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HOLBORN™
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ViewPoint

June 22, 2021

*Analyzing Industry Issues from an Independent Perspective*

# INFLATION

## *Are You Asking the Right Questions?*

***The U.S. money supply has increased by roughly one-third since the start of 2020***, sparking legitimate concerns about rising inflation, especially in bond markets. The year-over-year rise in annual money supply hit a new all-time high in January, with the 1970's being the only period in our history that comes close. Growth is expected to continue as the U.S. works itself out of the pandemic-induced economic crisis.

If you knew the answer to where inflation is heading and what impact it will have on your future results:

- How would you best balance your underwriting risk appetite with your investment strategy?
- What impact would inflation expectations have on your pricing?
- How would your investment strategy change?

***Good questions but with uncertain answers.*** We don't know if the inflationary indicators that we are observing right now will continue at a similar pace, accelerate or decline over the second half of 2021 or beyond.

Past experience in the insurance industry reminds us that unexpected rising inflation negatively impacts underwriting income by increasing future claims costs, especially on long-tail casualty business. Additionally, unexpected rising inflation can negatively impact investment returns due to reduced asset values. This mismatch between underwriting risk and investment returns could be further exacerbated by the continuation of social inflation trends, such as litigation financing causing nuclear verdicts, as courts reopen post-COVID.

The US economy is growing again, but that growth comes with the risk of inflation - a risk which requires careful attention. Our industry has recognized the growing impact of social inflation on liability claims and property catastrophe losses for years now. Price inflation, however, is a different kind of phenomenon, measuring the effects on everything and everyone participating in the economy.

### Investments: Reading Between the Lines

Not since the early 1980s has inflation been a daily headline and concern for US households. Much has been written about the inflationary period of the 1970s and the contributing factors that led to such price increases and fiscal miscalculations which exacerbated the problem.

Current spreads representing the difference between 2-year Treasury yields and 10-year Treasury yields are still relatively low by historical standards. This flattening of the curve is indicative of a market that believes that current inflationary measures are transitory (i.e., not anticipating higher borrowing costs in the longer tenures to compensate for elevated inflation). Based on the slope of the yield curve, markets do not appear to be anticipating a lasting surge in inflation.

Investment decisions should be mindful that the market may be underestimating the sustainability of inflationary pressures and the potential for distortive impacts of interventions by the Federal Reserve.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity


***Core consumer prices in the United States, as measured by the CPI, increased 3.8 percent in May of 2021*** over the same month in the previous year, the most significant 12-month increase since June 1992 (*Source: U.S. Bureau of Labor Statistics*). Other inflation-friendly factors requiring consideration include:

- Monetary supply in excess of $20T, roughly one-third higher than at the start of 2020
- Persistent near-zero short-term interest rate environment
- Surging demand for labor
- Supply constraints
- Record levels of fiscal expenditures, including stimulus distributions

There is an ongoing debate about whether the inflation at present is transitory or will persist. Year-over-year comparisons can be misleading due to anomalies in observed data points (i.e. COVID-induced lockdowns from 2020 would qualify as an anomaly), which may support the transitory argument. There are open questions as to whether the Federal Reserve has all of the tools required to successfully combat inflation or, more broadly, if the government would pull inflation fighting levers, such as inducing significant increases in interest rates.

> **"There is an ongoing debate about whether the inflation at present is transitory or will persist.**

### Understanding the Impact to Insurance

We know that many commodities prices, housing costs, and most asset classes have already surged beyond the Federal Reserve inflation target figure of 2%. We are also seeing ***trends in the property and casualty insurance industry showing the "tail" on liability claims is lengthening in duration across several classes of risk***. This is particularly dangerous for insurance companies in an inflationary environment, as the cost of future claims will rise unpredictably. In addition, the potential mismatches between invested assets and claims payments may cause an insurance company to take surplus losses as bond portfolios are rearranged. These potential “hits” to surplus are not insurable and extremely difficult to manage.

Any unexpected spike in inflation is bad news for the US property and casualty insurance industry. Insurers need to stay vigilant when underwriting, pricing, and managing risk.

Bill Burns’ March 10, 2021 “The Inflation Spector Looms for Property/Casualty Insurers” Carrier Management magazine article explains the three main risks to an insurance company of unexpectedly high inflation:

> “ ***Liabilities.*** Insurers carry liabilities in the form of loss reserves that are intended to pay claims in the future. If inflation is higher than the rate built into the loss reserves, then future payments will be greater than expected.
>
> ***Pricing.*** Insurers charge prices today that will pay for future claims. If inflation proves to be greater than the inflation rate anticipated in the prices, then insurers may not have sufficient funds to pay claims.
>
> ***Investments.*** Approximately 80 percent of the assets held by the P/C industry are in fixed income instruments such as Treasury, municipal and other bonds. These assets are structured to match the payments (cash flows) of the loss reserve liabilities they support. If companies sell current bonds so they can invest in newer, higher-yielding bonds, they will have to book losses upon the sale because higher interest rates drive down bond prices.

