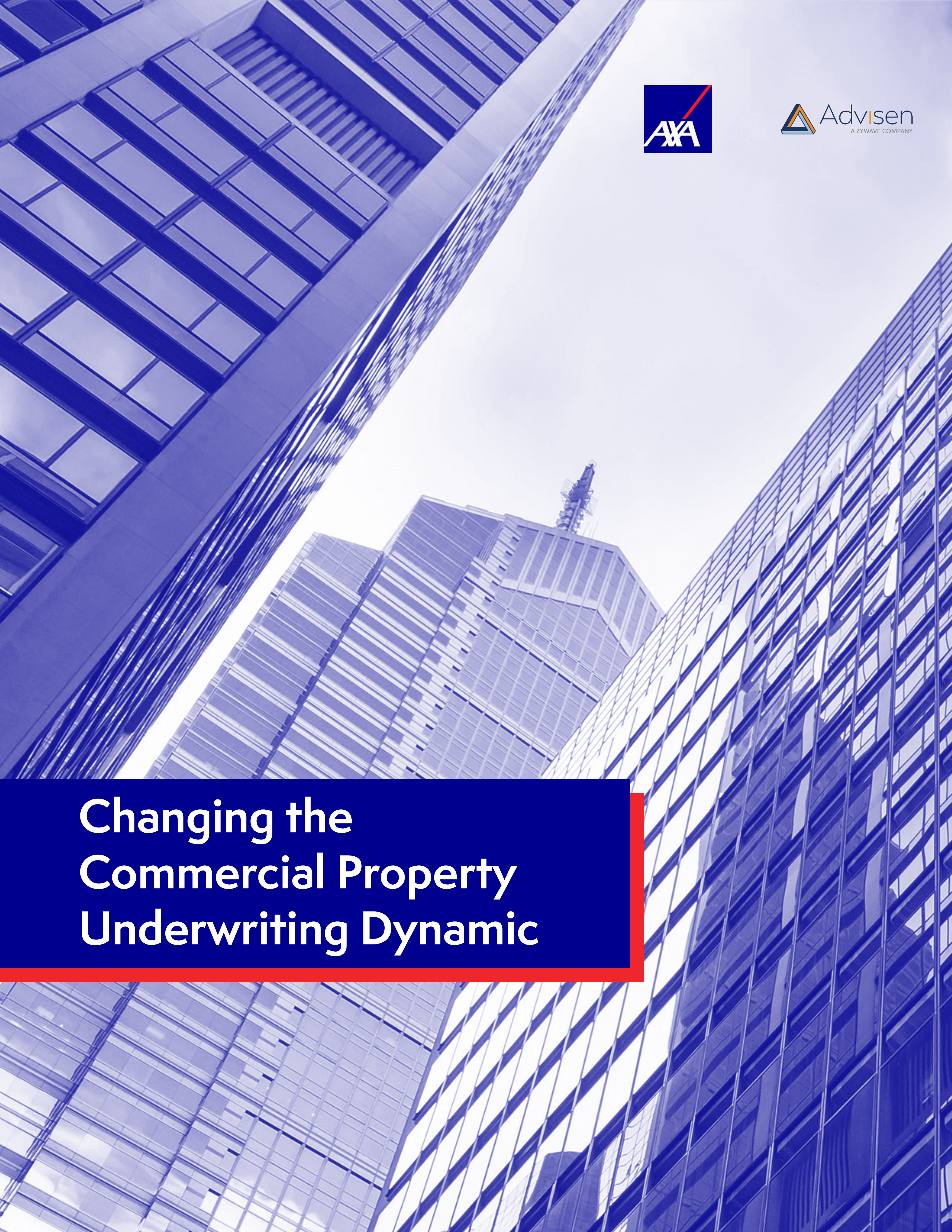

Changing the Commercial Property Underwriting Dynamic

Introduction

Current commercial property insurance market conditions—brought on by rising property losses from natural disasters and surging rebuilding costs due to pandemic-related struggles—have highlighted the inefficiencies of commercial property underwriting, emphasizing the need for change. By innovating the underwriting process through enhanced data collection and technology utilization, those within the commercial property market could be better positioned to navigate its evolving risks.

