



Inflation and the impact on Insurance Risk

Key Messages:

- It would appear that high inflation is here for some time. This means there is an increased risk that existing declared values will quickly get out of date.
- Not only does this mean that 'Day One' declarations should be correct but loading factors for future cost movements (policy year and reinstatement period), and the sums allowed for demolition and debris removal, need close monitoring.
- The temptation, to rely upon a previous assessment or internal estimate and just to index this for several years, could leave policyholders exposed given the variation in cost and foreign exchange movements.



What do we mean by inflation?

The rate of inflation is the change in prices for goods and services over time. While the Consumer Price Index (CPI) is often the figure reported in news headlines, due to the index composition, this rate doesn't always correlate to the changes in costs for goods or services in the construction or manufacturing sectors.

For example, the UK CPI figure was 7% for the year to March 2022 whereas the index of materials and fuels purchased by UK manufacturers was up 19.2% over the same period.

What has been happening?

General Price Inflation

The Consumer Prices Index rose by 7.0% in the 12 months to March 2022 according to the UK Office of National Statistics (ONS) . This is the highest CPI rate since March 1992, when it stood at 7.1%.

Construction Materials Inflation

In the UK, the ONS shows overall costs for basic metals and fabricated products were up 24.2% in the 12 months to March 2022 .

According to the US Bureau of Labor Statistics (BLS) , iron and steel costs were up 36% in the 12 months to March 2022. Compared to the lowest point over the last decade (in 2016), the cost of iron and steel materials and products were up 127%.



Similarly, the US BLS shows plastic pipe costs were up 57% in the 12 months to March 2022. Again, compared to the lowest point over the last decade (in 2016), the cost of these products was up 111%.

The World Bank indicates that Aluminium prices rose from around US\$ 2,190 per tonne in March 2021 to around US\$ 3,498 in March 2022, an increase of 59.7%.

The London Metals Exchange suggests that the price of copper has risen from around US\$ 8,700 per tonne in April 2021 to US\$ 9,800 per tonne in April 2022, an increase of 12.6% over this period.

Finished Goods Inflation

The annual rate of manufacturing output inflation increased to 11.9% in March 2022 according to the UK Office of National Statistics . This is the highest the annual rate has been since September 2008.

A significant contribution to this overall rate increase has been the cost of fuel, up 58.3% over this period, but metal, machinery and equipment costs have risen by 18.2%, transport costs up by 6.9% and chemicals costs were up 18.3%.

Across the European Union , producer price indices are up 14.9% in the 12 months to February 2022.

Why has this been happening?

Oil and Gas Prices

Energy prices have risen sharply since the start of 2022, with broad-based increases across all fuels. According to World Bank data, Brent crude oil averaged US\$ 116 per barrel in March 2022, an increase of 55% compared to December 2021.

The costs of crude oil had been steady increasing through most of 2021 from the lows of US\$ 45 per barrel in January 2021. These cost increases during 2021 were primarily driven by production capacity constraints, low storage inventories, geopolitics, and rising demand post-covid.

Most of the recent increases have been driven by the conflict in Ukraine. As sanctions against Russia were introduced, oil firms announced plans to exit or scale back Russian investment, and traders discontinued trades due to difficulties in obtaining cargo insurance or in making transactions.

These rises in oil and gas prices in Europe, are in turn leading to higher manufacturing costs, particularly for energy intensive industries such as brick and cement manufacture.

Increasing energy prices will also drive up the cost of extracting and refining metal ores, particularly for aluminium, iron ore, and steel.

Ongoing Impact of Covid

One of the early impacts of Covid was the forced closure of production plants around the world. When demand subsequently rebounded the reductions in capacity due to shutdowns and historically low inventory levels remained causing supply shortages and cost increases. Steel mills for example were quick to idle furnaces but were slow to bring this idle capacity back online in many locations.

As can be seen with the lockdowns in China in March and April 2022, there continues to be repercussions to the spread of Covid and this is having a knock-on effect on demand, supply chains and costs.

While capacity and inventories have mainly recovered, we continue to see some longer-term effects of Covid, from new restrictions in China to increased job vacancies as many employees took early retirement or changed careers.

