The Insurance Market Cycle:

Hard Versus Soft Markets

Provided by Associates Insurance Agency

The commercial insurance market is cyclical in nature, fluctuating between hard and soft markets. These cycles affect coverage availability, terms and pricing for businesses. As such, it's helpful for policyholders to know what to expect in both a hard and soft insurance market.

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A **soft market**, sometimes called a buyer's market, is characterized by stable or even lowering premiums, broader terms of coverage, increased capacity, higher available limits of liability, easier access to excess layers of coverage and greater competition among insurance carriers for new business. On the other hand, a **hard market**, sometimes called a seller's market, is characterized by increased premium expenses for insureds, stricter underwriting criteria, reduced capacity, restricted terms of coverage and less competition among insurance carriers for new business. During a hard market, some policyholders may receive nonrenewal notices from their insurance carriers. What's more, hard market cycles may prompt carriers to stop writing business in high-risk locations or even exit certain unprofitable lines of insurance altogether.

A wide range of factors can affect insurance pricing, but the following are some of the top contributors to hard markets:

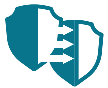
Catastrophic (CAT) losses — Floods, hurricanes, wildfires and other natural disasters, also called CAT losses, have become increasingly common and devastating. Years of large-scale disasters like these can compound losses for insurance carriers and drive up the cost of coverage overall, especially when it comes to commercial property policies.

Inconsistent underwriting profits — Underwriting profits refer to the difference between the premiums an insurance carrier collects and the money paid out in claims and expenses. When a carrier collects more in premiums than it pays out in claims and expenses, it will earn an underwriting profit. Conversely, a carrier that pays more in claims and expenses than it collects in premiums will sustain an underwriting loss. The carrier's combined ratio after dividends is a measure of underwriting profitability. This ratio reflects the percentage of each premium dollar a carrier puts toward spending on claims and expenses. A combined ratio above 100 indicates an underwriting loss. If carriers repeatedly experience combined ratios above 100, they will likely increase insureds' premiums to help combat their underwriting losses.

Mixed investment returns — Insurance carriers also generate income through investments. Carriers operating in the commercial insurance sector typically invest in various stocks, bonds, mortgages and real estate investments. Due to certain regulations, most carriers invest significantly in bonds. These investments provide stability against underwriting results, which can vary from year to year. When interest rates are high and returns from other investments are solid, carriers can make up underwriting losses through their investment income. However, when interest rates are low, carriers must pay close attention to their underwriting standards and other investment returns.

Economic concerns — The economy as a whole also affects an insurance carrier's ability to write new business. Amid periods of economic downturn or uncertainty, some policyholders — although it's not recommended — may purchase less coverage or forgo insurance completely in an effort to cut costs. Additionally, a business's revenue and payroll, which factor into how its premiums are set, may decline. This creates an environment where there is less premium income for carriers, motivating them to increase insureds' coverage expenses going forward.

Inflation issues — Rising inflation can make it challenging for insurance carriers to maintain coverage pricing and subsequently keep pace with more volatile loss trends. Unanticipated increases in loss expenses can result in higher incurred loss ratios for carriers, particularly as inflation affects key cost-driving factors (e.g., medical care, litigation and construction expenses).



Reinsurance challenges — Reinsurance provides coverage for insurance carriers, also known as primary insurers. With reinsurance, primary insurers can secure financial protection for risks they can't or don't wish to retain fully, thus offering a way to protect against extraordinary losses. As a result, reinsurance helps stabilize premiums for regular businesses by making it less risky for primary insurers to provide coverage. Nevertheless, reinsurers are exposed to many of the same events and trends affecting primary insurers and have to make pricing adjustments of their own. For instance, compounded CAT losses could cause reinsurers to limit capacity and increase primary insurers' premiums, ultimately creating a trickle-down effect for regular businesses.

In addition to the aforementioned contributors, here are other key factors that may influence a business's coverage costs:

The type of policy being purchased — The forms of insurance a business is seeking, as well as the details of such coverage (e.g., limits of liability and value of the insured property), will affect its insurance pricing.

The size of the business — As a general rule, the more employees a business has and the larger its revenue is, the more it will pay for insurance.

The industry of operation — Certain industries carry more risk than others. As a result, businesses operating in high-risk sectors are more likely to file insurance claims. With this in mind, a business involved in a risky industry will, on average, pay more in premiums.

The location of the business — The location of a business will also influence its coverage expenses. For example, if a business operates in an area prone to certain natural disasters, insurance carriers may determine that its facility is more at risk for property damage. This increased risk will translate to higher commercial property insurance premiums.

The business's claims history — A business's claims history, often referred to as loss history, will also impact insurance pricing. If a business has an extensive claims history, then insurance carriers will tend to consider the company more likely to file future claims. In turn, this means that the business will be deemed risky to insure, subjecting it to higher premiums.

The business's risk management practices — Now more than ever, a business that conducts a careful assessment of its unique exposures and establishes effective, well-documented risk management practices can appear more attractive to insurance carriers. After all, having a robust risk management program in place reduces the likelihood of costly claims occurring and minimizes the potential losses a business could experience from an unexpected event.

Overall, during a hard market, policyholders may face complex considerations regarding their coverage. Thankfully, businesses are not without recourse; those that proactively address their commercial exposures will be better prepared for a hardening market than those that don't. Additionally, policyholders who educate themselves on the trends influencing their insurance pricing will better understand how to manage their associated costs. Contact us today for further coverage guidance and risk management solutions.

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