JLT Re

COMMERCIAL AUTO MARKET BRIEFING

JLT Re
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INTRODUCTION

As we noted in our November 2017 report, THE ROAD AHEAD: TRENDS IN THE U.S. AUTO INSURANCE MARKET, a stronger economy, commercial driver shortage and smartphone-driven increase in distracted driving were leading factors in auto insurers' deteriorating claims experience since at least 2010.

These factors acutely impacted underwriting results in the commercial auto line in particular, resulting in sharp underperformance relative to all other major property and casualty (P&C) lines over this period. While new and emerging safety technologies promise to reduce claims frequency and severity in the long term, the only meaningful impact of this technology in aggregate so far has been to increase the average cost per accident—a sensor-infused bumper, for example, can cost three to six times as much to replace as its low-tech antecedent.

However, after several years of lagging improvements in rates, underwriting guidelines, and fleet management controls, among other improvements, the outlook for the U.S. commercial auto insurance segment is encouraging. While we expect to see more consolidation and exits amongst perennial under-performers, further rate strengthening should be reflected in improved accident year profit margins for the top tier underwriters in 2019 and through 2020.

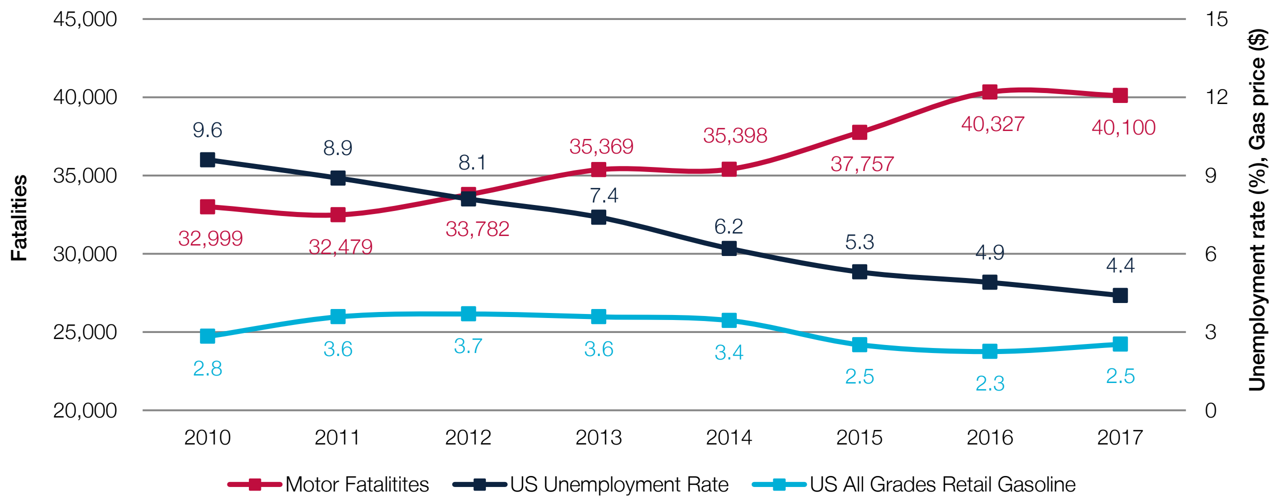
ACCIDENT FREQUENCY AND SEVERITY

From late 2010, a multitude of adverse issues have contributed to a distinct uptick in loss frequency for both personal and commercial auto lines carriers.

Reacting to deteriorating accident year loss ratios, carriers enacted serial rate increases that proved largely insufficient year after year. Many also struggled to maintain adequate accident year loss reserves. In light of these difficulties, several carriers changed their business model, reduced exposures or left the space entirely.

One of the core issues that has driven poor performance is simply the increase in miles driven. Economic recovery and reduced fuel prices mean more cars on the road, each driving more miles. At the same time, accidents attributed to distracted driving have surged in conjunction with the proliferation of smart phones and GPS. Meanwhile, accident frequency from aggressive and impaired driving spiked and remains high.

