# International Liability: Myth or logic?

## Introduction: Liability drivers for 2023

What do Greek mythology and Mathematical Set Theory have in common? They both help to describe the current state of the Energy Liability market and the drivers behind it.

Six months on from our last Review and three months after the key reinsurance treaty renewal season at January1 2023, how has the Liability market fared and where is it heading directionally?

We saw in our November 2022 Update that Lloyd's of London figures for this class showed that it had sustained five years of losses since 2017 (see Figure 1 below). However, the same results from the first half of 2022 (including Liability, D&O and Financial Lines) showed that it finally returned a modest underwriting profit for this period – a trend that is expected to continue when the full year data is released at the end of Q1 2023 (see Figure 2 below).

Figure 1: **Lloyd's Results for the Casualty Sector, Full Year for past 5 years**

| | Gross written premium £m | Accident year ratio % | Prior year movement % | Combined ratio % | Underwriting result £m |
|---|---|---|---|---|---|
| 2017 | 8,464 | 103.7 | (0.6) | 103.1 | (189) |
| 2018 | 9,094 | 103.9 | (1.0) | 102.9 | (183) |
| 2019 | 9,459 | 103.8 | 1.9 | 105.7 | (390) |
| 2020 | 9,067 | 105.2 | 5.1 | 110.3 | (688) |
| **2021** | **10,360** | **95.6** | **4.7** | **100.3** | **(17)** |

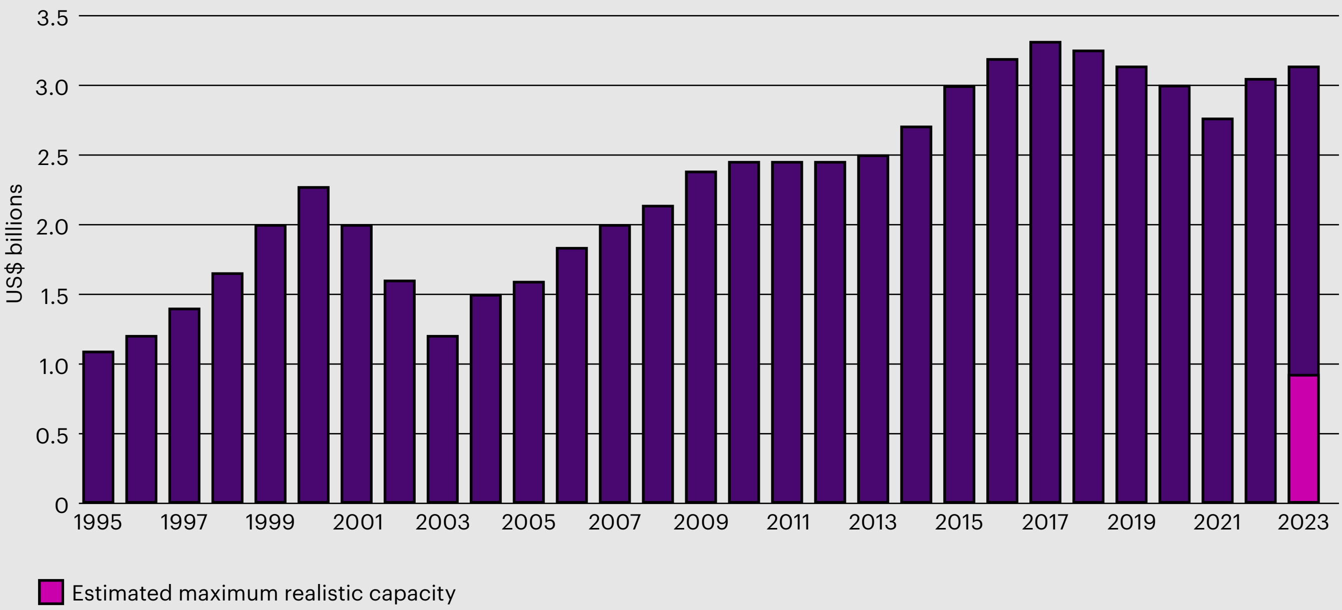
Source: https://assets.lloyds.com/media/81b1778b-e821-4424-b21e-26e0bf095f10/Lloyds_AR21_220323.pdf (page 27)

