STATE OF THE MARKET

Q3 | 2018

Hurricane season is in full swing, with Michael making landfall as a Category 4 storm. And yet, insurance markets — to date — have remained relatively stable. At AmWINS, our mission is to provide specialized insight that enables retail brokers and their clients to successfully navigate the current dynamic environment. In our Q3 State of the Market, our experts address the latest issues in the property and casualty space and the impact they may have on your business.

ON YOUR TEAM.

AmWINS Group, Inc.

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PROPERTY

The 2018 hurricane season may be enough to sustain the current property market—and single digit rate increases—*for another 6-9 months.*

For retail agents and brokers who value stability and consistency, the property marketplace offers plenty to be appreciative of through the third quarter of 2018.

"The state of the property market is much the same as we reported three months ago," says Harry Tucker, National Property Practice Leader for AmWINS.

"Capacity is stable and abundant, and likely to remain so in the near term," Tucker says.

Thus far this year, brokers are experiencing a competitive marketplace and flat to modest decreases for highly desirable, clean, non-CAT exposed accounts. Tougher classes, with losses and/or CAT-driven business rates, are up—in some instances, significantly.

With Hurricane Florence peaking as a Category 4 headed for the Carolinas several weeks ago, the industry was preparing for the worst, but ultimately, dodged a bullet. Hitting the southeastern coast as a Category 1 and primarily a rain event, Florence left a trail of flooding and disrupted lives, many of which were uninsured.

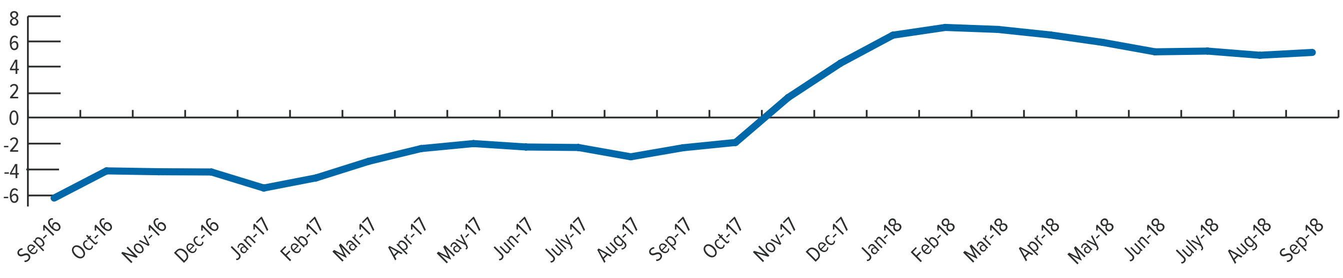
While 2018 began with a modest boost in rate resulting from unknowns surrounding HIM, and several "micro hard markets" (such as frame habitational, dealer open lot, wood working, scrap dealers, and classes with ongoing attritional losses) experienced rate increases due to limited capacity, these examples are limited. In general, rates remain stable and capacity plentiful. "Overall, averaged out across our book, rates are up mid to high single digits, as we predicted," says Tucker. "Absent any significant events between now and the end of the year, we expect this may even come down slightly."

In builder's risk, rates in desirable, non-frame classes remain low, driven both by strong overall capacity and standard-market pressure. Frame builder's risk rates are still up from the previous year and have not yet begun to significantly decline. Critical CAT pricing remains stable, and earthquake capacity remains at an all-time high, serving to keep pricing low by historical standards.

Through Q3, we expected property conditions to remain relatively unchanged for the remainder of 2018; however, as a result of losses from Hurricane Michael, we now expect the declining trend in average rate increases to slow or stop altogether.

RENEWAL PRICING TRENDS—PROPERTY RENEWALS, ROLLING QUARTERLY

Source: AmWINS property lines account data



Hurricane Michael was making landfall as we were completing the Q3 state of the market. We will publish another property update in Q4 as the impact of Hurricane Michael becomes more clear.

CASUALTY

Habitational risks and automobile liability remain extremely challenging, while brokers can *readily place coverage for products liability.*

REAL ESTATE

Although brokers will have no problems finding competitive markets for traditionally favorable lessor's risk exposures, habitational business is an entirely different story. Markets continue to pull back or even exit the space on the primary side.

"On apartment risks, we continue to see deteriorating results year over year," says Corey Alison, Executive Vice President at AmWINS Brokerage of Georgia. "We now see more accounts where it is no longer about rate, but instead about how much premium the carrier needs to fund for losses."

