

JONATHAN RODGERS

Jonathan Rodgers serves NAMIC as the director of Financial and Tax Policy. His responsibilities include representing member-company interests in the areas of solvency regulation, state and federal tax issues, and international policy affairs. He covers developments at the National Association of Insurance Commissioners and the International Association of Insurance Supervisors for any new standards or policy changes that impact U.S. property/casualty insurers.

RIDGE MUHLY

Ridge Muhly is a senior vice president and manager of The Mutual Practice in Treaty North America. He has been with Gen Re since 2002 when he was first a casualty facultative underwriter. Ridge graduated from The Pennsylvania State University with a BS in insurance. He holds the CPCU, ARe, ARM, ASLI, and RPLU designations.

For more information about this NAMIC Issue Analysis please visit www.namic.org/issues/our-positions or contact:

JONATHAN RODGERS
jrodgers@namic.org
317-875-5250 Ext. 1006

The National Association of Mutual Insurance Companies consists of more than 1,500 member companies, including seven of the top 10 property/casualty insurers in the United States. NAMIC member companies write \$357 billion in annual premiums and represent 69 percent of homeowners, 56 percent of automobile, and 31 percent of the business insurance markets.

TABLE OF CONTENTS

Where Are We Now	2
Homes and Motor Vehicles	2
We've Been Here Before	4
Insurance Industry Under Inflationary Pressure	5
Reconstruction Costs	6
Supply Chain Challenges	6
Social Inflation	7
The Future	7

NAMIC ISSUE ANALYSIS

Among the many cascading events that COVID-19 presented to the American people – the infusion of trillions of dollars of federal government COVID-relief spending into the economy, the ongoing supply chain disruptions, and the continued labor market struggles – have all played a large role in contributing to the high inflationary environment currently impacting the U.S. economy. The return of long-dormant inflation ends what many have called the “free money” era in which inflation and interest rates hovered around zero. Consumers are suddenly feeling the pinch at the grocery stores, gas pumps, and in other consumer goods.

The insurance industry now finds itself in a morass of soaring automobile and building material costs, labor shortages, and supply chain struggles, as well as dealing with several outsized and out-of-season extreme weather events, all while inflation outpaces premium increases.¹

As we approach 2023 with the tangible and intangible impacts of inflation's unwelcome return continuing to be felt, the question is whether this inflationary era is only temporary or will it prove to be long lasting? If the latter, how will the insurance industry be affected and what can be done to minimize the impact?

WHERE ARE WE NOW

The Consumer Price Index (CPI) surged 1.3% in June 2022, while the annual inflation rate in the U.S. increased to 9.1% in the same month, the largest increase in four decades.² The Property/Casualty insurance industry is experiencing the deleterious effects of these inflationary pressures firsthand, particularly in the homeowners and auto insurance lines, but also in the form of increased stress on investments in fixed-income instruments and loss reserves. Whether for repairs, parts/materials, the cost of labor, or any number of other variables relating to providing coverage, supply chain shortages and inflation invariably mean delays and higher costs.

HOMES AND MOTOR VEHICLES

Homes and motor vehicles are among the largest contributors to the historically high inflation rates recorded of late. In June 2021 alone, the CPI for used cars and trucks registered an increase of 45.2% over June 2020. The National Auto Dealers Association reported that the average new car price surpassed \$45,000 in January 2021 and the average used car price climbed to nearly \$30,000. The National Association of Home Builders reported in November 2021 that prices of goods used in residential construction climbed 12.2% for the first 10 months of that year, after climbing 4.6% over the same period in 2020. Furthermore, housing is in high demand with historically low inventory resulting in homes appreciating at a record rate. In March 2022, the year-over-year increase in home prices nationwide, including distressed sales was 20.9%; however, some predict a cooling off period due in part to rising mortgage rates potentially derailing prospective buyers.³

¹ <https://www.claimsjournal.com/news/national/2022/03/07/309044.htm>

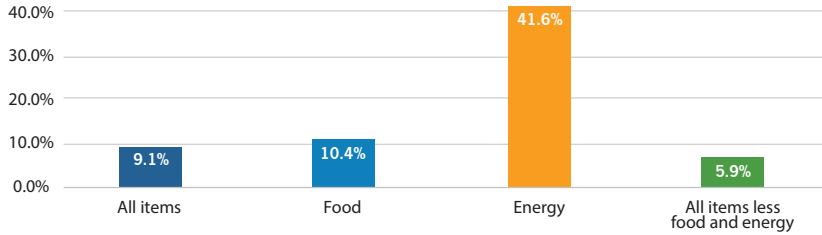
² <https://www.bls.gov/cpi/>

³ <https://www.corelogic.com/intelligence/u-s-home-price-insights/>

INFLATION RETURNS TEMPORARY VISIT OR EXTENDED STAY?