Figure 2: **Lloyd's Casualty results, 6 months ended 30 June 2022**

| | Gross written premium £m | Net earned premium £m | Net incurred claims £m | Net operating expenses £m | Underwriting results £m |
|---|---|---|---|---|---|
| Casualty | 6,030 | 3,507 | (1,670) | (1,412) | 425 |

Source: https://assets.lloyds.com/media/70dd122f-c82e-42fe-a8f5-0d3859bbcf27/Lloyd's%20Interim%20financial%20statement%20092022.pdf (page 16)

Figure 3: **International Non-Marine Liability Capacity, 1995-2023**




Source: WTW

Lloyd's Full Year 2022 Results will be released just prior to publication of our Energy Market Review, and initial indications are positive.

This changing trend towards profitability in the Lloyd's Casualty (Liability) sector is an encouraging development, which is broadly echoed across other Liability markets internationally, and is a result of tighter underwriting controls, greater risk selection and several years of compound rate increases.

The key question is: How has this impacted capacity and pricing and have any of the positive influences been derailed by the challenges of the recent reinsurance treaty renewal season?

### Liability capacity

After three consecutive years of decline, total Liability capacity continues to nudge gently back upwards as a handful of new insurers and MGAs have entered the market and some existing insurers have expanded their line size.

As a result, we have seen a measured increase in both total theoretical capacity (US$3.10 billion) and actual working capacity (US$900 million plus) as illustrated in Figure 3 above.

However, the dynamics behind this chart are somewhat more complex, as the more specific "Energy Liability" market is composed of a number of different sectors or subsets, each with their own drivers and loss ratios.

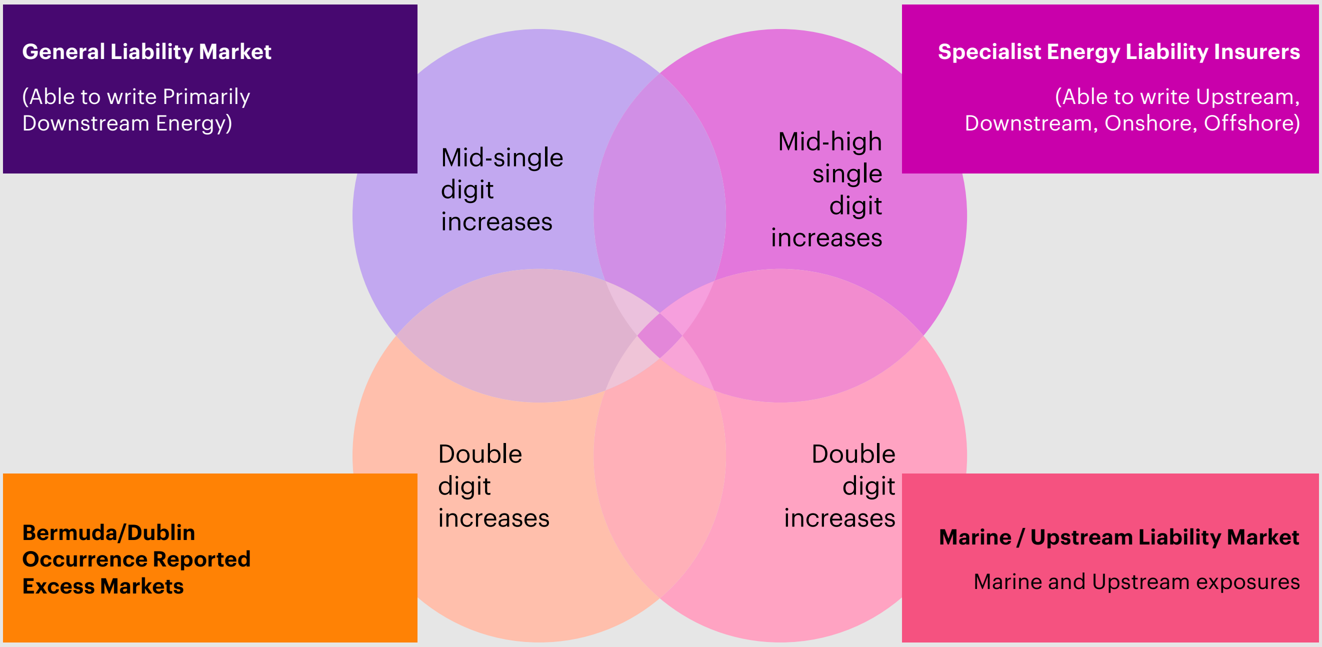
### Sector detector: market segments and their characteristics