As claims continue to trend upward, renewal rates are doing the same. Minimum premiums and retentions have also increased. It's not uncommon for minimum premiums and/or retentions to be twice what could be found just a few years ago from some markets.

Excess coverage is also proving problematic for apartments. "We are seeing a number of excess markets exiting and MGAs losing their paper due to deteriorating losses," Alison says. "There is definitely shrinking capacity in the lead $5 million layer."

Within this national trend are additional regional challenges. In the southeast, particularly Georgia and Florida, apartment business is finding placement challenges due to the growing frequency and severity of assault claims. "In many situations, no matter how much security a property provides, they still cannot completely remove the assault and battery exposure," Alison says.

In northeast states, slip and fall claims—combined with skyrocketing medical costs—have served to harden the habitational market. In New York, specifically, the need for lead coverage is an ongoing challenge for properties built prior to 1979. "There are a few E&S markets that will include coverage for lead on the liability form, but most carriers will exclude. You have to obtain a separate pollution policy, which turns the coverage from occurrence to claims made," Alison says. "Local Law 11 (on-going façade work on NYC buildings) also creates challenges in making sure the carrier is offering the proper protection for this repair work exposure."

CONSTRUCTION

In Florida, markets that had been active in new residential construction (non project-specific), whether for artisan or general contractors, are moving to exit the class or restrict coverage. This is especially the case for new condo construction and tract work. The particular concern is the increased number of construction defect claims. In addition to restricting the type of work, most insurers are applying "continuous or progressive" damage exclusions. "Markets want to protect themselves from being liable on multiple policies for the same loss," says Alison. MGAs are now stepping in to try and pick up business that the traditional E&S markets are moving away from now.

On project-specific work, more clients are opting for the Wrap route vs. Owners Interest or GC Project-Specific only. The Owner-Controlled Insurance Program (OCIP)/ Contractor-Controlled Insurance Program (CCIP) marketplace remains competitive, with no lack of interest from carriers for both primary liability and excess.

However, condo conversion coverage and lead excess on residential remain challenging. In particular, the first $5m of excess on condo remains a tough placement in high-risk construction defect states such as Florida, California, Arizona and Nevada. The ability to provide condo conversion coverage varies from carrier to carrier, depending on the state the work is in, the type of construction (frame vs. commercial grade) and the construction value. If a carrier offers the coverage, they will typically charge the additional rate up front instead of providing the option to buy the coverage midterm. Developers are working around this issue by placing a clause in their sales contract that stipulates that the building cannot be converted. Alternatively, a condo conversion form that states there is coverage as long as the insured has nothing to do with the conversion may be included with the policy. In such a case, if the property is sold and the new owner converts the property, the insured is still protected.

Another area that can create issues on projects is the use of exterior insulation and finish systems (EIFS). While the problems that many experienced with EIFS in the 1990's have been minimized by the advancement of both the

CONSTRUCTION *(continued)*

products themselves and the way in which they are applied, there are still some carriers that cannot cover any application of EIFS. While other carriers do offer coverage, the cost varies depending on a variety of factors, including whether the construction is over frame or commercial grade and what percentage of the job consists of EIFS. Carriers will also want to know the actual product and installer being used.

Overall, although the construction industry has its challenges, there is still an abundance of appetite from carriers to cover even the most challenging job. But, is the door open for primary carriers to increase attachment points, introduce more restrictive terms for specific risks or reduce limits? Time will tell.

AUTOMOBILE LIABILITY

In automobile liability, particularly in the transportation sector, buyers continue to be challenged by increasing insurance rates, government regulation, and a worsening driver shortage.

"This is probably the hardest market we've seen for transportation in primary markets. The term 'decrease upon renewal' is no longer in the market's vocabulary," says Chris Loggie, Senior Vice President at AmWINS Brokerage of the Midwest. "Along with the driver shortage, there is also an underwriter shortage. Every submission and every account is being heavily shopped, and underwriters are finding it difficult to keep up."

Some areas are particularly hard hit. New Jersey, New York, and California have consistently been a challenge, with markets either pulling out or increasing rates to punitive levels to effectively withdraw. However, because of broad access to E&S markets, transportation has been a significant growth sector for AmWINS.

"Capacity is at an all-time low, which is why retail agents and brokers need to partner with wholesalers who not only have access to markets, but who can work with those markets in difficult territories and come up with creative solutions," Loggie says.