Keep reading to learn more.

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The Current State of the Commercial Property Market

In recent years, the commercial property insurance space has continually hardened, resulting in a range of coverage and underwriting challenges. Specifically, a continued uptick in property-related losses has negatively impacted underwriting profitability and prompted quarterly premium rate increases since the third quarter of 2017. In addition to elevated coverage pricing, the hard market has also resulted in reduced capacity and further policy restrictions or exclusions.[1] Although the past year showed some signs of moderation and rate deceleration within the commercial property space (e.g., a transition from double-digit to single-digit rate increases), a greater market shift remains unlikely in the short term—thus contributing to ongoing underwriting concerns, rate increases and coverage challenges.[2]

Several factors have contributed to the current state of the market. Namely, a rise in the frequency and severity of natural disasters has subsequently caused a surge in commercial property claims and related costs. After all, extreme weather events (e.g., hurricanes, tornadoes, winter storms and wildfires) have become increasingly catastrophic over the years, leaving behind significant damages and claiming numerous lives. In the last five years (between 2017 and 2021), the National Oceanic and Atmospheric Administration (NOAA) reported **86 natural disasters** with overall damages exceeding $1 billion, **costing a total of $742.1 billion** and resulting in 4,519 deaths. Furthermore, the NOAA ranked 2021 as one of the most devastating years on record, contributing to 20 extreme weather events, resulting in **$145 billion in damages** and **688 fatalities**.[3]

1 https://axaxl.com/fast-fast-forward/articles/market-dynamics-driving-a-dynamic-market
2 https://www.wtwco.com/en-US/Insights/2021/11/insurance-marketplace-realities-2022-property
3 https://www.ncdc.noaa.gov/billions/

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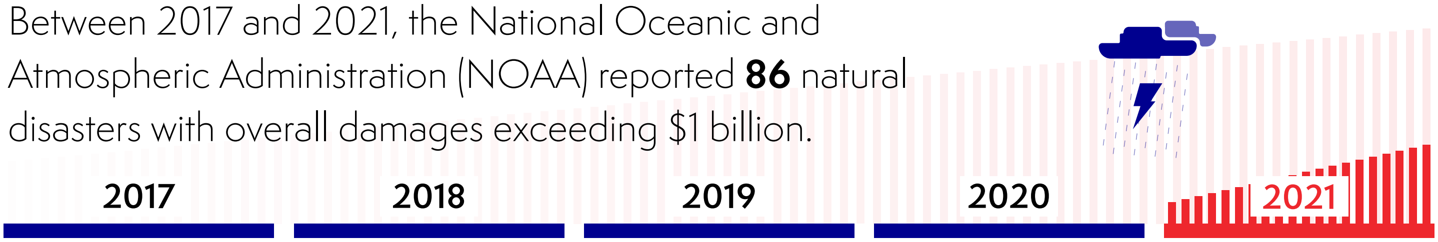

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Taking a closer look at these events, different areas of the country have faced varying natural disaster threats. Widespread drought and wildfires have recently plagued the West Coast, resulting in thousands of fires and burning millions of acres. In the past year alone, the National Interagency Fire Center recorded 52,729 wildfires in the area, contributing to the destruction of 6.6 million acres.[4] Meanwhile, hurricanes, tropical storms and severe flooding have become a growing concern across the Gulf and East Coasts. The NOAA confirmed that the 2021 Atlantic hurricane season recorded the third highest number of storms in history, producing 21 named storms (four of which were major hurricanes).[5] These storms have also surged in severity, with many Category 4 and 5 hurricanes over the past few years (i.e., Florence, Irma, Michael, Harvey and Ida), leading to substantial flood and wind damage.