Broadly speaking, there are four generic Liability market segments an Energy insurance buyer may encounter, as illustrated in the Venn Diagram in Figure 4 overleaf. These are as follows:

- General Liability insurers (both locally and globally), that write Onshore Energy as part of their wider portfolio.
- Specialist Energy insurers, able to write the whole range of an Energy insureds activities both On and Offshore.
- Marine/Upstream insurers, focusing on Offshore E&P and Marine activities.
- Bermuda/Dublin-based Excess Capacity insurers, able to wide a wide range of activities in the basis of an Occurrences Reported policy form.

Depending on risk and activity profile (Upstream, Downstream, Fully Integrated etc) and the amount of indemnity limit required, a buyer may need to access one, two, three or a combination of all four of these Liability market sectors. Each of these market sectors have differing drivers and loss results, which inform their different approaches to renewal rating.

Figure 4: **The various International Liability markets and current average rating increases, April 2023**




Source: WTW

General Liability Market insurers share the loss experience of the Specialist Energy insurers but their broader premium income base dilutes the impact of Energy-specific losses. The availability of local regional market capacity also adds a greater element of competition and as a result, renewal pricing from this market sector typically falls in the mid-single digit area.

Specialist Energy insurers have more concentrated exposure to a wider range of Liability losses in the Energy arena, including Offshore loss activity. Their renewal rates typically fall in the mid to high single-digit area.

The Marine/Upstream market has been particularly impacted by results from their Protection & Indemnity (P&I) portfolios, which has put pressure on their own Treaty Reinsurance renewals. As a result, they are generally imposing high single-digit to double-digit increases on their direct Upstream Energy programmes. This is similarly reflected in the P&I sector, albeit with some moderation compared to the prior year. One major P&I Club renewal was completed at modest single-digit increase (down from +45% in 2022, following improved Marine Liability loss ratios); however, the "Non-Poolable" sectors (for Upstream-related craft and activities) have experienced negative loss development, with one P&I Club renewing recently at a +15% rate increase.

The Bermuda/Dublin Occurrences Reported market is commonly imposing the greatest rises, with double-digit renewal increases common, as the leveraging impact of inflation has a disproportionately greater negative impact on loss ratios for these mid/high Excess Layer insurers.

Clearly, the dynamics are varied and complex. Direct buyers will therefore have varying renewal experiences, dependent upon their risk profile, coverage requirements and market segments that they need to access.

Irrespective of market sector, there are a number of common drivers and restraints dictating Liability market behaviours more broadly.

### Multi-headed market drivers for buyers to overcome

In Greek mythology, the gates to the Underworld were guarded by a multi-headed dog named Cerberus; safe passage could only be achieved by navigating past the jaws of the beast. It is similarly helpful to understand the various conflicting drivers and restraints in the Liability market, in order to best anticipate the challenges and to safely conclude a successful renewal.

The multi-headed drivers of rate pressure are:

- Increased treaty costs
- Economic inflation
- Social inflation
- Adverse prior loss development/Insufficient reserving

Restraining factors acting as a "leash" to mitigating against these pressures are:

- Increases in capacity
- Greater market choice/competition

These key factors are examined below.

### Reinsurance treaty renewal season: hype or happening?

Much discussion in this Review is understandably devoted to the January 1 reinsurance treaty renewal season and its impact of current insurance market conditions.

The Liability reinsurance treaty renewals that took place at January 1 were generally considered challenging but fair; while rating increases were imposed, they were not to the same extent as those suffered by the Nat Cat-exposed Property reinsurance treaty sector. Nevertheless, single-digit to low double-digit treaty increases were the norm, with loss impacted treaty renewals paying significantly more. To mitigate increases, many Liability treaty buyers elected to retain more risk themselves. One Liability insurer, for example, doubled their retention and still received a 10% increase in their treaty reinsurance costs. Buyer experience is also being affected by Liability sector; those Liability insurers with a significant Marine Liability portfolio were more severely hit as a result of a number of recent losses and adverse loss developments in this sector.

