Trend Review
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Hesitant Capital Had Looming Role at January 1 Reinsurance Renewals

Secondary perils fuel pressure on property catastrophe reinsurance, force shifts in capital deployment strategies

The much-anticipated reinsurance price hikes and tighter terms in the run-up to January 1, 2023, renewal season did not fall short of expectations. Secondary perils continue to fuel volatility around property catastrophe risks, rendering available reinsurance capacity as a sideline observer for the segment. How the potential redeployment of capital affects the relationship dynamics between reinsurers and insurers was discussed by an expert panel on *AM BestTV*.

AM Best is maintaining its Stable outlook on the global reinsurance segment, due to a mix of counter-balancing factors. Managing Director Anthony Diodato moderated the panel discussion, which included:

- Carlos Wong-Fupuy, Senior Director of Global Reinsurance, AM Best
- Aditya Dutt, President of Aeolus Capital Management
- Liz Cunningham, CEO of Somers Re

New Capital Is Being Very Cautious

Carlos Wong-Fupuy started the panel discussion by underscoring the rationale behind AM Best's ongoing Stable outlook for the global reinsurance segment. Although the positive and negative factors have strong underlying dynamics, they tend to counterbalance each other. He noted that risks are increasing in a more uncertain world, with insurable risks becoming more difficult to price.

The increased natural catastrophe activity in the past six years has not been driven by one significant event. Even in years without a major event, the accumulation of medium-sized or smaller events has translated into an average of claims in excess of $100 billion, which by all measures is significant.

This segment has, by AM Best's estimates, been generating return-on-equity ratios of approximately 4-5%, in a market where the cost of capital is at least twice as much. This is during a period of increased economic uncertainty, driven by concerns about inflation and recession. That cost of capital is due to increase even further.

These drivers are not just related to natural catastrophes. Geopolitical uncertainty and economic instability are impacting investor sentiment. Despite improving pricing trends and tighter terms and conditions, new capital is taking a very cautious approach. While the market remains well capitalized, it's important to note how capital is being deployed and that significant amounts remain on the sidelines.

On the positive side, it's clear that pricing conditions and terms have improved. The market remains disciplined, and insurance demand is quite strong. Given the shift from property catastrophe over the past two years, results have started to stabilize. More time is needed to see those results translate into something more permanent.

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Tense Renewals amid Changing Risk Appetites

Somers Re CEO Liz Cunningham detailed the price increases at the January 1 renewals, with double-digit growth occurring pretty much across all lines and in most geographic regions as well. Property writers experienced the heaviest hit, with catastrophe-exposed lines up 50% to 100% generally. Those were price corrections, and corrections to the terms and attachment points across the property space.

Cunningham said prior year reserve developments drove increases for casualty lines, along with overall portfolio performance. There were also significant hikes in certain pockets of the specialty lines segment, such as aerospace, which were driven by geopolitical uncertainty.

Aditya Dutt, president of Aeolus Capital Management, described the 2022-2023 timeframe as one of great significance when held up against the past decades. Although there are unique characteristics to the current market climate, some are comparable to past experience.

What has differed is the steady level of available capacity, in contrast to historic events of the past when that capacity was depleted and set the stage for a new influx of reinsurers and capital. Wong-Fupuy said that most global reinsurers remain very well capitalized. There are more recent concerns on the investment side, because of the unrealized investment losses, but no pressures on liquidity.

Even well-capitalized companies have been moving away from property catastrophe and reinsurance. These days it’s become difficult to find an exclusive property catastrophe reinsurer. However, it is a role that Aeolus Capital Management continues to have.

Dutt said some factors influencing the capital inflow are beyond the segment’s control, such as the rapid interest rate changes and the estimated ~20% drop-off in equity markets, all within the past 12 months alone. He cited the difference in economic conditions relative to the past 30 years, coupled with the increased incidence of large catastrophe events.

Common Traits Among Those Exiting Property-Catastrophe

Cunningham mentioned how much the world has changed in five years, with the needs of the population shifting as pandemic restrictions are removed. This has affected insurance purchasing and the related uncertainty is still working its way through. There is a hesitance to bring new capital in, which she said could change in 2023.

While a number of peak participants exited or trimmed back their property capacity in 2022, Cunningham said others see market inflation as a turning point and an opportunity. Those who left did share similar market characteristics, being larger, multi-platform players. She cited the cost of doing business on platforms such as the London market, where commissions can be five points higher than in Bermuda or Europe. A larger player with that multi-platform option can switch and put the business in play where the economics make sense.