Across the Midwest—an area prone to winter storms—losses caused by secondary perils (e.g., hailstorms and snow) have surged throughout the past few decades. Within the Great Plains (also called "Tornado Alley"), destructive tornadoes continue to wreak havoc. What's worse, tornado season has become less predictable, with tornadoes now being recorded earlier and later in the year. Tornadoes have also begun spreading to areas outside of Tornado Alley, evidenced by states such as Alabama and Kentucky reporting more than double the annual number of tornadoes compared to 2000.[6]

Apart from a rise in extreme weather events, the commercial property insurance market has also been influenced by the COVID-19 pandemic in recent years. While the market has not encountered a substantial number of claims attributed directly to the pandemic, various trends created by COVID-19—mainly supply chain and inflation issues—have gone

4 https://www.iii.org/article/spotlight-on-catastrophes-insurance-issues
5 https://www.noaa.gov/news-release/active-2021-atlantic-hurricane-season-officially-ends
6 https://www.usatoday.com/in-depth/news/nation/2021/06/16/tornado-season-changing-spreading-across-south-deaths-and-destruction/5134403001/

on to affect commercial property rebuilding costs and subsequent coverage expenses. In particular, the availability of various building materials (e.g., lumber and steel) diminished during 2021, whereas demand for these items skyrocketed. In response, the price of these materials soared, therefore inflating property construction costs; in fact, the Insurance Journal reported that property construction expenses jumped by 8.1% between 2020 and 2021.[7] Making matters worse, ongoing pandemic-related worker shortages in the construction sector have resulted in rising labor costs and potential project delays. Amid supply chain issues and inflation concerns, property losses that require the rebuilding of damaged structures have surged in cost—influencing overall claim expenses, minimizing underwriting profitability and, in some cases, posing underinsurance concerns for policyholders.

Altogether, these natural disasters and pandemic-related struggles have placed a significant strain on the commercial property insurance market, contributing to large-scale claims and major underwriting losses. Looking ahead, extreme weather events are expected to only become more common and costly. Additionally, the unpredictable nature of the pandemic still makes it hard to determine when supply chain problems, inflation issues and related property rebuilding cost concerns will subside. This means commercial property insurers will likely find it increasingly difficult to keep up with rising claim frequency and severity for the foreseeable future. Such challenges highlight how critical it is for underwriters to adapt to current market trends and update their evaluation strategies in this evolving risk landscape.

[7] https://www.insurancejournal.com/blogs/the-hanover/2021/06/14/618400.htm

The History of Underwriting in the Commercial Property Market

Historically, underwriting processes within the commercial property market have been quite manual and tedious. In other words, underwriters have relied heavily on putting pencil to paper, leveraging various spreadsheets based on property location and conducting their own calculations.

What's more, underwriters have looked to brokers and insureds to provide them with a variety of information—information that is critical to generating accurate property valuations, assessing potential exposures, and determining coverage capabilities. This information may include property occupancies, operational hazards, building contents, business income estimates and data on adjacent buildings, among other topics.

Unfortunately, it's common for underwriters to receive limited or inaccurate information and resources from these parties. This lackluster reporting may stem from a diminished sense of trust between insureds and underwriters. Insureds may fear that reporting higher values may lead to increased premium. With limited ways to double-check valuations and other information shared, underwriters typically often take the data they receive at face value (unless a figure or calculation ends up being uncharacteristically high or low). In some cases, underwriters might try to confirm this information online, but it hasn't always been easy to access.

"In current market conditions, given inflation and supply chain issues, undervaluing property can have a big impact on the claims experience."

Mark Evans, AXA XL's Head of Property Claims

There are several problems with these manual underwriting processes. First, they can be extremely time-consuming and inefficient for all parties involved, including those providing data and the underwriters who utilize this information to make important calculations and coverage decisions. Additionally, any incorrect data that underwriters are provided could significantly impact their final valuations and associated policy determinations. In the case of underreported values, underwriters may determine a reduced premium rate for an insured. Yet, this may result in the insurer taking on more risk than they realize. When a claim occurs, the resulting costs could exceed the insured's coverage capabilities, leaving them underinsured, generating elevated underwriting losses and potentially tarnishing the relationship between the insured and their insurer. Especially amid a hard market, underreporting can carry serious consequences.[8]

Consider a 10,000-square-foot building that, today, would cost about $1 million to replace. Unfortunately, a business may still be providing their insurers with older information that says the building is valued at $750,000. If the property value is not reevaluated, and a property underwriter bases coverage and premium on that $750,000 value, obvious issues will crop up if there is a loss.