Supply Chain and Logistics Changes

One early consequence of Covid was that many shipping lines retrenched older container vessels. This reduction in vessel numbers, combined with temporary closure of shipping container manufacturers and changes in demand along major routes, meant that there was reduced capacity on many lines and containers ended up in the wrong locations. For example, the cost of shipping a 40-foot container to Europe from Asia went from US\$ 1,800 at the start of 2020 to over US\$ 10,000 by the end of that year.

According to Container Trades Statistics, about 25% more cargo was shipped from Asia to the US in the first eight months of 2021 compared with the same period in 2019 pre-pandemic, demonstrating the shift in demand along certain routes. In practice, this has created challenges for port operators and logistics firms.

Shanghai is the world's largest container port and while the government there has stated its intent to support the operation of the port, the recent forced closure of factories and distribution centres across China, due to Covid is leading to reduced exports. Container Trades Statistics state in their latest market highlight that Far East Exports were down 24% in February 2022.

The lockdowns in China are also having an impact on internal demand for goods, as factories and retail operations are closed. While this may reduce the demand, and hence price, for oil & gas these closures are likely to exasperate the existing supply chain issues for goods coming from China , driving up the cost of goods and materials exported to European countries.

Geo-political Changes

Even before the start of the conflict in Ukraine there were trade tensions across the world that were having an impact of the cost of goods and materials.

Going back as far as the imposition of trade tariffs on steel and aluminium imports by the Trump administration in the US in early 2018, there have been significant new cross-border controls or tariffs that fuelled an increase in costs over the last few years. While some of these have been removed by new trade agreements or the reversal of trade tariffs, there remains ongoing barriers to trade that have pushed up costs.

In the UK, Brexit has had an impact on costs, through shortages of labour (e.g. HGV drivers and abattoir workers), increased regulatory costs or UK exporters finding it harder to get the components they need from the EU . A recent academic paper even suggesting that Brexit alone constitutes 2.9% of the increase in consumer prices.

Changes in Labour Markets

U.S. economy near maximum employment and average hourly wages jumped 0.6% in December 2021. In the UK, job creation has hit record levels, and the government were mulling minimum wage increases to ease the pain of the cost-of-living surge.

Companies in certain industries have to pay higher wages to attract or keep staff. The well-publicised shortage of heavy goods vehicle drivers in late 2021, exacerbated by Covid-19 and Brexit, has pushed up transportation costs as firms have increased wages to attract drivers.

What are the forecasts for inflation?

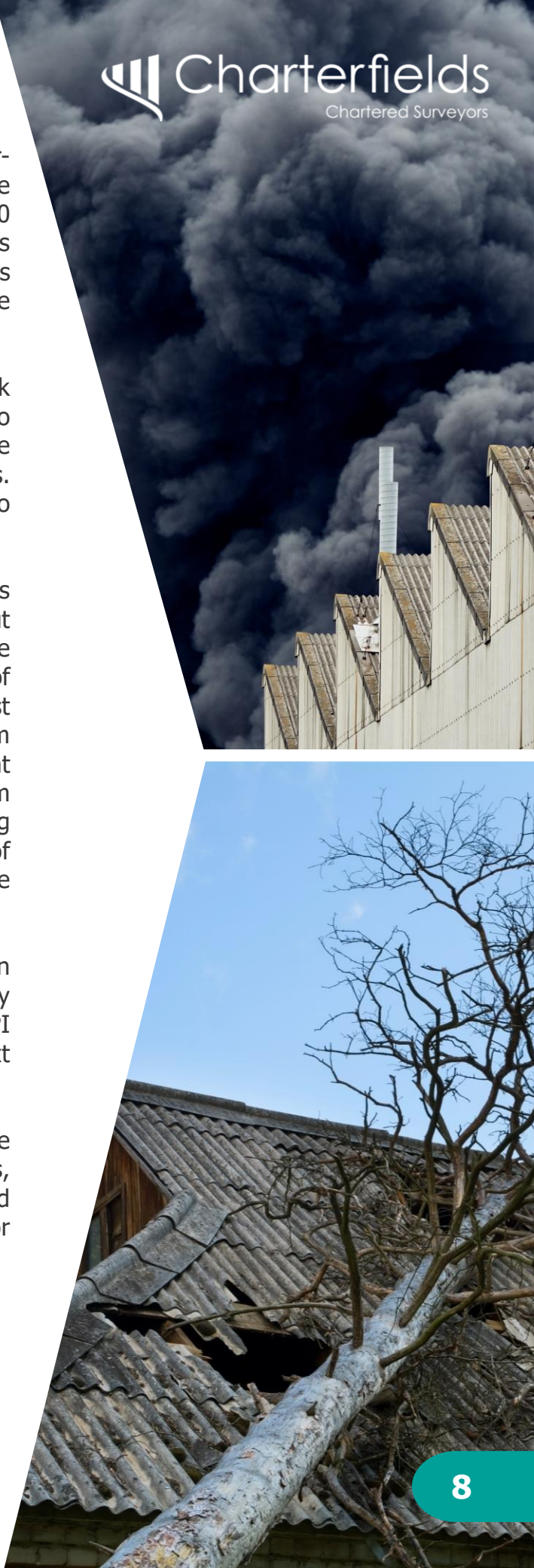
The World Bank expects that because of war-related trade and production disruptions, the price of Brent crude oil will average US\$ 100 a barrel in 2022. European natural-gas prices are expected to be twice as high in 2022 as they were in 2021, while coal prices are expected to be 80% higher.