Consumer Price Index

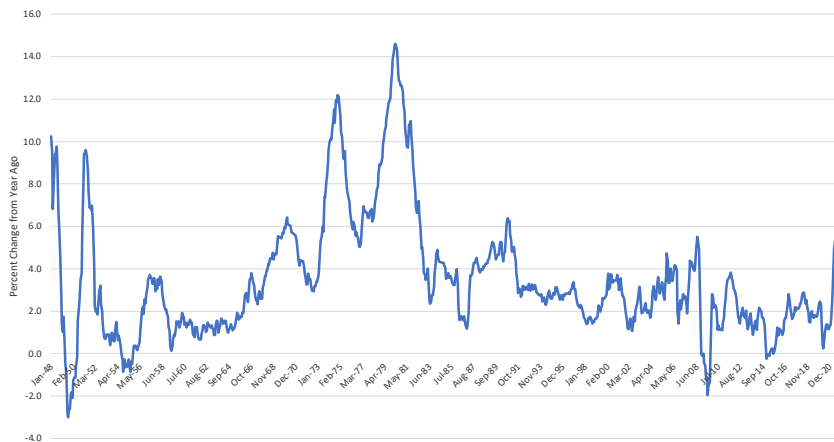
12-month percentage change, selected categories – June 2022, not seasonally adjusted



Source: U.S. Bureau of Labor Statistics, <https://www.bls.gov/charts/consumer-price-index-by-category.htm>

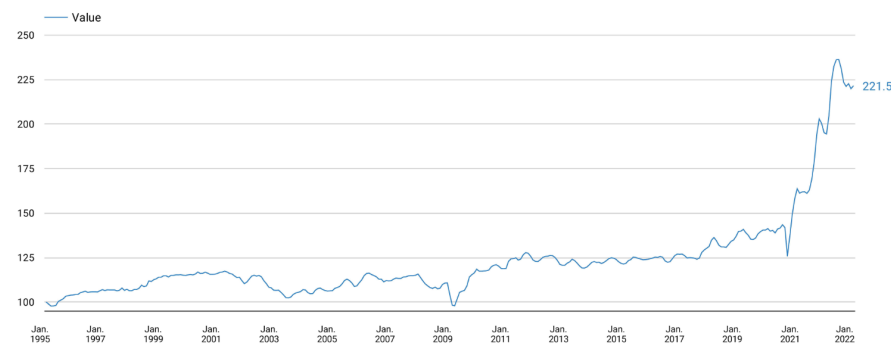
Consumer Price Index for All Urban Consumers