U.S. Unemployment Rate (%), Retail Gasoline Prices (USD/Gallon) vs Motor Fatalitites



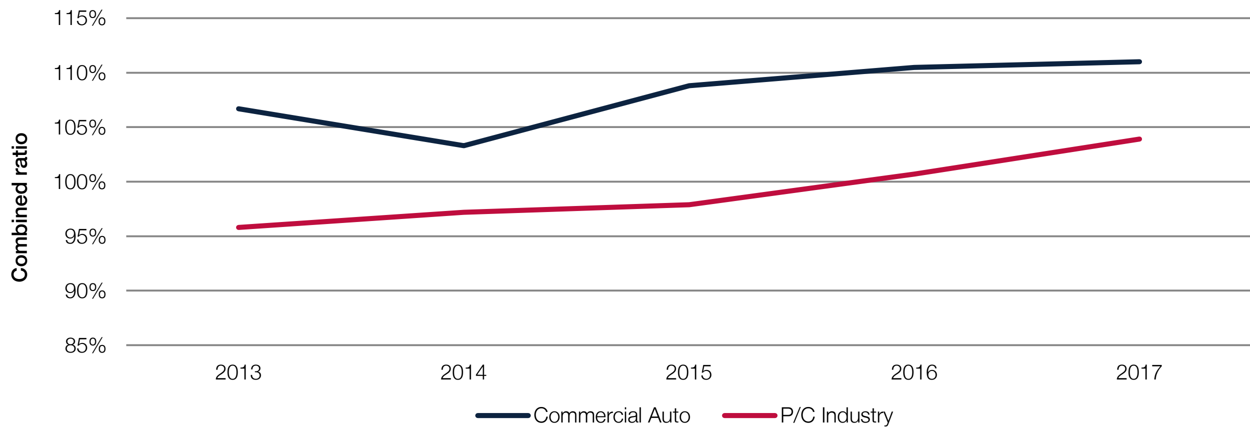
Source: National Center for Statistics & Analytics(NCSA), National Safety Council

The rise in frequency was multiplied by a subsequent rise in severity, driven by U.S. medical cost increases and more expensive components and services.

Economic growth means greater demand for logistics. More commercial fleet activity has contributed to premium growth for insurance carriers, but has also resulted in a severe shortage of experienced truck drivers. In addition to a large number of relatively inexperienced drivers taking the wheel, many long and short-haul drivers are overworked and operating at chronically higher levels of fatigue.

From a five-year low of 103.3% in 2014, the sector's combined ratio has been on a slow rise, reaching 111% at year-end 2017. There is evidence of minor improvement in 2018, although the line remains far from profitable and the aggregate combined ratio is 6.9pp above the P&C industry average.

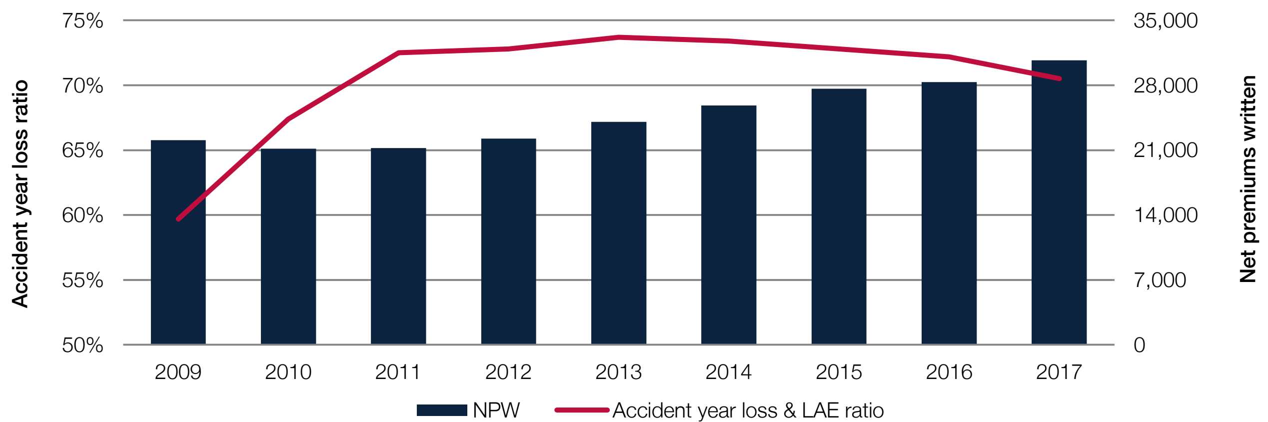
Calendar year combined ratio – commercial auto vs aggregate P&C sector