Metal prices are projected by the World Bank to increase by about 16% in 2022 relative to 2021 and ease somewhat in 2023, while remaining at historically elevated levels. Nickel and aluminium prices are expected to increase by 52% and 38% respectively.

The heightened volatility in commodity prices after February 2022 reflects concerns about the current and potential impact of the Ukraine war on the production and trade of commodities. Russia is the world's largest exporter of pig iron, natural gas, palladium and nickel and accounts for a significant proportion of platinum and refined aluminium exports. Ukraine is also a key exporter of pig iron, as well as being the largest exporter of neon gas, a critical input into the manufacture of electronic chips.

The Bank of England expect UK CPI inflation to exceed 8% later this year. However, they also state that they expect the rate of CPI inflation to fall considerably over the next couple of years.

Overall, despite the uncertainties on the impact of the Ukraine conflict on prices, inflation for construction materials and related products will be at relatively high levels for some time.



How does inflation impact insurers?

Weaker fixed income returns – while equities can offer an inflation hedge, it can also mean elevated capital requirements should the stock market be volatile. Combined with weaker fixed income returns due to higher liabilities costs, and insurers may face a need to rebuild margins through reducing cover, disputing more claims or higher premiums.

Larger claims – inflation will translate into higher claims for insurers, which they may not have anticipated at the beginning of the policies.

Greater unanticipated costs – insurers will face inflation in their own costs as well as unanticipated increases in claims costs, particularly for larger claims that take years to settle.

How does inflation impact policyholders?

In light of the pressure on margins instigated by inflation, we expect to see insurers and reinsurers refocus on premium growth, perhaps reversing the slowing of premium increases seen over the last few quarters.

There is also likely to be an increased focus on the accuracy of declared values submitted by policyholders and we expect that there may be additional expectations from insurers in terms of documentary evidence to support figures submitted on renewal.

Continuing a trend that began with the 'hardening' of the insurance market (i.e. increased premiums) we expect to see further tightening of claims handling by insurers, including the reassessment of declared values, and more detailed investigations on loss causation.



📌 Conclusions – what actions should policyholders take?

In April 2022, the British Chambers of Commerce quarterly economic study found that 70% of construction firms and 72% of transportation and distribution firms were expecting to increase their prices over the coming three months.

It would appear that high inflation is here for some time. This means there is an increased risk that existing declared values will quickly get out of date.

Not only does this mean that 'Day One' declarations should be correct but loading factors for future cost movements (policy year and reinstatement period), and the sums allowed for demolition and debris removal, need close monitoring.

Policyholders ought to conduct careful analysis to arrive at accurate reinstatement costs, particularly when considering declared values for property damage insurance policies. It is vital to reflect the appropriate cost movements if updating previous declared values or historic costs.

If a formal independent assessment has not been carried out in recent history – three years being the recommended period between assessment points - then this would be wise.

The temptation, to rely upon a previous assessment or internal estimate and just to index this for several years, could leave policyholders critically exposed.



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