Some may be waiting for definitive signs that pricing equilibrium has occurred and will last, according to Dutt. He explained that past patterns have been cyclical with large rate increases following years with significant catastrophe losses. That price discovery phase after 9/11 and Hurricane Katrina, Rita and Wilma happened to be followed by relatively clean years. Investors were rewarded for entering the market. “That has not been true for the past five years,” Dutt said. “Until we convince investors, which is very difficult to do, that we have reached pricing equilibrium, it’s very difficult for capital to come back in.”

Another factor is the accommodative monetary policy that has flooded the capital markets with money in a coordinated fashion. As those policies now get reversed, the cost of capital is rising across the board. A hurdle lies in persuading investors that an asset class has sustainable margins.

Cunningham noted that there are many dynamics behind what constitutes a level of adequacy, especially in view of losses and the macroeconomic factors in play. She said a rate deemed adequate in 2020 now requires additional points to withstand inflationary pressures.

Fording the Gap Between Available Capacity and Reinsurance Demand

Wong-Fupuy said the market dislocation did not reach the level expected by some back in December, possibly because the primary segment was prepared or had already adjusted. For several years, AM Best has observed the primary segment's profitability levels outperforming the reinsurance segment. There was excess reinsurance capacity being deployed into working layers in the primary segment at favorable terms, which probably should have retained that exposure. Now that adjustment is being made, which Wong-Fupuy believes could be healthy for the primary and reinsurance segments. He also noted that cost of capital discussion had previously involved very low inflation rates, which need to be addressed as well.

Dutt described the renewal season as difficult, with prices, terms and retention levels all changing. It was largely the result of cedents and reinsurers reaching a realistic meeting point, and increased retentions by primary insurance companies in the property catastrophe space. He explained that not all catastrophe business is conducted at the January 1 renewal season, and significant business is yet to be done through the year.

Heavy loss years have often been followed by innovation in the market, such as the property catastrophe modeling that developed significantly after 1992. Insurance-linked securities followed suit the early 2000s as investors saw merits in a non-correlated asset class. "It's now $90 billion or $100 billion of capital that is seeking that non-correlated exposure," Dutt said. "I would argue in the future, the specialist property cat reinsurance company would take the form of an ILS fund because that's where you can deliver this distilled property cat exposure to an investor who really wants it."

Dutt added that the diversified model is also critical in that it allows rated companies to leverage their capital more effectively by writing a diversified portfolio of risk. While mixing the primary insurance business with reinsurance is another play, the demands contained within can differ. Reinsurance focuses on underwriting and portfolio management skill. "The primary insurance business focuses on operations, scale, costs and underwriting excellence," Dutt said.

Cunningham believes the risk profiles of a primary insurer and reinsurer are completely different. While both are regulated industries, the regulation that primary insurers face is very distinctive. The difficulties surrounding the January 1 renewals did help to sharpen the focus on the importance of maintaining good long-term relationships throughout the cycle, but she characterized it as a providers' market.

Florida's Story Still in Search of Concluding Chapter

The impact of Florida's legislative reforms remain a work in progress. Measures to address rampant litigation against insurers and needed reinsurance capacity will take time to play out. Wong-Fupuy believes that mid-year renewal pricing may not reflect these legislative efforts, with plans for state-funded reinsurance capacity taking even longer to play out. That may ultimately determine how much opportunity is created in Florida, and whether the private sector is willing to underwrite more of it. "It doesn't affect the risks themselves," Wong-Fupuy said. "It's a very cat-exposed area. That's something that we can't change."

Diodato steered the discussion toward catastrophe modeling and asked whether there was an over-reliance on it. Dutt noted that models are not quite an accurate representation of reality but can serve as a proxy. He acknowledged that investors, with an assist from reinsurers, have probably over-relied on catastrophe models. The three key modules within that modeling—hazard, vulnerability, and damage—have changed very significantly over the last 15 years. Exposure growth in Florida and California, and other parts of the world that are now at risk has been very significant. “So much so that we have switched from (being a) seller to a buyer of protection for certain geographies and perils,” he said.

In conclusion, Wong-Fupuy noted how the market has evolved on a short-term basis into a more uncertain world with more difficult to price risks. The immediate reaction has been to reduce exposures, to withdraw from certain lines of business, which he views as a very prudent and logical approach. But a main challenge is that the more difficult risks are not going away—climate and cyber are two key examples. “The relevance that the reinsurance and insurance segment have to play in the broader economy is something that requires innovation and creativity to keep playing a significant role there.”

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