All items in U.S. city average



Manheim Used Vehicle Value Index

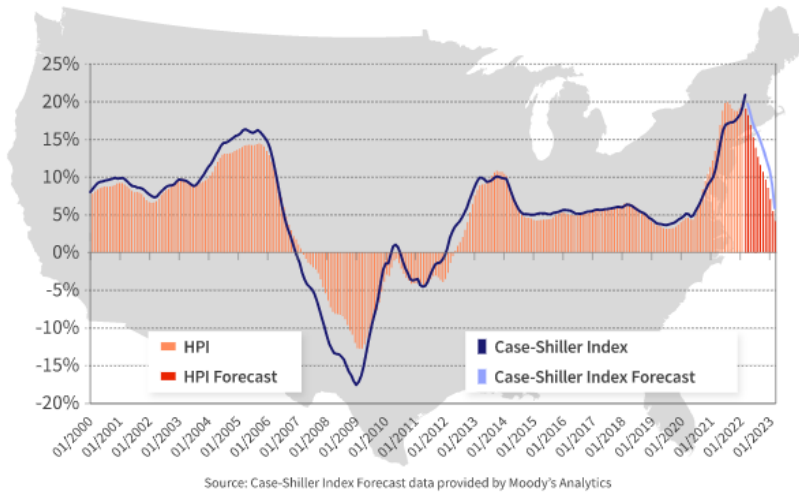
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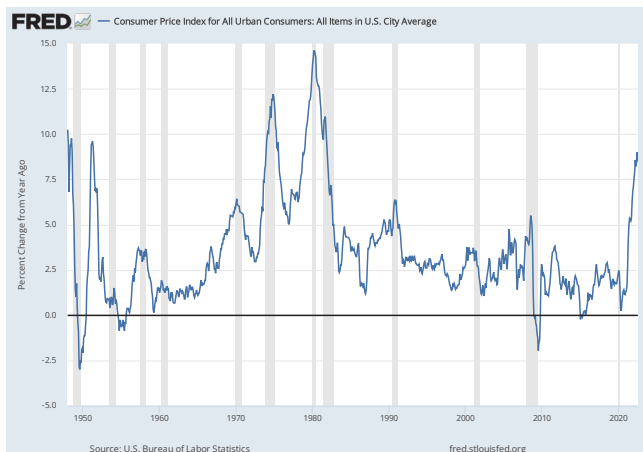
HPI & Case Schiller Index

2000 to present month with forecasts one year into the future



WE'VE BEEN HERE BEFORE

Inflation is not a static event – it is part of the economic cycle, and inflationary periods have defined the American economy at various points throughout history. In the immediate post-World-War-II period, for example, inflation spiked partly due to product shortages as manufacturing shifted from producing weapons to making consumer durable products.⁴ Moreover, consumers flush with savings, who had been getting by with aging cars and appliances on the brink of breakdown in the war-mobilized economy, helped fuel an extraordinary inflationary fire that culminated with the CPI peaking at 20.1% in March 1947.⁵ Over the next two years, as manufacturing completed its transition to peacetime production, demand subsided and inflation dramatically declined. This post-war period could also be characterized as a period of rising interest rates, as bond yields climbed persistently from 1946 to 1981.



⁴ <https://www.ft.com/content/f6bf6064-a348-4f37-b784-5b9e7ba05448>

⁵ Ibid.

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Heightened inflation returned in the 1970s, ranging from 6% in 1973 to 14% in 1982. Driven in large part by multiple surges in crude oil prices, the inflation fever finally broke when the Federal Reserve raised interest rates from 10% to 20%.⁶ However, with the breaking fever came two crippling recessions that lasted until November 1982.⁷ Ultimately interest rates peaked in 1981 and went down persistently for the next 40 years. Given that inflation has been with us for more than a year and interest rates are starting to rise, it appears that the generational trend has reversed itself once more. While there is no way of knowing what will happen next, looking to the past may be instructive. Many people are confronting major inflation and interest rates going up for the first time in their lifetime.

As policymakers sift through potential solutions to the current inflationary cycle, one commentator suggests looking back to the aforementioned post-WWII period, given the similarities of supply shortages, forced savings, and renewed demand for consumer goods.⁸ This was also followed by a period of rising interest rates. Others suggest that we're entering a new era marked by geopolitical tensions, protectionist policies, and natural disasters, all of which will continue to stress global supply networks and, in turn, fuel inflationary headwinds for years to come.⁹

INSURANCE INDUSTRY UNDER INFLATIONARY PRESSURE

History confirms that the inflation of the 1970s and early 1980s had dramatic adverse effects on the insurance industry, leading to weakened underwriting quality and performance, reduced reserve levels, and increased rates for policyholders and consumers. Property/Casualty insurers will be challenged to stem the tide of an extended period of inflation and rising interest rates; however, strong balance sheets and capital positions have Property/Casualty insurers in a stronger position today than during the period of the late 1970s and 1980s.