Source: A.M. Best

On an accident year basis, we see that loss ratios remain elevated, but have improved moderately from 73.7% in 2013 to 70.5% in 2017. While we expect the most recent accident year loss ratios to deteriorate somewhat, this is a promising sign for a sector in need of relief. We expect the top tier insurers to show material improvement in 2019-20, assisted to a degree by the application of analytics in pricing and risk selection.

U.S. Commercial Auto AY Loss & LAE Ratio vs NPW



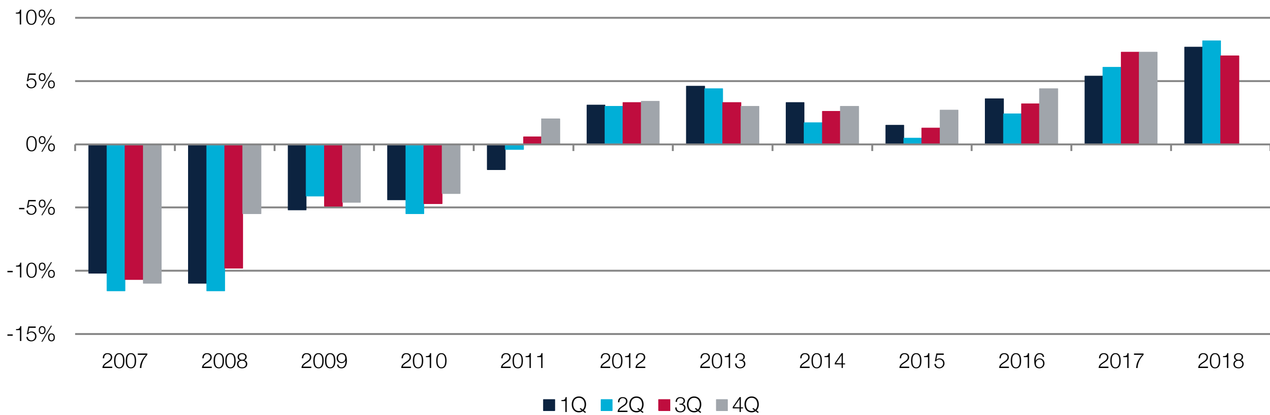
Source: A.M. Best

CORRECTIVE ACTIONS

The industry has been combating these issues with rate increases since 2011, and the aggregate increase is just starting to prove adequate in some segments.

