THE MARKET HAS BEEN SOFT FOR OVER A DECADE WHY DID IT START TO TURN NOW?

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From early 2018 onwards the aviation insurance market has seen a the start of a shift in the pricing of aviation policies, turning from at least a dozen years of year-on-year rate reductions to increasing premiums. This article highlights the factors driving this change in direction for the US general aviation insurance market.

In a free market one could assume that such a change in market dynamics could have been triggered by a shift in the balance of supply and demand. This was only partially the case. Demand for aviation insurance is fairly stable and can be easily be catered for by the industry, so not a factor. Supply of insurance offering by the insurers reduced only slightly in terms of the number of insurers offering this product. Reinsurance capacity for the segments didn't reduce either. But capacity offered to the market did shrink somewhat artificially by aviation underwriters no longer offering their lines to the same extent, or by restricting it for specific segments.

For an underlying client base that appreciates a certain predictability of insurance pricing, it's probably for the better that the forces of supply and demand didn't exert their full power, but that – in general – a gradual, digestible change was implemented.

To see why insurers started to ask for more premium and selectively to restrict their capacity, we'll look at what happened on both sides of the equation: incoming premium and outgoing cost.

1 RATES HAVE GONE DOWN FOR A VERY LONG TIME

Quite evidently, this is the main reason for why they are going up now. Increased competition caused the market to enter into a downward trend during the latter half of the last decade. Around the time several new insurers entered the market there was still a margin to be made, so the incumbents didn't sacrifice market share and protected their portfolio whilst the new entrants undercut them to gain market share. This dynamic lead to continuous rate reductions, and continued past the point where there was still a margin in the market, spiralling to a low rating level where underwriters as a whole are losing money.

As aviation underwriters struggled to create a turning market on their own, other strategies were employed like shifting portfolio composition: attempting to reduce exposure to loss-making business and growing into areas perceived to be more profitable. Staying away from risks perceived as difficult to insure is still a seen as an effective measure, whereas growth into new segments has been shown to not yield any better results.

2 DIMINISHING INVESTMENT INCOME

Since the economic crisis interest rates have been extremely low, very little margin for underwriters was made on the investments. Thus, this item in the P&L dried up. The booming stock market post the depression didn't help much, as most insurance companies take little risk on the asset side, but rather invest their income on secure fixed interest rate government or corporate bonds. Interest rates are starting to slowly pick up now again, but are a long way still from subsidizing underwriting profit in a meaningful way.

3 LOSSES IN OTHER LINES OF BUSINESS

Underwriters were unable to effectively hit the brakes in that dynamic of year-on-year rate reductions on their own. The hurricanes of 2017 (Harvey, Irma, Maria) created the opportunity to break out of this spiral. The losses of insurance companies overall in 2017 highlighted the fact that an underperforming aviation segment could not be cross-subsidized any longer by the larger P&C lines.

4 RESERVING BUFFERS USED UP

Insurance companies carry some buffer from past years through prudent reserving of losses. In the soft market this helped a while to hide deteriorating underwriting results in a financial year view by releasing some of that buffer again (and only building up a slimmer new buffer). Once that stream was used up, there was less possibility to cover the lack of profitability.

5 INCREASING LOSS ADJUSTMENT EXPENSE

Since external service providers of the industry such as loss adjusters and lawyers are becoming a little more expensive every year through inflation, it should be quite natural that insurance premiums tick up slightly annually to make up for that increased cost in handling claims. If they don't, it's another cost increasing relative to premium.

6 INCREASING COST OF REPAIR

With aircraft becoming more complex and of composite material, repair costs are going up. As has been highlighted also in this publication, this is a factor which can't be ignored. Partial hull losses are simply costing more to repair now than they used to.

7 INCREASING FREQUENCY AND SEVERITY OF HIGH LIABILITY AWARDS

The awarded payments for injury and fatality cases in the US have a lot of precedence in being comparatively high for smooth-limit policies. However, in recent years there has been a series of liability claims above 10m USD that could not be covered by the available premium base. Some of these losses were headline making and are well known, others were settled without media attention but nevertheless in double-digit million figures. In recent years a handful of injury and fatality cases made up between 10% and 20% of total GA market premium each year, spread across the market.

8 INCREASING ACQUISITION COST

The portion of the incoming premium paid to brokers is another factor on the cost side that has been increasing. The increasing acquisition cost as a percentage of premium has pushed up the combined ratio of insurers.

9 INCREASING INTERNAL COST

Overall premium income to the market reducing doesn't mean that the costs of underwriters for their business is reducing in parallel. To the contrary, since the number of policies hasn't reduced the cost ratios of insurers has been increasing. Underwriters have attempted to mitigate this effect by cutting cost through efficiency gains, automation or outsourcing, but there is only so much that can be done on this.

None of these factors on its own would have driven the market to change, in fact most of these have been around for a long time. But precisely the continued pressure on results by all of these has caused the market to initiate change: either (more) insurance companies would have pulled out of the class of aviation business and thus caused a severe cut in supply of capacity, or underwriters could reverse the trend of reducing rates and charge more for their product again. For the stability of the market place these changes don't happen overnight in a drastic manner, but the changes need to be maintained over a longer period to ensure that the product offering becomes sustainable again for parties in the value chain.