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How Inflation Impacts Insurance Claims and How Actuaries Can Step In to Help

As inflation drives up claims costs, setting accurate reserves is more important than ever.

By: Pinnacle Actuarial Resources Inc. | October 2023

Businesses across sectors have been grappling with the impacts of inflation for several quarters. The insurance industry is no exception.

"For the last 18 to 24 months, we have regularly heard from clients about concerns with inflation and supply chain disruption," said Derek Freihaut, FCAS, MAAA, principal and consulting actuary with Pinnacle Actuarial Resources. "A thoughtful actuarial partner will take the full impact of inflation into account in the work they produce for clients," he said.

It's fairly simple to understand how inflation increases costs for insurers. If the materials needed to make an insured whole — to replace or repair a home, for example — are more expensive, a carrier will have to pay out more.

"Everything costs more," Freihaut said. "For claims, if more money is needed, reserves will need to go up."

But it's not just inflation that has been increasing claims costs. Supply chain issues are making it more difficult to get needed supplies for repairs. Labor costs also increased as a result of the Great Resignation. "It was an extremely tight labor market," Freihaut said. "If it's harder to find employees, it's harder to find people to fix, manufacture, ship or otherwise complete things."

All of these factors result in longer claims durations, which can be expensive for insurers. Actuaries must take into consideration that it is taking longer to settle claims than historical data may show.

"When claims take longer to close, they generally end up costing more," Freihaut said. "More things may go wrong while the claim is open, or it may require more money to close the claim."

Few lines are immune to these inflationary pressures. It's easy to see the effects of inflation in property or auto lines, but liability, too, is seeing increased costs due to delays and longer claims durations. Added to that is the impact of social inflation, a trend where verdicts have crept higher and higher in recent years.

"COVID shut down courts. As a consequence, there were issues with insurers getting claims through the court system. So we're still seeing some backlog of liability claims working their way through the system after courts reopened," Freihaut said.

"The large verdicts which are sometimes due to social inflation are a complicated issue and are attributable to a number of factors. One of those factors is perception. Companies struggling with large verdicts on the liability side may be victims of the fact that a million dollars isn't perceived as the same large amount as it had been historically. Inflation may be pushing on that perception even more."

The Ripple Effects: Inflation's Impact on Excess Layers and Reinsurance

Derek Freihaut, FCAS, MAAA, Principal and Consulting Actuary, Pinnacle Actuarial Resources

Inflation's effects on the insurance industry go beyond increasing the costs of individual claims. When claims costs rise, they're more likely to exceed an insured's primary policy layer, bringing more losses into the excess layers.

As Freihaut explained, "If you have 10% inflation but you're only covering losses for the first $100,000, the impact of the inflation on you might be 7 or 8%. The impact of inflation on the excess losses that you're ceding to somebody else — the excess of $100,000 — might be 15 or 20% or more."

Excess layers, therefore, also feel the sting of inflation, perhaps even more than primary carriers or companies with captives who underwrite their own exposures.

"Due to inflation, more losses are piercing the excess layer. Excess layers also receive the full impact of inflationary increases on losses already in the layer," Freihaut said. "Excess layers get hit much harder in highly inflationary environments."

All of these factors are contributing to higher reinsurance rates. As insurers see higher loss costs, reinsurers — who provide financial protection to carriers — are facing losses as well.

"To the extent that you have excess coverage, inflation will tend to drive up reinsurance costs even further," Freihaut said.

How the Right Actuarial Partner Can Help

In today's inflationary environment, setting adequate insurance rates and calculating appropriate reserves is paramount. Carriers should look to their actuarial partners for help analyzing the cost of risks so they can be sure they're setting their reserves and rates accurately.

"You need to make sure you're getting the appropriate rate and holding suitable reserves," Freihaut said. "Estimates that are too high or too low can lead to problems."

Strong actuarial partners know how to adjust their estimates to anticipate the effects of inflation on claims. They understand how inflation has affected different lines and different carriers. Insurers may feel the effects of inflation more strongly depending on the types or locations of their exposures.

"Inflation must be considered when an actuary develops estimates of reserves. It also plays out in how we project existing claims and how expensive we think individual claims are," Freihaut added.

Pinnacle Actuarial Resources understands the importance of accurately evaluating the financial cost of a given exposure. The firm communicates regularly with clients and works with them to make changes to their reserve estimates to adjust for the effects of inflation.

"We advise clients on how and why inflation is incorporated in the reserve estimate," Freihaut said. "Communication is critical to help clients understand what's going on in the market and help them make the right business decisions with respect to their reserve levels and premiums."

And Pinnacle is paying attention to inflation trends to ensure that as the economic pressure eases, so too do their projections. "Even as we went into the high-inflation period of 2022, by the time we were in the fall, most economists were calling for inflation to be cut in half in 2023 and return to more normal levels thereafter," Freihaut said. "We understood that fundamentally and counseled our clients accordingly. It would not have been appropriate to project out that inflation was going to stay at 8 to 10% for the next several years. It is important that we consider the various potential changes in inflation so that our estimates help clients to make the best possible business decisions."

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