ASPEN OPINION

ENVIRONMENTAL: A TALE OF TWO MARKETS?

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William McElroy observes that the withdrawal of significant underwriting capacity usually marks an inflexion point for pricing - particularly if it is clear that the retreat has been prompted by volatile results. Yet the recent withdrawal of some long-established providers from pollution legal liability has seemingly encouraged a more competitive market and prices in the pollution market have continued to fall. Meanwhile, the reported hardening of prices in casualty combined classes may yet prove optimistic.

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Two Products

The environmental class of business is typically described by two discrete types of programs: pollution coverage and environmental casualty. Traditional pollution coverage - often termed as pollution legal liability - generally insures only losses resulting from a pollution condition. Coverage is shaped by regulatory obligations, contractual duties imposed by customers, business requirements imposed by lenders or investors, as well as sound risk management principles. Underwriters' risk includes clean-up cost, bodily injury (BI) and property damage (PD) from pollution incidents at a site. Cover is often focused on site conditions rather than operations and occurs from loss arising or migrating from the insured location. Business is written on a claims-made basis and is generally of short duration. However, while claims may be reported within a limited period, the uncertainty of valuations may cause a very long development period before reaching the ultimate loss valuation.

In contrast, environmental casualty combines standard general liability coverage with pollution coverage in a single policy under a single limit. Business is driven by limited capacity in the broader casualty market to insure operational risk with some element of environmental exposure. Cover is focused on operational risk and general liability will include coverage for BI and PD resulting from premises risk and products liability. In addition, coverage is often provided for clean-up costs, BI and PD resulting from pollution incidents at insured locations or resulting from covered operations. This would include, for example, an explosion from a chemical release or spill at a work site. In contrast to pollution coverage, environmental casualty is written on an occurrence basis with long tail claims resolution.

State of the Market

Pricing in the pollution market has been depressed for some time despite the withdrawal of some long-established providers and large loss activity in the segment. Indeed, elements of the market that seem to need correction are being more strongly influenced by capacity from newer entrants. Newer markets are at times offering more generous terms than those at which established markets are non-renewing. However, there have been recent signs of improvement in terms and conditions. Historically, policy terms of between five and ten years were commonplace, but it is now becoming more difficult to bind carriers for such a long duration. In addition, it is becoming increasing apparent that losses associated with mold conditions are exceeding expectations in terms of both frequency and severity.

Mold and construction defect related losses, which are not rare, are prompting insurers to increase deductibles especially in states exposed to weather-related catastrophes. Elsewhere, the historically competitive real estate segment (portfolios including hospitality, habitational, higher education and medical) is being reassessed and the assumption that this is a low-hazard sector is being challenged by thoughtful underwriters. Re-evaluation is also occurring following losses on brownfield project placements which had been a growth area. This underwriting scrutiny is focusing on the distinction between truly fortuitous events, and the emergence or re-emergence of chronic contamination conditions.

Environmental casualty is usually written in the excess & surplus lines market. This allows flexibility in form and rate of coverage to meet the particular needs of buyers that is not possible in the admitted market. While environmental casualty

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would be expected to be more closely linked to pricing activity in the general casualty market, it has not always been that way. A worrying trend appears to be emerging as some of the more challenging elements of pollution coverage are creeping into the environmental casualty market. More important, in some segments, standards of underwriting scrutiny seem more lax than those applied in the standard pollution market despite high profile losses.

Rate increases have not adequately addressed the increased pollution risk migrating to the environmental casualty market as loss emergence is outpacing any suggestion of rising rates or improvement in terms and conditions. For example, a convergence of a number of factors has increased both the severity and frequency of losses in automobile hazard but these trends are not being captured in the pricing of excess liability coverage in the environmental casualty market.

Similarities in Business

The long tail nature of environmental business suggests that underwriters should be particularly attuned to the dangers of aggressive top line growth into an oversupplied market. While prices may still be falling in the pollution coverage arena, there are signs that experienced underwriters are introducing a more disciplined approach to risk selection, limits and policy term.

The real story of performance in the segment can be difficult to discern against the backdrop of changing forms of coverage, frequent changes in carrier and lengthening reporting and development periods. However, the entire narrative of aggressive new capacity in the pollution segment interacting with incumbent loss development has a predictable outcome. While the environmental casualty market segment may seem more stable, it is concerning to see the more volatile elements of pollution coverage creeping into the environmental casualty market already challenged by casualty pricing trends. More unpleasant surprises should be expected.