Supply chains have been snarled by labor shortages, lack of materials and delays in distribution, all of which negatively affect economic recovery. These supply chain constraints have led to increases in claim costs related to parts and materials. Supply chain bottlenecks have also caused slowdowns in the claim settlement process. For P&C insurers, bottlenecks on supplies often mean higher costs as they need to provide their customers with rental vehicles, temporary housing and other assistance.

To a certain degree, companies generally use historical inflationary trends when estimating liabilities and pricing policies; however, traditional approaches may not fully capture the true cost when trends spike above recent levels. Insurers may be able to mitigate the impact on income through additional monitoring and more frequent product pricing to account for higher expected expenses and claims costs.

HOW INFLATION AFFECTS LIABILITIES AND PRICING

When inflation rates exceed the provision built into insurers' rates and loss reserves, P&C professionals may find it impacts different lines of business **to varying degrees**. It can be helpful to divide lines of business into the following two categories:

- **Short-tail lines of business,** such as property or personal auto, are sensitive to the immediate impacts of inflation. That is, a personal automobile claim cost is influenced by the current availability of certain vehicle parts as well as the cost of medical care in the event of an accident. The more sudden effect allows insurers to more quickly adjust their approach to estimating the balance sheet and/or pricing.
- **Long-tail lines of business** take longer to register the effects of inflation. For instance, workers' compensation claims might not be settled until years after they are filed. In a high-inflation environment, the additional lag between occurrence and claim closure increases uncertainty around both the liability estimates for claims and, to a greater extent, the appropriate pricing for future policies.

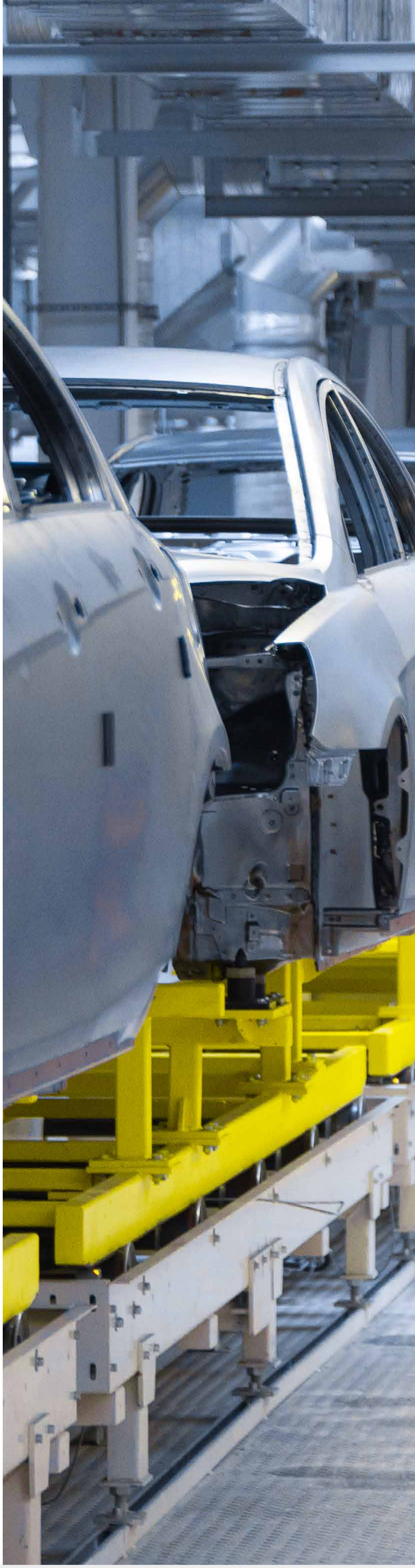
As insurers try to forecast their liabilities appropriately, it will be vital to consider that long timeframes for some payouts, and the difficulty in predicting future claims, may elevate the likelihood of miscalculating current claims. Even as inflation is expected to ease in the future, it can hurt insurance companies' bottom lines, especially on long-tail lines of business where underappreciated inflation may exponentially impact claim costs down the line.

For example, auto insurance tended to be underpriced in 2021 in part because of high physical damage claim costs. Data from S&P Global Market Intelligence shows that while loss ratios for private auto insurers had improved between 2016 and 2020, those loss ratios jumped by 13 percentage points to 67% in 2021.

Insurers may need to reconsider their approach to adequately forecast and factor in inflation during a changing inflationary environment. These practices include the following:

- **From an actuarial perspective,** review of historical data and the imbedded impact of inflation driving changes in claim severity allows insurers to adjust assumptions to reflect current costs. Inflation can then be factored into the methodology in a forward-looking manner for both short- and long-tail lines of business based on expectations about the future rate of inflation and expected losses. Pricing should reflect the risk being written.
- **In terms of pricing,** more frequent rate reviews that incorporate the most recent data may help identify changing patterns, gauge the impact of inflation and adjust pricing accordingly. Data analytics (and monitoring those analytics frequently) can identify emerging patterns and anomalies to signal when pricing adjustments may be necessary.
- **Traditional actuarial methodologies** often implicitly assume historical inflation levels are representative of future inflation rates. Explicit adjustments to various assumptions — including loss development factors — to reflect changes in the current and anticipated prospective inflationary environment can improve the estimates. Predictive analytics may also be used to better forecast future scenarios.

Overall, it is critical for P&C professionals to use technology and refined modeling to better anticipate future claim costs.



HOW INFLATION AFFECTS INVESTMENTS

Preparing investment portfolios for inflationary pressures varies greatly by the assets held in said portfolio and each insurer's risk tolerance. For instance, if a P&C insurer holds onto current assets while the underlying loss liabilities increase, it may experience a discrepancy between its assets and liabilities.

To accurately account for the effects of inflation, insurers should consider which assets need to be reallocated, including:

- Increase liquidity by allocating greater amounts to cash holdings and shorter-maturity securities. This tactic might "mitigate the impact of higher inflationary scenarios **in terms of absolute losses**," but returns would likely diminish once inflation decreases.
- Increase holdings in stocks and real estate for better returns to offset losses from inflation. However, these types of assets bring an inherent volatility to the balance sheet.
- Weigh risk tolerance for equity exposures against non-Treasury Inflation-Protected Securities fixed income assets. Over time, equity assets typically perform better in a high-inflation environment because the pricing can be modified to account for higher rates.

WHAT IS NEXT FOR P&C INSURERS?

The effects of inflation will continue, increasing the uncertainty throughout the industry, but P&C insurers can mitigate risks if they have a deep understanding of their data. They should focus on digital maturity and analytics and not rely solely on past assumptions that may be rendered unreliable by a historic rise in inflation.

- Companies that prioritize investments in data analytics are well positioned to adapt. For example, machine learning technology can help carriers engage in scenario modeling to better predict liabilities and accurately price claims. Leveraging predictive analytics can provide **several benefits**, including reducing underwriting expenses, identifying risks and opportunities earlier and enhancing overall profitability. CFOs should also monitor analytics closely and incorporate consumer data to gain insights regarding profitability, reserves and any necessary adjustments.

Insurers looking to **optimize their analytics** or undergo wider digital transformation should consider working with an external advisor. An experienced third-party consultant can help determine where to start, bring sector specialists to the table and provide the necessary technology to harness data and extract insights. **BDO's knowledgeable professionals** are available to help P&C insurers navigate next steps amid current market volatility.

HAVE QUESTIONS OR WANT TO LEARN MORE? **CONTACT US!**

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