The key question is: how much of this reinsurance treaty cost can/will the affected Liability insurers pass on to the direct buyer? In addition, many Liability insurers do not renew their treaties until later in the year; as such, they are not immediately impacted by rising treaty costs. Market commentators are therefore watching closely to see what the remainder of 2023 holds for the remaining reinsurance treaty renewal seasons.

### Inflation: a “double header” for Liability

The pressures of **economic inflation** are a common denominator across most classes of insurance and Liability is no exception: All key elements of Liability exposure, including Physical Damage, Bodily Injury, Pollution, Employers Liability/Workers Compensation and Auto Liability, have recently been impacted by inflationary pressures.

As an example, one insurer cited that their average claim for a medium-sized pollution loss has risen from US$20 million to US$30 million, fuelled in part by increased legal fees and the increasing cost per hour rate of technical and remediation specialists.

From a Physical Damage perspective, average rebuild costs have increased substantially, following the significant increase in construction materials. Average Bodily Injury awards have also been impacted by increased health care costs and wage inflation in many regions has increased the compensation costs for loss of salary.

In response to the above, many insurers are applying a base inflation loading to their renewals (separate to any exposure base change calculation) of 7% to 7.5%.

More unique to Liability as a class is the additional factor of **social inflation**. Increasing litigation, broader definitions of liability, plaintiff-friendly legal decisions, the spread of “no win no fee” legal contingency fees and a significant increase in average jury awards have all contributed to the frequency and size of liability claims.

This is most pronounced in the United States, where awards for the top US jury verdicts more that tripled over a five-year period; however, the same trends are becoming increasingly manifest globally.

### Balancing factors: capacity and competition

The welcome arrival of some new capacity has increased competition and choice in the market; this is most pronounced for buyers that purchase smaller indemnity limits. Buyers with larger limits still require the agreement and participation of most of the market; however, the increase in capacity has at least enabled them to fill self-insured gaps, reinstate limits that were by necessity previously reduced and deselect any opportunistic insurers.

## Current market developments: other features and considerations

### Leveraging effect of inflation

Interestingly, for major/catastrophe risks the dynamic of loss cost inflation can impact differently across a Liability programme. For example, with the average size of large losses increasing, a major explosion and pollution event that previously cost US$150 million may now cost in the region of US$250 million. Whilst a Primary layer will always be exposed to such an event, the upper layers of a programme become increasingly more exposed, and so the loss cost impact of inflation can have a disproportionate impact of the higher layers of cover. As a result, inflationary-factored pricing pressures can vary, depending upon the limit purchased and the layers involved.

> “The key question is: how much of this reinsurance treaty cost can/will the affected Liability insurers pass on to the direct buyer?”

## Return of the billion-dollar programme?

A feature of recent years has been shrinking limits and increased retentions, as buyers purchasing higher overall programme limits struggled to find sufficient capacity and/or refused to be held hostage to opportunistic pricing from some quarters. Buyers who previously completed US$1 billion of limit with ease several years ago, have seen limits in the recent past reduce by several hundred million dollars. This was most pronounced for buyers exposed to Nat Cat Liability perils (e.g. Wildfire), Midstream exposures and/or with US domestic operations as part of their profile.

The recent measured expansion in capacity and insurer choice has enabled buyers to build-back their overall programme limits to amounts approaching their previous levels. However, many buyers are electing to continue with the significantly increased self-retentions that they were obliged to accept in the recent past, and then selectively top-up or infill with new/increased capacity as it becomes available at acceptable pricing levels. As a result, there has been a proliferation of captive activity in the past few years, as buyers were obliged by necessity to self-insure. Many buyers have therefore become more comfortable with including long tail exposures within their captives, which remain a more prominent feature of their Liability programme placement strategy.

Through a combination of increased average retentions and greater capacity, average programme limit sizes are now starting to return to previous levels, driven by an awareness of the continued growth in maximum liability exposures. Clearly a trade-off exists, as buyers reconcile increasing levels of liability risk with budget constraints and affordability considerations. The ability to identify and execute the most effective risk transfer approach remains a key broker requirement for all buyers.

Billion-dollar limits are therefore back on the agenda for some buyers, albeit often with significantly increased retentions. They remain a challenge for those buyers with less mainstream exposures and/or where sanctions or ESG considerations limit market availability.

## Sustainable capacity?

The ever-increasing focus on ESG considerations poses both challenges and opportunities for Liability insurers and their customers.