In the fourth quarter of 2018, AmWINS will be introducing an innovative program designed for transportation accounts with up to 24 power units. Available in all states, the program will offer automobile liability, cargo, physical damage, and general liability lines.

"It's not often you have something new coming into the market, but that's a strength we can bring to retail agents," says Sandy Reddy, Senior Vice President with AmWINS Transportation Underwriters.

With the combined ratio for automobile liability expected to run over 110 again in 2018, the hard market shows no signs of subsiding. "There is not much capacity in the space, and rates will continue to rise," Loggie says.

PRODUCTS LIABILITY

In contrast to the tight underwriting appetite for habitational risks and auto liability, underwriters can't seem to get enough products liability business.

"Every carrier we deal with wants to write more products liability," says Tom Dillon, National Casualty Practice Leader for AmWINS.

With standard markets fighting for business in this sector, E&S markets are left looking at accounts with poor loss history, as well as a few traditionally difficult classes, including pharmaceuticals and invasive medical products, imported goods, and tobacco products.

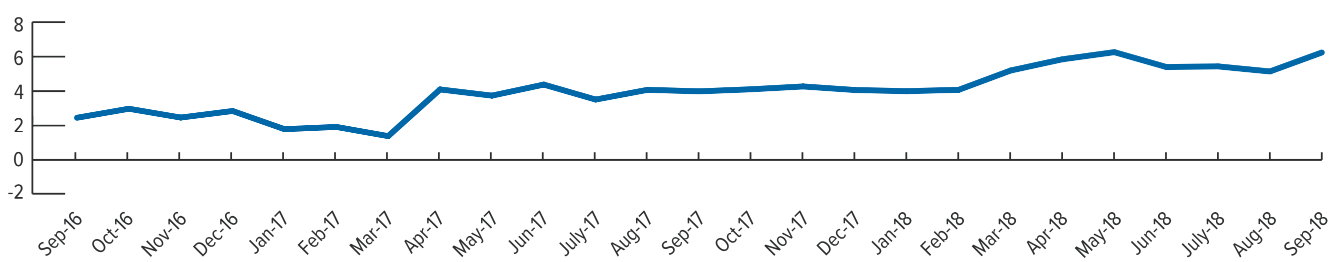
Standard-lines markets are even willing to take on product liability for startup ventures. Although this is generally good news for retail agents, it does come with a risk.

"New ventures have an expectation of revenue on which policies are priced. If they don't get the revenue they expect, which happens often, brokers can find themselves midway through a policy term trying to renegotiate premiums," Alison says.

As 2018 winds down, casualty conditions continue to vary widely. While the market for lessor's risk exposures remains competitive, carrier withdrawal and claim severity in the habitational business space has contributed to a slight hardening, particularly in the Northeast. In construction, however, abundant capacity still exists, as MGAs compete for new residential construction business that traditional E&S carriers are moving away from. In automobile liability, capacity has reached a historic low, creating a hard market that shows no sign of abating. Conversely, carriers are eager to write more products liability business, resulting in an extremely competitive market.

RENEWAL PRICING TRENDS—CASUALTY RENEWALS, ROLLING QUARTERLY

Source: AmWINS casualty lines account data



PROFESSIONAL LINES

On balance, the professional lines market is characterized by ***consistency,*** while cyber insurance has become a ***buyer's market.***

In professional liability, while some conditions have changed—and some expected developments have not turned out as forecast—the segment as a whole is characterized by a remarkable consistency. The market remains soft overall, particularly in miscellaneous lines, while public D&O and parts of the health care market remain challenging.

“In public D&O, rates are rising, particularly on primary liability where insurers have become more cautious. Carriers are also particularly concerned with IPOs and M&A,” says David Lewison, National Professional Lines Practice Leader for AmWINS.

Underscoring insurers’ concerns with public D&O is claim severity, driven by regulatory enforcement and increased costs of claim defense. Underlying problems with public companies can remain hidden while the stock market is strong, as plaintiffs have less to complain about when stock prices rise. However, when the SEC comes in to investigate, the plaintiffs can follow right along.

“We had hoped to see, through the current administration’s focus on deregulation, less of a regulatory concern, but the SEC still has plenty of claims to investigate. And if the SEC is involved, claims costs skyrocket,” Lewison says. “Companies under investigation want to defend themselves using the best law firms, and those rates have escalated quickly and continue to climb.”