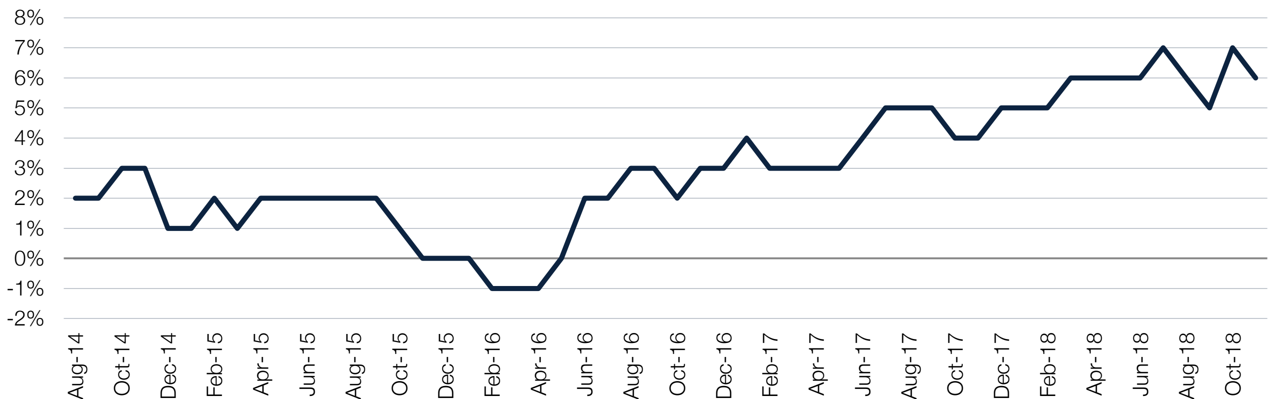
The commercial auto segment led the way with considerable rate increases in recent years, reaching a peak quarterly increase of 8.2% in Q2 2018 per The Council of Insurance Agents & Brokers (CIAB). In a sign that rates are beginning to prove adequate, for the first time in the past ten consecutive quarters, the Q3 2018 increase was less than the previous quarter, coming in at 7%. Other major insurance rate surveys, including the IVANS Index and MarketScout, show similar trends.

U.S. Commercial Auto Quarterly Rate Changes



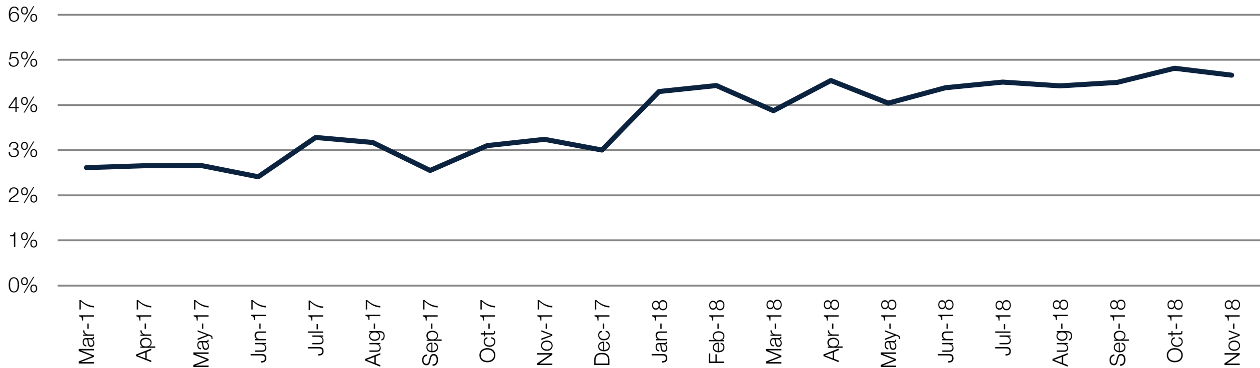
Source: A.M. Best

U.S. Commercial Auto Monthly Rate Changes



Source: MarketScout & Wells Fargo Securities, LLC.

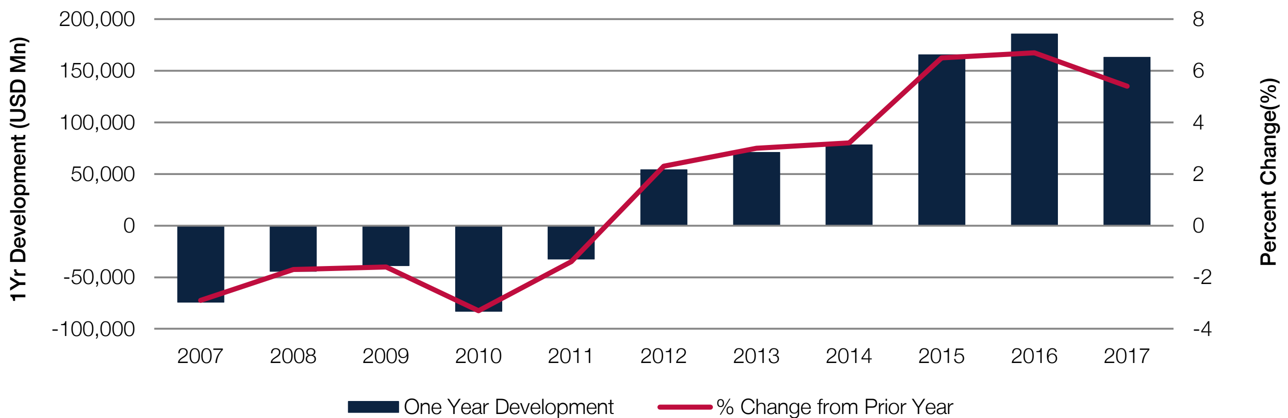
U.S. Commercial Auto Monthly Rate Changes