Much debate is ongoing about the future viability of insurance coverage for the less sustainable Natural Resources activities. Capacity for thermal coal and oil sands operations is increasingly constrained, as markets respond to pressure from activist investors to decarbonise their portfolios and some buyers have elected to withdraw from or severely limit their capabilities in respect of oil & gas business. While insurers are questioning buyers about their ESG strategy and commitment to change, buyers are rightly concerned to establish their long-term commitment of insurers to the oil & gas sector. The optimum position is to establish a partnership approach with those insurers who are committed to supporting buyers over the long term that can demonstrate their own commitment to the energy transition. What is clear is that all insurers are motivated to favour buyers that have a strong climate transition plan and strong ESG credentials.

Insurers and brokers are also developing schemes to cover the emerging liability exposures from such activities and hydrogen, battery storage and carbon capture more appropriately. A particular issue that is recognised is the need to suitably address liability for loss of Carbon Credits, particularly in the field of CCS, and at least one lead insurer is making good progress in developing a suitable solution.

## Coverage considerations

In addition to ESG issues and greater sanctions scrutiny, the most common coverage trends are the increasingly broad imposition of exclusions relating to PFAS (Perfluoralkyl and Perfluoralkyl Substances) and Climate Change Liability. Whilst PFAS exclusions are increasingly broad blanket, buyers that can articulate their exposures have the most success in limiting any exclusions to fire retardant activities. Climate Liability exclusions are also becoming increasingly commonly imposed. This is illustrated by the most recent JL London Umbrella form JL2022-016, which amongst other changes, includes exclusions in respect of both PFAS and Climate Change.

Where such exclusions cannot be avoided, brokers are striving to ensure that their application is clear, defined and limited, in order to prevent the law of unintended consequences. For example, a loosely defined Climate Change clause that excludes greenhouse gases could potentially exclude liability for a methane gas explosion, although clearly this is not the intent. Consistency and clarity of coverage therefore remain key concerns for brokers and clients.

## Conclusion: Greek tragedy or logical progression?

We have seen through the lens of Greek mythology and Set Theory that a complex combination of conflicting market drivers and differing market segments exist within the Energy Liability space. As a result, the renewal experience of buyers will be very varied. Those buyers accessing low limits for clean closed Onshore Energy exposures will have a much easier renewal ride than those requiring high limits, with Offshore/Marine and well as Onshore exposures, and/or with a lower renewable energy mix.

The above factors, together with the broader Energy loss record (particularly in respect of Midstream, Marine/Offshore and Auto) are also the reason why renewal pricing increases for Energy buyers tends to run at a slightly higher percentage level that for those with non-Energy, General Liability exposures only.

The positive news is that the worst fears surrounding the January 1 reinsurance treaty renewal season were unfounded — at least in respect of the Liability sector. Some rate increase pressure has filtered through, combined with the continuing inflation concerns; however, the gradual increase in capacity and positive underwriting results in many quarters have moderated these drivers. The net result is that renewal increases in the mid-single digit to mid-upper single digit range are now the norm, being a slight moderation since this time in 2022, when high single-digit to low double-digit rises were more prevalent.

The big question is the pricing trajectory for the rest of the year. Much will depend upon the remaining 2023 reinsurance treaty renewal seasons - which will dictate market sentiment — as well as the supply of Liability capacity and the rate at which premium income limits are used up (being a particular consideration for Lloyd's insurers in the fourth quarter of 2023).

Our expectation is for no dramatic change, and potentially a further measured easing of market conditions throughout 2023. However, buyers are wary that with the market broadly at acceptable technical rating levels, adverse prior loss developments, combined with the erosive effect of inflation, could reverse the slow path to profitability. The future commitment of some insurers to the Energy sector also remains a concern that is being closely watched.

For the insurance buyer, a stable sustainable and predictable market benefits everyone. Whilst brokers will continue strive to ensure the best possible renewal pricing at the broadest available coverage for their clients, there is an ever-increasing realisation that a focus on sustainable partnerships with reliable insurers remains a key strategy to ensure a positive long-term outcome and avoid any future Greek coverage tragedy.

**Mike Newsom Davis is Global Head of Liability, Natural Resources Global Line of Business, WTW.**
mike.newsom-davis@wtwco.com