In extended inflationary periods, insurers will be challenged to keep pricing and reserve levels on pace with inflation. The Federal Reserve will likely continue to raise interest rates to try to head off inflation, challenging insurer portfolios heavily invested in fixed-income instruments (U.S. treasuries, municipal bonds, etc.).¹⁰ Historically, Property/Casualty insurers have invested between 10% and 20% of their surplus in common stock to keep pace with inflation to pay claims (auto repairs, construction costs, health care expenses, and labor) that are growing with inflation.¹¹

Higher expenses for insurance operations and inflated unanticipated loss cost increases result in higher incurred loss ratios, particularly as **inflation impacts key factors such as construction costs, skilled labor, auto repairs/total vehicle replacement costs, and litigation costs**. The insurance area continues to feel its greatest pain in sectors associated with these key cost drivers. Simply put, if costs to repair vehicles and homes increase and/or if there are more claims or litigation activity associated with those claims, insurance premiums are likely to go up as well.

⁶ <https://www.insurancejournal.com/news/national/2021/03/23/606467.htm#:~:text=Inflation%2C%20defined%20as%20the%20rate,is%20chasing%20too%20few%20goods>.

⁷ <https://bancroft.berkeley.edu/ROHO/projects/debt/1980srecession.html>

⁸ <https://www.ft.com/content/f6bf6064-a348-4f37-b784-5b9e7ba05448>

⁹ <https://www.wsj.com/articles/new-age-of-scarce-supply-risks-inflationary-headwinds-challenging-central-banks-11651060801>

¹⁰ CNBC: <https://www.cnbc.com/2022/07/27/fed-decision-july-2022.html>

¹¹ NAIC: <https://content.naic.org/sites/default/files/capital-markets-special-report-cash-invested-assets-2019.pdf>

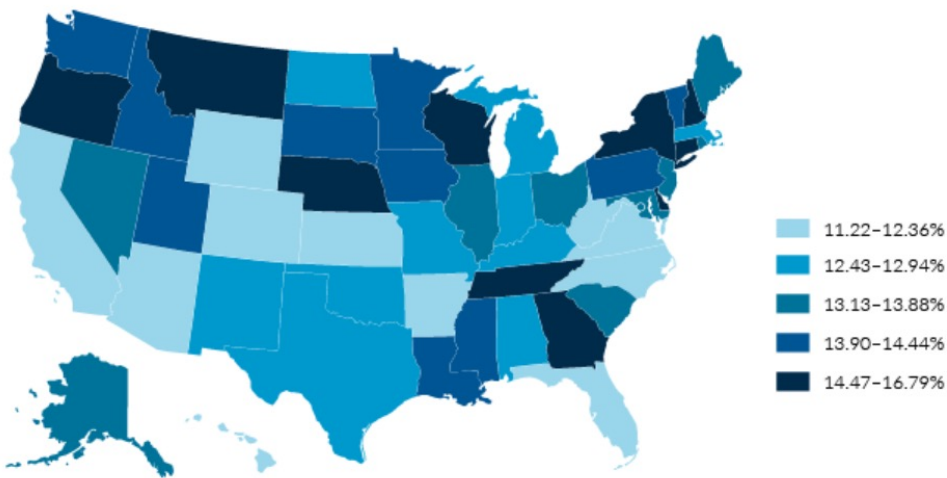
NAMIC ISSUE ANALYSIS

RECONSTRUCTION COSTS

Total reconstruction costs, including materials and labor, shot up 13.5% from April 2021 to April 2022, almost doubling the increase between January 2021 and January 2022. Powering the surge were price hikes in lumber and fuel prices, as well as increases in the costs to produce and transport goods.¹² Spikes in construction labor and material costs and/or shortages in labor mean higher repair costs and delays as contractors have difficulty finding skilled craft positions and as backlogs in work mount. A recent analysis by the Home Builders Institute estimates that the construction industry is facing a shortage of more than 200,000 skilled trade workers.^{13 14}

Not surprisingly, reconstruction costs rose in all states, paced by Delaware (16.8%), New York (16.2%), and Connecticut (15.5%).¹⁵

Changes in Reconstruction Costs by States



States are grouped in quantiles, each range/color in the legend includes 20% of the total number of states. All rates, percentages, increases, decreases, etc., are calculated as percentage changes from April 2021 to April 2022, unless otherwise noted. Source: Verisk

SUPPLY CHAIN CHALLENGES

Specific inflationary pressures in the short-tail auto insurance markets relate to both parts and labor costs. Supply chain challenges are adding to already elevated costs of materials and parts, with procurement of the computer chips necessary for most newer vehicles presenting particular availability challenges. With fewer chips available, the cost of new vehicles and repairs involving these chips become significantly more expensive. At the same time, many auto repair shops are facing severe staffing shortages, leading to longer wait times and higher labor costs for consumers.

