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Market Segment Outlook: Delegated Underwriting Authority Enterprises

DUAEs are increasingly proving their ability to manage a number of emerging risks by leveraging their expertise and intelligent use of data

AM Best is assigning a Positive outlook for the global delegated underwriting authority enterprises (DUAE) market. The Positive outlook reflects AM Best's expectation that this distribution segment will continue to strengthen owing to the growing interest from capacity providers and diverse capital investments, as well as the emergence of specialty expertise and technological advancements. Factors supporting the outlook include the following:

- Ongoing growth throughout this distribution channel, driven by technology, talent, and diverse sources of capital
- Growing interest in program business by capacity providers
- Private equity investments in the delegated underwriting authority market

Near-term concerns include the following:

- A potential pullback of capital and risk-bearing capacity, as well as elevated reinsurance costs
- Looming economic challenges, including stubbornly elevated inflation that will likely impact underwriting and reserve margins

AM Best defines a DUAE as a third-party appointed by a (re)insurer, through contractual agreements, to perform underwriting, claims handling, and other administrative functions on behalf of its partners. DUAEs comprise entities such as managing general agents, cover holders, program administrators, program underwriters, underwriting agencies, and appointed representatives.

DUAE Market Constitutes a Significant Distribution Channel

As an important distribution channel in the US for risks not widely accepted by standard carriers, DUAEs are increasingly proving their ability to manage emerging risks such as cyber and climate by leveraging their expertise and intelligent use of data, as well as pivoting risk strategies in ways that traditional carriers are not accustomed to. The DUAEs' responsiveness to emerging risks is driving investments, technology, and overall growth.

Businesses that suffered during the pandemic are now resurging, thanks to the post-pandemic rise in premium rates. Specific niche markets where DUAEs have assisted insurers with access to new business opportunities include cyber insurance. DUAE programs that specialize in cyber have been the beneficiaries of significant investments in their programs. Thus far in 2022, cyber-focused investments are just shy of $1 billion, driven by the DUAEs' ability to capitalize on their expertise and advanced technology to strengthen their distribution channels.

The growth of volatile risks such as exposures to the frequency and severity of US weather-related events in the excess and surplus (E&S) lines market supported the double-digit increase in premium for that market in 2021. Challenges due to secondary perils allow DUAEs to play a vital role in matching these risks and insurers. As admitted carriers continue to retract capacity from property catastrophe risks, the E&S distribution channel will see steady results.

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In Europe and Asia-Pacific, the DUAE markets are fragmented. In some countries, DUAEs have long-established operations with high penetration rates; in others, the market is nascent or emerging. The fragmentation in part reflects the way insurance business is transacted/distributed, as well as regulations governing insurance agents and DUAEs in individual countries.

Additionally, DUAEs have proven their attractiveness as employers, with an influx of new talent the last several years. Executives and underwriters may be shifting from the traditional insurance market, as they look for enhanced compensation and equity rewards from DUAEs, but the flexibility of the model is also an incentive for talent with tech experience, such as software developers and data miners. DUAEs are fostering an entrepreneurial culture in their organizations, allowing their key staff to retain agency over their programs and results. Competition for talent from the traditional market and beyond is expected to remain tight, as the market continues to attract diverse sources of capital.

Significant investments in technology allow DUAEs to better analyze data in volatile markets and attract talent from the tech industry. The focus on quality technology is not only about data analysis and modeling—there is a need for continually streamlined technology that can identify untapped niche markets, increase touchpoints with clients, and improve the policyholder experience. Cost efficiencies and accessible technology provide an added benefit.

Early adopters are reaping the benefits of these investments, which provide ample growth opportunities. As technological advancements continue to develop rapidly, investments in the segment will remain a valuable response to supply-side drivers, as carriers and other capacity partners look to navigate hard market conditions. Steady investments in technology, especially those that allow for new ways to analyze data sets, will continue.