Although the market overall continues to be soft, one area where buyers are not finding pricing quite as low as in past years is in bottom excess layers, where rates have flattened out. “Insurers have become better and better at modeling to understand where claims costs are,” says Lewison. “As a result, whereas lower excess layers used to be priced as low as 50 percent of primary, now the rates can be closer to 70 or even 80 percent of the primary price.”

Diving deeper into the market, brokers will face some challenges placing certain classes of business. Debt collection services have been a problem in E&O due to the frequency of Federal Debt Collection Practices Act (FDCPA) and Telephone Consumer Protection Act (TCPA) claims. Medical professional liability for correctional facilities has also seen significant market constriction.

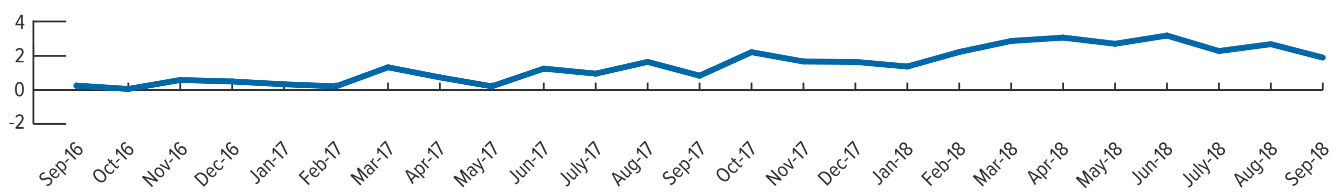
“There are now fewer than five insurers that will write medical professional for correctional or prison accounts, and when they do, it’s on their terms and pricing,” Lewison says.

One area of market firming that was expected but did not come to pass is employment practices liability insurance (EPLI).

“At the start of this year, we had expected to see some firming in the market due to concerns over claims arising from the ‘Me Too’ Movement, but a dramatic change hasn’t happened,” Lewison says. “Underwriters have seen more new business submission activity around EPLI, but it appears they’ve priced business appropriately for the expected level of claim activity.” It’s possible that companies and insurers are working together to settle the bad claims faster to avoid bad press, as well. Industries that have high-wage earners are being treated cautiously by carriers, as higher retentions are commonplace in those industries.

RENEWAL PRICING TRENDS—PROFESSIONAL LINES RENEWALS, ROLLING QUARTERLY

Source: AmWINS professionl lines account data



CYBER LINES

Interest in cyber insurance continues to grow, driven by news of cyber crimes, ransomware, and breaches, and cyber buyers are finding a growing number of markets willing to serve them.

“We have over 100 cyber markets now, which is definitely creating a buyers’ market,” Lewison says. In many cases, renewal decreases can be achieved.

The competitive market, while generating more activity for brokers, also creates additional complexity. Coverage enhancements are very commonplace. Not all carriers, however, are alike and willing to offer the same enhancements. “Brokers need to spend more time differentiating among carriers’ products that are not standardized. This is definitely a case where partnering with a wholesaler who has deep expertise in the cyber market can help,” says Lewison.

The market is also seeing a new breed of cyber insurer that focuses heavily on risk management and prevention, rather than simply breach response. “We’ve seen several newer MGAs that are offering very robust tools for clients to help them detect and prevent threats, whether it’s attempts at network intrusion, software updates that need to be made, or other weaknesses that make a business susceptible to being exploited,” Lewison says. “Insurers are offering even lower rates because they believe the tools they offer in risk management will have an impact on claims costs.”

Carriers also continue to broaden both coverage language and underwriting appetite. Business income and contingent business income is becoming more common as part of underlying cyber forms, rather than by endorsement or enhancement. However, brokers may also find that non-cyber markets that were including coverage as a throw-in to property policies are less willing to do so after having suffered losses for which no discrete premium was collected.

Additionally, cyber is making inroads into the personal lines market. “Identity theft coverage has been offered by some personal lines carriers for a while. Now we are seeing bona fide cyber coverage—assistance with ransomware, cyber extortion, cybercrime, and personal data exposure—offered in response to a growing need, as well as an increasing number of ‘smart’ home devices that are at risk of cyber breach.”

Although personal lines cyber products have primarily been targeted to the high net worth segment of the market, interest is expected to increase across personal lines, just as it has expanded in the commercial sector.

No drastic changes are expected in the professional market in the months ahead, although continued product development and evolution in underwriting make it important that brokers are knowledgeable about current conditions. Doing business with a wholesaler that devotes the time and resources to understanding the spectrum of the professional lines and cyber marketplace is essential.