Source: IVANS Index
**IVANS is calculated as renewal premium change, which does includes the impact of exposure*

After years of underpricing risks in an extremely difficult environment of rising frequency & severity trends, the sector has naturally seen significant adverse reserve development. Looking at recent trends, development levels remain elevated compared to historical averages, but may have reached a tipping point with lower development in 2017 and further reductions anticipated for full-year 2018.

U.S. Commercial Auto Liability Reserve development



Source: A.M. Best

Carriers in this space have been forced to tighten underwriting guidelines and implement stronger risk control measures to offset the rise in frequency. Commercial auto writers are now focusing their resources on the implementation of improved underwriting and efficiencies, leading to lower loss frequency trends. In the aggregate, the sector has made positive strides and we have observed commercial auto claim frequency flatten in 2017 and 2018. Underwriters have re-evaluated their risk appetite, focusing on the more profitable industry niches while avoiding others.

In addition to stronger risk selection, there are a number of risk control measures companies have taken to reduce frequency. Examples include periodic monitoring of MVRs and road testing of drivers in the vehicles they will be operating. Additionally, companies have mandated rules such as seat belt usage, hands-free cell phones, driver safety incentives and more frequent vehicle inspections. Telematics and GPS tracking are now fundamental to fleet management, with data showing they are reducing not only accident frequency and severity but also reducing the number of “close calls”.

The motor industry as a whole has benefitted from prudent regulations that include the Carrier Safety Act of 2010 (CSA 2010). The program is designed to improve safety and prevent motor vehicle crashes, fatalities and injuries. One of core components of the CSA is the Carrier Safety Measurement System (CSMS) which provides timely, accurate and publically available safety performance and equipment maintenance data to the Federal Motor Carrier Safety Administration (FMCSA). The CSMS has improved results for the trucking insurance industry by giving carriers access to improved underwriting data and therefore improving risk selection. Insurance companies are using these scores to identify unsafe motor carriers and make more informed underwriting decisions.

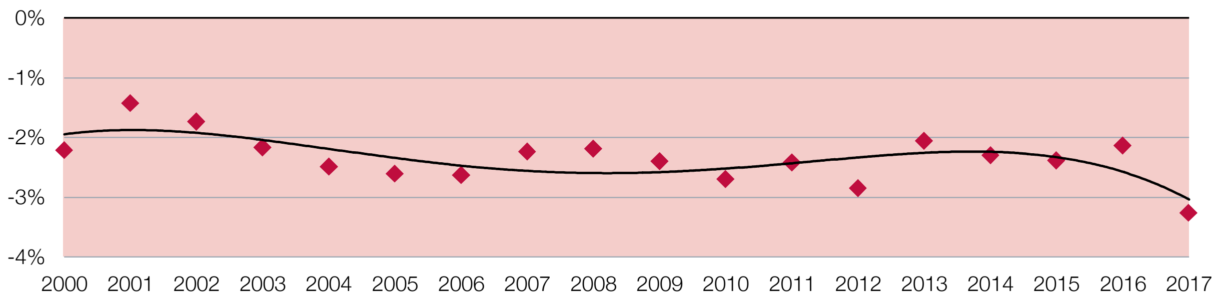
The FMCSA mandates the use of Electronic Logging Devices (ELDs) in commercial vehicles, replacing the manually-written log books of the past. ELDs have greatly improved the quality and quantity of data available to operators and insurers and have led directly to a marked reduction in accidents related to sleep deprivation. As of April 2018, all CDL drivers are now required maintain an ELD and remain in compliance with hours of service rules. These positive regulatory actions are making the road safer for all drivers and “driving” what should be a long-term improvement in underwriting results.