Growing Interest from Capacity Providers

Most lines of business have experienced pricing increases and hardening market conditions over the past 12 months. For most DUAEs, however, capacity remains available and sufficient. In contrast, capacity is tighter for new DUAE entrants and certain products (e.g., peak peril property catastrophe exposure).

Global reinsurers' appetites for DUAE business have grown, as they look to diversify and manage counter-party relationships. Additionally, the expansion of participatory fronting companies is providing greater access for reinsurer participation. This acceptance of risk by a fronting company supports the alignment of interest and helps fortify processes, partnerships, underwriting capabilities, claims handling, and management of reinsurance. These factors are the key drivers of the significant expansion in the number of fronting companies globally.

The UK and London markets are among the most developed DUAE markets outside the US, with significant growth in established businesses, new start-ups, and M&A in recent years. Lloyd's, which pulled capacity in 2020 as part of its broader program to reduce its exposure to underperforming businesses, has since expanded capacity and is expected to remain a major source of global DUAE capacity.

Capital supplied by the insurance-linked securities (ILS) market for DUAEs is also expected to continue to grow. ILS capital is seeking to back DUAEs with strong track records, for which the traditional reinsurance market is proving tougher at this time. As DUAEs increasingly look to maintain reinsurance capital, this trend is likely to continue into next year.

Private Equity Investments in DUAE Market Fueling M&A

The segment has attracted more sources of capital from other than traditional carriers or fronting arrangements. DUAEs have shown that they can maintain low balance sheet risk, high free cash flow from operations, and wide EBITDA margins. Private equity investors are taking advantage of opportunities to invest in the segment owing to wider margins from the hard market and a general resistance to economic down cycles.

Private equity capital helps DUAEs scale their businesses, as well as solidify M&A. According to the 2022 Conning Strategic Study Series, 79 acquisitions took place in 2021, more than doubling the previous year's record of 29. M&A growth was also robust in the first half of 2022. Finance costs are rising due to high valuations, but M&A is expected to continue to grow in 2023. M&A is not only a key indicator of synergy in the market, but also an indicator of the amount of capital available.

Longevity of Expanded Sources of Capital

Near-term concerns about sources of capital could become an issue for reinsurers. The growing number of private equity-backed DUAEs raises concerns about the commitment of private equity investors over the long term. A key concern for reinsurers is the longevity of private capital investments given the potential for underperformance by a book of business in volatile markets, especially those with large catastrophe-exposed books. Addressing alignment issues with investors and carriers, such as identifying potential exit strategies, is important.

Looming Economic Challenges

The market faces a number of macroeconomic challenges. Although inflation tends to escalate premium volume, concerns about the impact on current and prior year expected losses is growing. An extended period of accelerating inflation is especially problematic for long-tail lines of business, underscoring the importance of revisiting prior assumptions and adjusting rates. Expectations of a recession in the US will remain a consideration in the market. The DUAE market is likely to see less demand in some classes of business, such as economically sensitive commercial lines, as would be expected in a recessionary environment.

Looking Ahead

DUAEs have become a relied upon distribution channel for insurers of all types and under all market conditions. Talent and technology have played a vital role in adding value to the market. As larger insurance companies struggle with legacy systems and databases, the smaller DUAEs have proven to be agile implementing systems that can perform the risk selection, pricing, and underwriting that are central to insurers' profitability. Furthermore, the influx of professionals with superior underwriting skills and a network of relationships have enhanced the value-add of DUAEs. Given the migration of underwriting talent to DUAEs, ongoing support from reinsurers has been a major driver of the segment's success.

The DUAE market should continue to grow as an attractive option for capacity looking to diversify and access distribution.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook

Positive	A Positive market segment outlook indicates that AM Best expects market trends to have a positive influence on companies operating in the market over the next 12 months. However, a Positive outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Positive.
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BEST'S MARKET SEGMENT REPORT

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