"An experienced wholesaler brings specialization that the retailer can, in turn, bring to the client,” Lewison says. “That adds value to the broker-buyer relationship.”

SMALL ACCOUNTS

Succeeding in the highly competitive small accounts marketplace requires *high efficiency and strong market access.*

Wildfires, mudslides, hailstorms, and more: all factors that would normally add up to trouble in the small premium, small accounts marketplace. However, competition in this market, including personal lines and small commercial lines, continues to be fierce, driven by the continued influx of new capital into the space.

"Despite Mother Nature's wrath, there has been very little loss of enthusiasm for writing small accounts, and that's reflected in continued depression of rates. It's simply a very active, highly competitive landscape," says Tony Gresham, President of AmWINS Access.

Capital continues to enter the market from two key areas: traditional P&C carriers who may not have been participants in small accounts but view it as an effective way to deploy capital, and new entrants from outside the P&C sector. All parties are looking to leverage better risk modeling and portfolio underwriting as a way to create predictable returns.

"With portfolio underwriting, there is limited risk of a single account or small number of accounts causing volatile returns," says David Lavins, Chief Operating Officer of AmWINS Access. "Meanwhile, improvements in catastrophe modeling have enabled P&C risks to be much more quantifiable. Those factors have really turned small commercial accounts and personal lines into an asset class, which it was not before."

"The attraction is that the small account market now offers a relatively predictable rate of return on a scaled book of business," says Gresham. "Recent developments in technology enable markets to deploy significant amounts of capital in a highly efficient and low-cost manner, yielding relatively predictable returns and less volatility than in the large P&C market."

The continued flow of capacity has ensured that rates on small accounts remain highly competitive. While there are some localized exceptions, such as areas impacted by recent storms or wildfires, property rates continue to remain very soft. Similarly, small casualty accounts enjoy a competitive rate environment, with only a few specific classes seeing prescriptive changes in underwriting and rate.

The most sought-after classes in the small business market include lessor's risk only, contractors, restaurants, bars, and taverns. Hotels, motels, and convenience stores will find markets somewhat more limited due to liability concerns, and churches—particularly those with ornate or historic architectural details—tend to meet with greater underwriting reluctance.

This paradigm shift by capital providers will continue to dampen the market impact of adverse events of weather, and with no reason to expect significant changes, retail agents and carriers alike will be best served by working with distribution partners that can provide efficient and thorough access to the market.

"Retailers should work with wholesalers who have broad-based relationships with underwriters and who have the processes and controls in place so that products can be delivered efficiently," Lavins says.

"Despite Mother Nature's wrath, there has been very little loss of enthusiasm for writing small accounts, and that's reflected in continued depression of rates. It's simply a very active, highly competitive landscape," says Tony Gresham, President of AmWINS Access.

FLOOD SPECIAL

Private flood insurance options are *increasingly relevant* for insureds.

As Congress continues to mull substantive reforms to the National Flood Insurance Program (NFIP), on July 31, 2018, it voted to extend the authorization for the NFIP through November 30, 2018, with no changes having been made. Despite critics' efforts to push for major reform to the NFIP, Congress has now passed six short-term extensions and allowed the program to lapse, however briefly, in both 2017 and 2018.

Formed by Congress in 1968, the NFIP had been a self-sustaining entity, with premiums covering the program's losses and administrative costs. That all changed in 2005 with a $16 billion flood loss from Hurricane Katrina. After further losses from Hurricanes Sandy, Harvey and others, the program accumulated over $36.5 billion in debt. In late October 2017, Congress passed a bill to forgive $16 billion of the NFIP's debt.

"Due to an increase in the frequency and magnitude of major flood events and the lack of needed reform to the NFIP, taxpayers will continue to pay the losses through federal aid programs," says Zak Hooker, Flood Underwriter at AmWINS Group in Charlotte, North Carolina.

In an attempt to manage losses, the Federal Emergency Management Agency (FEMA), the entity that administers the NFIP, has made significant changes to the program in recent years. In 2016, the program began eliminating or reducing rate subsidies and implementing a 25 percent annual rate increase until "full-risk rates" are achieved for all pre-FIRM (Flood Insurance Rate Map) subsidized policies. These changes affected non-primary residential properties, properties with severe repetitive loss, and those that were substantially damaged or improved.

