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Social Inflation: What Is It and Why Should Reinsurers Care?

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Social inflation is the latest buzzword given to the phenomenon of unexpected rising insurance claim costs because of societal trends and views toward litigation.

While social inflation as a concept is not new, it recently has become very popular in the insurance press and now appears frequently in the general press. Nearly every insurance company CEO is talking about social inflation and how claims costs are increasing in ways that were not anticipated.

First, let us set the scene before we jump into social inflation. Reinsurers, through traditional reinsurance contracts, provide economic capital support to ceding insurers by indemnifying ceding insurers for all or part of their underlying policy liabilities. This allows ceding insurers to write more business and maintain sufficient balance sheet surplus.

When entering into a nonfacultative reinsurance treaty, the reinsurer "underwrites" the ceding insurer and the ceded book of business to set the reinsurance premium. The reinsurer usually has a great deal of experience across similar books of business of several ceding insurers, which better permits the reinsurer to anticipate both premium flow and loss/expense obligations over the life of the underlying policies ceded to the reinsurance contract.

Reinsurance Underwriting Analysis

When underwriting a ceding insurer and its book of business, the reinsurer will consider many factors in determining how it anticipates the ceded book of business will develop over the life of the reinsurance contract. This is most often an actuarial determination, with consideration given to factors such as economic inflation, interest rates, historical loss experience, loss trends, the competitiveness of the marketplace, the underwriting skill and experience of the ceding insurer's underwriting personnel, historical and anticipated profitability, and the legal and regulatory landscape. These and other factors go into deciding whether to offer reinsurance terms and, if so, into developing the reinsurance premium.

Of course, the reinsurer's underlying premise is to charge a sufficient reinsurance premium to pay all of the reinsurance obligations and come out with a profit. Thus, the analysis of the ceding insurer and its business, along with the reasonableness and credibility of the likely economic outcome of the reinsurance contract, is critical to the reinsurer. Much of this analysis depends on the information provided by the ceding insurer. But, with factors like social inflation, reliance on information from the ceding insurer is not enough.

Anticipating how a book of business will turn out is key to profitability for both the ceding insurer and the reinsurer. When actual experience turns out to be way off the anticipated outcome, both the ceding insurer and the reinsurer will lose. A bad outcome makes renewal of a reinsurance program, if even possible, more difficult and more costly for the ceding insurer.

What Is Social Inflation?

There is no common definition of social inflation. It has been described many ways, but there are some themes that run through all of the descriptions. First, it concerns the rising costs of insurance claims. Those rising costs are being fueled by trends in society like significantly increased jury awards against corporate policyholders (what some call the "nuclear verdict").

Second, these increased awards and settlements appear to be caused by some or all of the following factors.

- More liberal treatment of claims
- Erosion of the tort reforms build into the legal system during the last century
- Third-party litigation funding
- Erosion in the trust of corporate America
- Changing views of social responsibility and the righting of wrongs (see the #MeToo movement)
- Populism
- Society's desensitization to large jury verdicts and settlements

A number of commentators have identified generational attitude shifts concerning the responsibility for damages allegedly suffered at the hands of corporate America. Jurors accept the litigious nature of our society and are unfazed by jury awards and settlements in the tens of millions of dollars. The average juror sees professional athletes and entertainers, as well as corporate CEOs and billionaires, reaping enormous benefits from society. Commercials by plaintiffs' law firms in nearly every market tout their ability to win millions for their clients ("XYZ Law Firm got me $1.5 million when insurance offered only $150,000").

When faced with a plaintiff's significant injury while sitting on a jury, jurors have no qualms about righting what they perceive as a wrong done to the plaintiff by rich corporations. Thus, the predictability of jury verdicts has gone out the window as these so-called nuclear verdicts have proliferated.

A number of commentators also think third-party litigation funding has helped fuel the rising costs of claims. Litigation funding companies provide significant resources to plaintiffs' attorneys in exchange for a percentage of the recovery. This funding takes the burden off the plaintiff's attorney to go out of pocket to retain experts, find witnesses, and develop sophisticated trial presentations. With litigation funding, the plaintiff's lawyer can afford focus groups, mock juries, and trial technology.

Without litigation funding, many of these claims would not have been brought or would not have lasted as long as they have been lasting. Defendants up against plaintiffs backed by litigation funding have had to bolster their legal teams, making some cases much more costly to defend than in the past. Defendants, faced with well-funded plaintiffs' lawyers with sophisticated technology, have had to match those resources to even the playing field. No doubt, this has caused a rise in claim costs.