"In this case, this business may be buying insufficient insurance if they have a total loss and need to totally rebuild," AXA XL's Head of Property Claims **Mark Evans** explained. *"In current market conditions, given inflation and supply chain issues, undervaluing property can have a big impact on the claims experience."*

Compounding underwriting concerns, the commercial property market's risks and exposures are constantly changing, making it increasingly difficult to make accurate calculations and coverage decisions. The uncertainty surrounding the ongoing COVID-19 pandemic has certainly put added stress on underwriters, as they must consider evolving supply chain complications and inflation struggles within the scope of property valuations. Extreme weather events have also forced underwriters to reevaluate their current tactics. Such natural disasters are not only rising in frequency and severity, but they are also extending to areas that haven't been exposed in the past, as evidenced by trends such as the growing number of tornadoes occurring outside Tornado Alley. These shifts have only made it more challenging for underwriters to evaluate properties' weather-related exposures based on their location, emphasizing the need for enhanced underwriting processes.

8 https://axaxl.com/fast-fast-forward/articles/property-perspective_why-accurate-property-valuations-matter-and-three-ways-to-get-the-right-numbers

The last major change to underwriting processes within the commercial property insurance market took place during the late 1980s, upon the introduction of catastrophe modeling—also known as CAT modeling. This form of modeling was developed as property insurers became increasingly aware of their growing catastrophic exposures—namely, natural disasters. CAT modeling combines a wide range of important data (e.g., historical disaster information, property demographics, scientific research and financial reports) to determine the potential cost of catastrophic events within a particular geographic area. By utilizing vast databases across multiple disciplines and a series of four modules (i.e., event, hazard, vulnerability and financial), CAT modeling allows for the physical simulation of various natural disasters that could occur in a specific area, providing more accurate projections regarding the effects these disasters may have on nearby communities and properties.[9]

Since its debut, underwriters have utilized CAT modeling to improve their overall decision-making capabilities, better determine properties' unique natural disaster risks and establish more effective coverage pricing strategies to combat these exposures. In other words, CAT modeling promoted the utilization of both financial and scientific data within underwriting processes to help insurers effectively plan for natural disasters, thus opening up capacity across the market.[10] Similar to how CAT modeling introduced a paradigm shift in commercial property underwriting, ongoing underwriting inefficiencies in today's hard market highlight how vital it is for yet another shift in the realm of underwriting innovation.

9 https://www.rms.com/catastrophe-modeling
10 https://www.iii.org/article/catastrophe-modeling-vital-tool-risk-management-box

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Michele Sansone, AXA XL's Chief Underwriting Officer for Americas Property

Innovating the Commercial Property Underwriting Process

There are multiple steps that need to be taken to enhance commercial property underwriting processes. First and foremost, data collection measures must improve. Specifically, underwriters should have easier access to all of the information they need to conduct accurate calculations and make effective coverage decisions.

According to **Michele Sansone**, AXA XL's Chief Underwriting Officer for Americas Property, *"Not getting accurate Total Insurable Values (TIVs) across our clients' enterprises is a challenge because it does not allow us to price the risk adequately."*

In commercial property insurance, TIV is the sum of the full value of a client's covered property, business income values and any other insured property, like equipment. It's the collective valuation of the business' operation.

"Too often in the annual property underwriting process, TIVs get a passing glance. They are not updated regularly," Sansone added. "When businesses provide out-of-date or underestimated TIVs, risk pricing is based on faulty data." In order to bolster data collection measures, it's important to break down the barriers standing between policyholders and insurers, establishing a more transparent and trusting relationship. This may entail insurers communicating with their insureds to explain that data collection is intended to ensure an accurate underwriting experience, therefore providing more personalized coverage that addresses unique property exposures. Policyholders also need to be made aware of the risks involved with underreporting their information, helping discourage them from sharing inaccurate data.

"While the primary purpose of property valuations is to supply underwriters with data, they also demonstrate a spirit of collaboration when done accurately and transparently," Sansone said. "They are the bedrock of a trusting relationship that yields long-term benefits for insurers and insureds alike."

Additionally, it's important for insurers to be more open with insureds about the underwriting process and further explain how their information is utilized in coverage pricing and related decisions.