AUTO INSURANCE ONE-YEAR RESERVE DEVELOPMENT TRENDS

A longer term look at reserve trends between the three statutory auto lines provides some additional insight.

Reserve development in the auto physical lines remains favorable, averaging 2.35% from 2001 to 2017, which is a reduction from the auto physical loss ratio from favorable development. However, one-year loss reserve development for U.S. commercial auto liability and personal auto liability transitioned from favorable to unfavorable development over the same period, only showing modest improvement in 2016 to 2017.

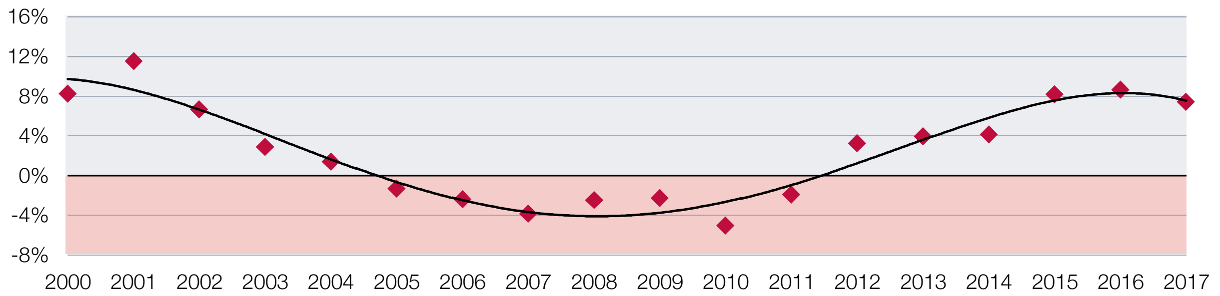
One-year reserve development ratio trend for US Auto Physical Damage as a percentage of Net Premiums Earned



Source: S&P Global Market Intelligence

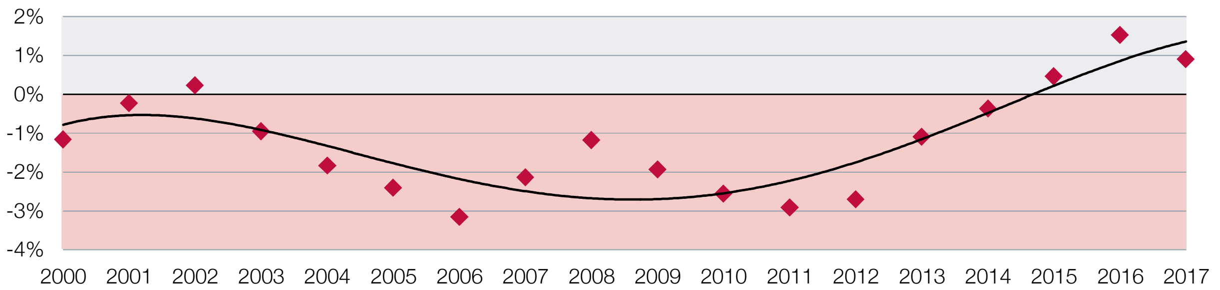
Commercial auto loss liability transitioned from favorable to unfavorable loss reserve development in 2011, indicating growing loss reserve deficiency over the last five years. Reinsurers have been driving rate increases to keep up with unfavorable loss trends; commercial auto liability can be regarded as a true hard market. Similarly, loss development for private passenger liability entered unfavorable territory in 2015, with signs of a persisting reserve deficiency. However, in 2017, the commercial auto reserve trend flattened and actually shows a modest decrease, a step in the right direction.