### COMMODITIES PRICING AFFECTS CATASTROPHE COSTS

Lumber and other commodity costs have skyrocketed. CoreLogic estimates a countrywide 42% year-over-year price increase for lumber in the US in their Q2 2021 Quarterly Construction Insight (QCI) report. This astronomic one-year price increase can be attributed to an increase in demand from the remodeling and housing boom seen in the US, as well as price spikes at sawmills, who saw disruptions of their production during the COVID-19 lockdowns and are still unable to keep up with the demand seen in today’s market. This classic mismatch between increased demand and decreased supply has forced lumber prices higher than we have seen in decades.

This inflationary pressure does not stop at lumber. Labor prices in the construction market, as well as costs for other construction materials, have seen outsized increases as well. Like costs for gasoline and food, costs and inflation figures for lumber, labor, and materials vary state by state. CoreLogic’s QCI report details state-by-state inflationary figures for these three segments of construction costs.

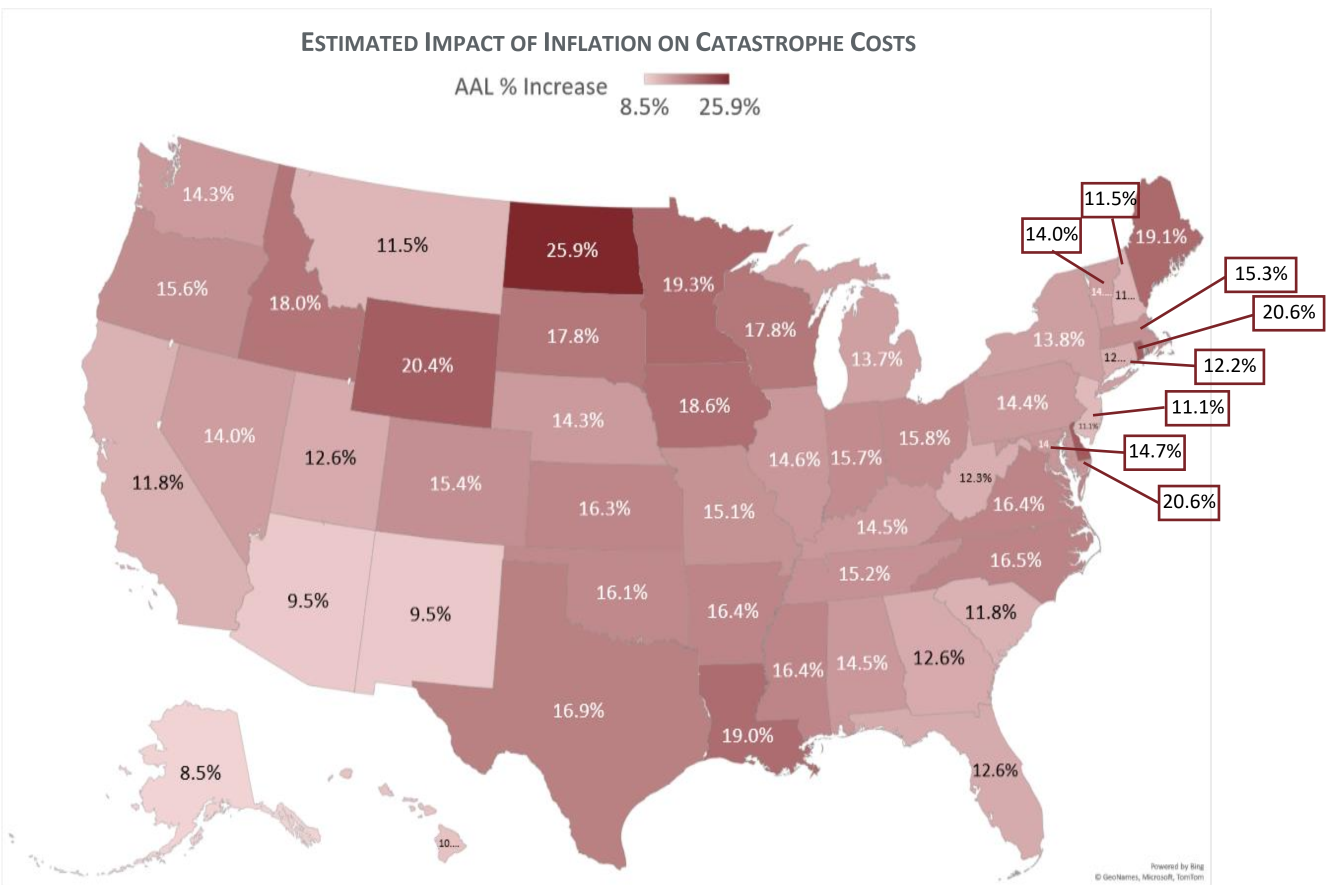
Holborn estimated the impact on catastrophe costs to the industry by applying these state-level inflation figures to distributions of modeled cat costs, including demand surge calculations. The estimated potential Average Annual Loss (AAL – the expected cat loss in any given year) grew in ALL states due to these increased inflationary pressures. Most notably:

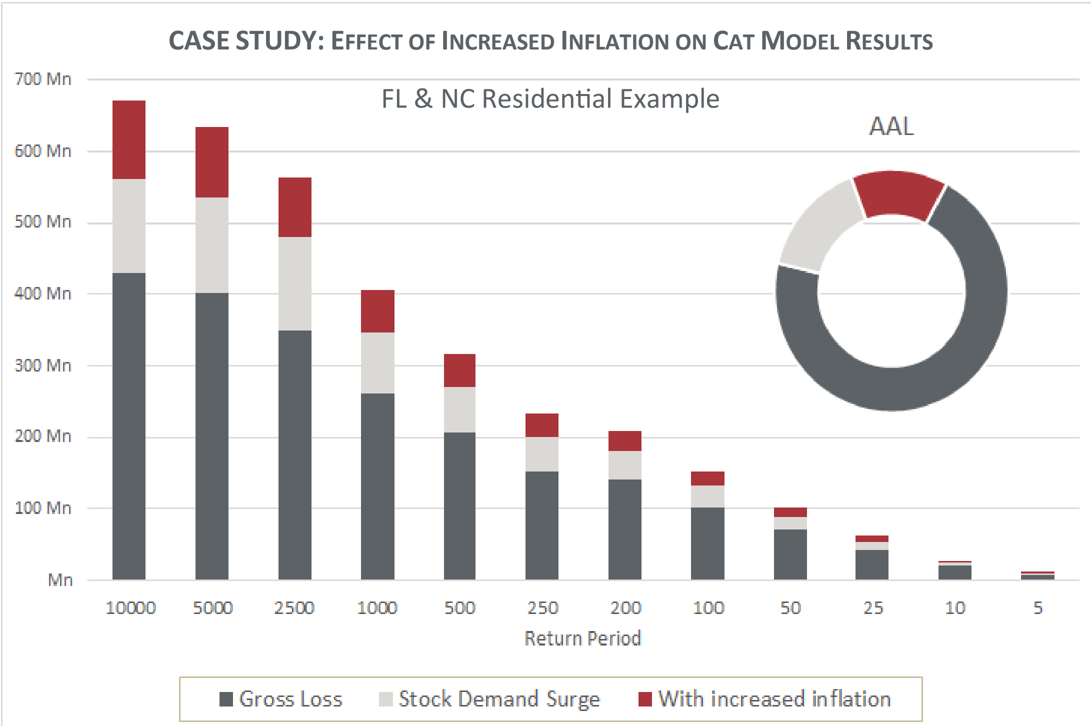
- North Dakota tops our list due to their estimated 24% increase in labor costs and 43% lumber inflation figure.
- South Dakota and Idaho have the next highest labor cost increases, their overall AAL impact figures are tempered by lower-than-average lumber price increases.
- States that have seen the highest lumber and labor price increases (ND, DE, RI, WY, MN, etc.) rank the highest on a scale of potential impact on their cat claims.

In a catastrophic event, pricing pressures can cause losses to jump even further due to the amplifying effect of demand surge. To illustrate the effects excess inflation can have on catastrophe losses, Holborn prepared a case study on cat model results using the inflation figures detailed in CoreLogic's QCI report. Holborn assumed a residential writer in NC and FL, with roughly a 1.5% market share of the residential market in those states. We then adjusted the modeled losses and demand surge estimates for all events by applying distributions based on CoreLogic's inflation figures for lumber, labor and other construction materials.

In our study, larger events see an increased effect of demand surge, due to the heightened demand in a catastrophe recovery situation. This result shows prominence in the tail of the resulting Exceedance Probability Curve (EP Curve – a probabilistic measure of maximum potential cat loss). However, even the more frequent and less severe events influencing the 5- to 25-year return periods can see losses increased 15+% over the model's stock demand surge assumptions.

These results underscore the importance of being prepared for unexpected elements of loss activity that can stress the limits of catastrophe reinsurance programs.






## CONCLUSION

A robust and well thought-out reinsurance program can serve as a hedge and help insurers avoid unwanted volatility, as well as loss to net income and policyholders' surplus. Our Holborn Team is ready to assist our clients in analyzing this risk and structuring sound and comprehensive reinsurance programs that mitigate undesired influences on loss events and claims loss volatility.

To reach out to your Holborn Broking team, please click the link below:

https://www.holborn.com/contact-us/