¹² <https://www.verisk.com/insurance/visualize/inflation-lifts-reconstruction-costs-as-fuel-prices-boost-volatility/#:~:text=Overall%20inflation%E2%80%94up%208.5%20percent,the%20start%20of%20the%20pandemic.>

¹³ <https://us.milliman.com/en/insight/the-toll-of-increasing-construction-labor-and-supply-costs-on-insurance>

¹⁴ <https://hbi.org/wp-content/uploads/Final-HBI-Construction-Labor-Market-Report-news-release-11-4-21.pdf>

¹⁵ Ibid.

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SOCIAL INFLATION

In addition to economic inflation, evidence suggests we must also consider the impact of social inflation, which generally denotes untenable and increased litigation and claim costs. In 2021, NAMIC and Gen Re collaborated on a five-part series¹⁶ examining social inflation and its impact on insurers. The series highlights how the increase in litigation verdicts and costs causes extreme disruptions for insurers working to adequately price and reserve for their underwritten coverages. There are many sources that fuel social inflation and with increases in third-party litigation funding and non-economic damage recoveries, “nuclear verdicts” are trending toward becoming the rule rather than the exception. Social inflation is also evident on the first-party side through the torrent of Assignment of Benefit claims in states such as Florida.¹⁷ And finally, the increasingly frequent shift of attorney fee awards away from the American Rule that each party pays its own attorney fees and costs and onto insurers is impacting the neutrality of litigants in courts of law. All of these practices can have negative effects on insurance marketplaces by fundamentally altering the balance and fairness of proceedings.

THE FUTURE

Noted economist Charles Goodhart says the world was in the midst of a seismic shift prior to the pandemic. He argues that a long period of inexpensive labor fueled by globalization served to keep prices and wages artificially low for decades.¹⁸ He further argues that shifting demographics – older populations and declining birth rates – are resulting in worker shortages and higher prices, adding that as a result inflation in developed economies will settle between 3% and 4%, compared to the roughly 1.5% that existed pre-pandemic.¹⁹ Others dispute this, claiming that declining numbers of workers and more retirees could actually drive inflation lower as has been recently seen in Japan.²⁰ John H. Cochrane, senior fellow, Hoover Institution, and professor of finance at Stanford University, attributes the actions of the Fed, through its decade of purchasing Treasury securities and trillions of dollars of COVID-relief deficit spending, as contributing to the current high inflationary environment. In an article published by the National Bureau of Economic Research, he notes “inflation breaks out when the quantity of debt exceeds people’s expectations of repayment.”²¹ Based on this logic, absent an acknowledgment that the debt will be paid down and/or future deficit spending will be restrained, raising interest rates may make inflation worse. “In a fiscally driven inflation, it can happen that the central bank raises rates to fight inflation, which raises the deficit via interest costs, and thereby only makes inflation worse.” With \$30 trillion of total federal debt outstanding, or 130% of 2021 U.S. Gross Domestic Product, interest payments will increase substantially in a rising interest rate environment.

Regardless of the differing forecasts, an emerging consensus suggests that inflation, while likely to not reach the double digits seen in the early 1980s, will nevertheless be with us for quite some time and possibly be exacerbated by geopolitical events or domestic monetary and fiscal policy. It appears that these uncertainties – for insurers and their individual and business customers – are the realities of the environment in which they operate.

¹⁶ <https://www.genre.com/knowledge/blog/2021/may/social-inflation-is-complicated-and-costly-five-perspectives-to-help-insurers-identify-trends-and-respond-en>

¹⁷ Assured Comment: Florida Homeowners’ Market Becoming Uninsurable?

¹⁸ <https://www.wsj.com/articles/inflation-high-forecast-economist-goodhart-cpi-11646837755#:~:text=He%20predicted%20that%20inflation%20in,Mr.>

¹⁹ Ibid.

²⁰ Ibid.

²¹ https://www.nber.org/system/files/working_papers/w30096/w30096.pdf



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3601 Vincennes Road | Indianapolis, IN 46268 | 317.875.5250
20 F Street, NW, Suite 510 | Washington, D.C. 20001 | 202.628.1558