One-year reserve development ratio trend for US Commercial Auto Liability as a percentage of Net Premiums Earned



Source: S&P Global Market Intelligence

One-year reserve development ratio trend for US Private Passenger Auto Liability as a percentage of Net Premiums Earned



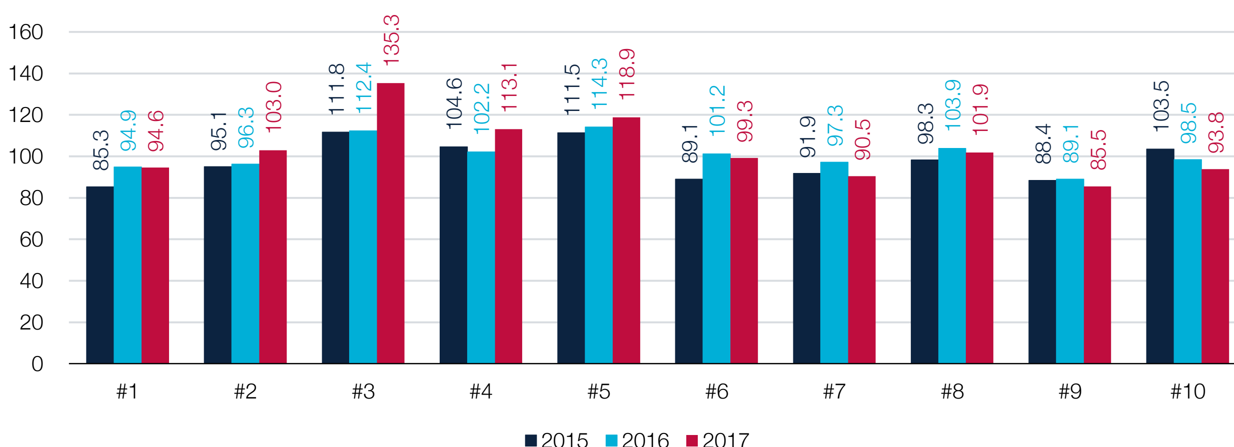
Source: S&P Global Market Intelligence

CARRIER DIFFERENTIATION

Not all carriers have suffered the same during these difficult market conditions. Proactive companies with strong underwriting guidelines have already been enjoying solid margins and will likely continue to do so as the sector hardens.

A look at the top ten shows a wide range of results. Some players in the top ten commercial auto writers have nearly doubled their direct written premiums in the space over the past five years, while maintaining strong underwriting profit each year. Meanwhile, others have seen their results deteriorating. There is even greater diversity of results outside of the top ten, with a combined ratio gap of over 50 points between the top and bottom tiers.

Top 10 Commercial Auto Carriers' Combined Ratio (%)



Source: A.M. Best

The commercial auto line remains a sore spot for many insurers, but it's clear that underwriting strategy and risk controls can materially improve results. Many of the top performers effectively use new technologies, including telematics and other data-driven risk selection, to reduce losses & claims expenses. Additionally, risk composition can be a differentiator. Several carriers have found success focusing on diversified small businesses with small fleets, while many carriers that focus exclusively on large fleets and long-haul trucking have fared far worse due to adverse systemic risk factors.

One of the thornier issues with commercial auto is that it is often written only as an accommodation or as part of a larger commercial risk package. Underwriters may thus be forced to accept a poorly-priced auto book to retain the larger account. In these situations, reinsurance can be a particularly useful risk and capital management tool.

LOOKING AHEAD – A LIGHT AT THE END OF THE TUNNEL

With significant headwinds at the macro level, the commercial auto space is far from out of the woods, and will likely remain a thorn in the side for many larger legacy players that have been hit the hardest.

The rising amount of miles driven, lower fuel costs and distracted driving are significant issues that will not dissipate overnight, but we have seen the positive impact of the implementation of regulations and risk controls moving the sector towards a “normalization” of loss frequency over the course of 2018. Combined with the lagging improvement in rates, many carriers, particularly the commercial auto specialists, are seeing improvements in today’s margins.

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