Apart from creating more transparent and trusting relationships, data collection measures can be improved by giving insureds additional avenues to share their information. Rather than simply asking insureds to manually fill out an application for their commercial property, they should be able to provide their data through various means (e.g., mobile insurance applications, online platforms, and personal conversations with brokers). Establishing a variety of methods for sharing this information will not only make data collection easier, but it may also allow insurers to gather additional, higher quality information, thus enhancing underwriting processes and providing insureds with the best possible coverage. Having access to a larger quantity of quality data could also give insureds opportunities to advance their product and service offerings.

In addition to improving data collection measures, commercial property underwriting processes can be innovated through the increased utilization of technology and adaptation of digital tools. Relying more heavily on technology can eliminate the tedious aspects currently involved in the risk assessment and underwriting processes and simplify property valuation and premium calculation practices.

AXA XL, for instance, is looking to provide digitized tool to help in assessing property risks and giving clients a "bigger" picture of their potential property exposures.

"Usually, risk assessments focus on a company's primary locations," explained **Scott Ewing**, Head of AXA XL Risk Consulting in the Americas. *"Smaller sites are overlooked, but that also means potential risk exposures are overlooked too."*

His team has introduced Risk Scanning, a risk assessment tool that allows for a more thorough, cost-effective assessment across all of a business' properties in a fraction of the time. Through a digital application, AXA XL tailors a risk survey of closed questions asked to risk managers, facility managers or others on-site. This survey covers a variety of risks, including fire and explosion, intrusion and theft, natural hazards, environment, health and safety, cyber, storage and vehicle fleets. Using external data, AXA XL then analyzes each location, weighting different risk variables and the probability of risk occurrence, and proposes actions and protection recommendations to mitigate the risks.

"Especially given the severe weather we continue to see, companies of all sizes and across industries can benefit by taking the extra step to boost their property protections using Risk Scanning's risk scores, recommendations and decision-making tools to build more inclusive, complete loss prevention plans," Sansone said.

By adopting new technology, the commercial property insurance market is looking to minimize the likelihood of underwriting errors stemming from manual mistakes and provide insureds with more timely communications regarding their coverage. Examples of such technology may include:

Data collection, storage and processing tools

(e.g., a platform for insureds to submit commercial property information)

Predictive modeling programs

(e.g., a service that offers virtual simulations of various disaster scenarios and outlines potential claim expenses)

Altogether, implementing these enhanced data collection measures and technology offerings can make all the difference in helping underwriters correctly and efficiently assess commercial properties; it can allow insurers to take on appropriate amounts of risk and providing policyholders with a positive coverage experience. However, insurers don't need to enhance their underwriting processes alone. Through collaboration with other insurers and industry professionals (e.g., working together to create data collection platforms and sharing predictive modeling insights), underwriting practices across the commercial property insurance market can be improved, prompting greater innovation.

Reinvigorating Commercial Property Underwriting

AXA XL is no stranger to innovation in the realm of commercial property underwriting. Establishing strong relationships with insureds and establishing a sense of transparency are key priorities at AXA XL. Insureds are encouraged to share their data to enhance underwriting capabilities, and AXA XL is also committed to providing valuable insights and information.

Risk avoidance is still the best risk management technique, so strong loss prevention practices and risk engineering are key. Accounts that have business continuity plans in place, make capital expenditures on improvements to fortify properties more securely from extreme weather events and can demonstrate they are better year over year from a risk perspective fare better than those that do not.

In addition to new services like Risk Scanning, AXA XL's property risk engineering services give insureds access to a range of important data that can be utilized to minimize potential commercial property losses and subsequent claims, keeping coverage costs under control and promoting policyholder satisfaction.

"After all, it's vital to give insureds information and risk mitigation guidance that matters," **Ewing** said. *"At AXA XL, insurance is more than just a document; instead, it's an actionable feedback loop that requires input from all parties involved—including underwriters and insureds."*

Clearly, underwriting processes within the commercial property insurance market need to shift. Fortunately, adopting innovative strategies—such as enhanced data collection measures and increased technology utilization—can help eliminate underwriting inefficiencies and help both insurers and policyholders ensure proper protection amid the latest market conditions.