In 2017, FEMA announced additional rate increases. For pre-FIRM subsidized policies, rates are increasing 5 percent on average for primary residences to over 20 percent on average for commercial properties and non-primary residences, with an expected overall average rate increase of 6.3 percent.

However, these premium increases are unlikely to dig NFIP out of its hole. "With its current debt load, it's hard to imagine the NFIP being able to pay that off through premium increases, certainly not in the foreseeable future. The question is what other changes to the program might have to be made as a result," says Missy Klor, Vice President at AmWINS Access in Morehead City, North Carolina.

A study released in April 2017 by the U.S. Government Accountability Office (GAO) found that "reducing federal exposure and improving resilience to flooding will require comprehensive reform of the NFIP."

Recent flood events have created a heightened level of awareness of flood insurance coverage, but the uncertainty of the public flood marketplace has contributed to the decline in the NFIP in recent years. The NFIP peaked at 5.7 million policies-in-force in 2009, with roughly 5 million NFIP policies-in-force today. The private market for flood insurance has developed rapidly to fill the void.

"Due to an increase in the frequency and magnitude of major flood events and the lack of needed reform to the NFIP, taxpayers will continue to pay the losses through federal aid programs," says Zak Hooker, Flood Underwriter at AmWINS Group in Charlotte, North Carolina.

"As lenders become increasingly aware of the acceptance of private flood for federally backed mortgages, growth in the private market will continue to be on the rise," says Hooker. According to 2017 statutory insurance filings compiled by S&P Global Market Intelligence, there was $624 million of private flood insurance written in 2017, up from $413 million in 2016—a 51% increase.

Although flood is a difficult peril to underwrite, increasing sophistication in the private market – arguably more sophisticated mapping than FEMA utilizes – means that carriers can offer attractive pricing on desirable risks. To help retailers place coverage in the private market, AmWINS rolled out in-house private flood products, complementing the existing ability to offer NFIP coverage.

"AmWINS provides retailers options for flood coverage, which is a valuable tool to have in their arsenal in this volatile marketplace," Klor says.

PROGRAM BUSINESS UPDATE

Specialization is the key to success in the booming Program Business market.

The competitive conditions seen in program business are showing no signs of abating and are driven by record levels of capacity. “There is simply a lot of carrier capacity that has entered the program space over the course of the past several years. The program sector is not only growing, it is one of the fastest growing sectors of the market,” says Ben Francavilla, President of AmWINS Program Underwriters.

In 2017, the growth of program markets in the U.S. outpaced the growth of the rest of the property-casualty market, according to Conning & Company. Francavilla also points to the Target Market Program Administrators Association’s (TMPAA) October summit as further evidence of this trend.

“Sixteen years ago, there were 12 carriers represented at the TMPAA summit. This year, there will be more than 60,” he says.

Capacity in the program sector is coming not just from traditional program carriers and E&S markets, but also from alternative capital, reinsurers, and even standard-lines insurers. “We continue to see an evolution of the market where carriers are looking to programs as a place to grow, especially when other products have become stagnant,” Francavilla says.

There is a great deal of competition across program business. With few exceptions, buyers will find competitive pricing, as well as broad and creative coverages, even in the loss-sensitive classes. However, there are some exceptions, the most notable of which is transportation.

“The transportation sector within the programs marketplace is mirroring the results outside the marketplace, so it is very difficult to try to place a new, standalone auto program. However, we have broad access to markets who will write auto as an ancillary piece within a program,” says Francavilla.

Capacity is likely to keep increasing as carriers look for additional ways to grow written premium. Although this robust market presents opportunities for retail brokers, it should be approached with some caution. Success in program business requires combining a wide range of knowledge about many different classes of business with a high level of specialization, something that underwriters and MGAs new to a line of business may not be able to provide. Retailers should also look for program administrators with proven underwriting skills, a history of profitability, an extensive distribution network, actuarial expertise, and effective supporting technology that can scale with increases in business.

“In the program space, the ability to truly and fully understand risk is essential,” Francavilla says. “We manage over 60 programs in the AmWINS Underwriting division. Our program offerings cover a range of different risks and industry areas, with over three decades of experience, as opposed to just a year or two. That makes a huge difference in this market.”

ABOUT AmWINS

AmWINS Group, Inc. is the largest independent wholesale distributor of specialty insurance products in the United States, dedicated to serving retail insurance agents by providing property and casualty products, specialty group benefit products and administrative services. Based in Charlotte, N.C., the company operates through more than 115 offices globally and handles premium placements in excess of $15.3 billion dollars annually.

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