Other factors are court decisions expanding liability, a broader reading on contract terms, and changes in laws and regulations that increase insurance losses. While most social inflation articles do not spend much time on legislative changes, certainly the reviver statutes for child abuse will increase insurance losses where legacy occurrence policies may be called on to defend and indemnify those revived claims.

The Effect of Social Inflation on Insurance Companies

Higher claim costs lead to higher insurance premiums. It is that simple. Greater insurance premiums lead to greater reinsurance premiums. This is what insurers are seeing in lines of business such as commercial automobile, directors and officers, medical malpractice, and commercial general liability. Moreover, unanticipated higher claim costs and significant jury verdicts may cause some insurance companies to shut down lines of business or, in the extreme situation, go out of business.

When insurance premiums rise, competition becomes fierce among those insurance companies in the marketplace still willing to write the underlying business. Yet, other companies, some new to the business, may undercut the rising premiums to gain market share. A downward premium trend because of competition in the face of social inflation could cause several new insurance insolvencies.

The problem ceding insurers face is that it is very difficult to measure and predict social inflation. This is because there is a behavioral element to social inflation arising from generational and attitudinal changes in society about fair compensation and righting wrongs.

Like other past trends, social inflation is something rating agencies are looking at when evaluating the financial stability of insurance companies. For public companies, rating agency commentary about how those companies are addressing social inflation could cause negative sentiment among investors. Moreover, if the rating agencies start downgrading insurance companies because of social inflation, that will affect the ability of those downgraded insurance companies to write business, obtain financing, and procure reinsurance.

An insurance company's response to social inflation may also trigger regulatory inquiry or action. Obviously, a regulatory action could affect a ceding insurer's ability to obtain reinsurance and continue writing business and, under certain circumstances, could cause termination of a reinsurance contract.

Why Should Reinsurers Care about Social Inflation?

Reinsurers are subject to many of the same issues that face ceding insurers dealing with social inflation. The rising costs of insurance claims and significantly higher jury verdicts and settlements directly affect reinsurers because those changes alter the economic dynamics of the reinsurance contract. Nevertheless, generally reinsurers are one step removed and have no direct control over the policies issued or claims managed by ceding insurers. This makes them even more vulnerable to social inflation of insurance claims.

With the very low interest rate environment we have had for the past several years, reinsurers' margins are tied to positive underwriting results and predicable claim developments. When unanticipated claim costs and expenses occur due to social inflation, a reinsurer's ability to make a profit may disappear. In fact, enough runaway verdicts on high-severity claims will cause a reinsurance contract to go negative for the reinsurer.

Social inflation is similar to any emerging risk except that social inflation is not an actual risk but a driver of the increased costs to address risks. Like emerging risks, the effects of social inflation may skew reinsurance contracts by significantly altering the economic underpinnings of the reinsurance contract from when originally written.

This is especially true for legacy property and casualty reinsurance contracts covering occurrence-based policies that are still running off. A reinsurer may have a reinsurance contract with a ceding insurer that for years or decades has been in the black with a loss ratio of 70 percent. Social inflation can cause long-tail claims to resolve at much more expensive settlements or jury awards than in the past, pushing the overall loss ratio for the reinsurance contract to 100 percent or more. Additionally, legacy claims filed under reviver statutes may reawaken dormant treaties.

Because of these economic considerations, reinsurers are watching carefully for trends in monthly and quarterly claims and are working with their ceding insurers to anticipate and mitigate the effects of social inflation. That is a daunting task given the uncertainty and unpredictability of social inflation.

What Can Reinsurers Do about Social Inflation?

As with all uncertainties, reinsurers need to monitor claims developments closely and analyze the data to determine whether and how they will engage in new reinsurance contracts covering lines of business affected by social inflation. Unfortunately, there is not much a reinsurer can do about legacy reinsurance contracts.

Reinsurers can, however, closely monitor claims and assist the ceding insurer in the claims resolution process. Most reinsurance contracts allow reinsurers to associate with the ceding insurer in the defense or control of claims. Social inflation may prompt some reinsurers to invoke the association clause and become more proactive with larger claims. More proactive involvement by reinsurers, especially those with significant treaty participations, could mitigate social inflation by speeding up the settlement process.

Conclusion

While social inflation and its effect on insurance claims is not new, it has become a much more significant issue for ceding insurers and reinsurers in the past several years. The unpredictability that social inflation brings to insurance claims makes a challenging business even more challenging.

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