November 30, 2022

Market Segment Outlook: Global Reinsurance

The outlook remains at Stable, as positive factors are counterbalanced by negative ones

AM Best is maintaining its Stable outlook on the global reinsurance segment. Market conditions are highly uncertain. Despite most drivers not being seen as stable in isolation, overall a number of positive factors are counterbalanced by negative ones.

The main negative drivers are listed below:

- Heightened natural catastrophe activity continues to test investor risk tolerance levels. This is compounded by geo-political and economic uncertainty.
- Despite improving pricing trends and tighter terms and conditions, new capital is cautious and so far has not been forthcoming. Similar constraints are seen on the ILS (insurance-linked securities) side, particularly for retro capacity.
- The segment remains well capitalized, but ongoing interest rate hikes and volatile investment markets have materially reduced shareholders' equity on a market value basis.
- Inflationary pressures and the risk of recession make profitability targets more challenging over the long term.

These negative factors offset a number of positive ones, such as:

- Positive pricing momentum and enhanced market discipline continue, including tighter terms and conditions.
- Demand for reinsurance capacity continues to grow, as primary carriers look for stable results and capital efficiency in an uncertain environment.
- Some major players are starting to stabilize their results by reducing property cat exposures or benefitting from a diversified business mix, including significant life books in the case of the largest reinsurers.

Volatile Property Cat Activity Continues To Dampen Investor Appetite

Negative pressures on reinsurers' results over the last few years have been driven not only by traditional natural catastrophe events, but also by the growth of secondary perils, the pandemic, and, more recently, the Ukraine-Russia conflict. This has been compounded by financial, economic, social, and geo-political uncertainty in general. Although the segment remains well capitalized, the instability of financial results and inability of most players to meet their cost of capital has tested investors' risk tolerance. This has been more evident in the ILS markets, including retro, which, owing to severe losses and trapped capital issues, has been unable to expand or re-load in recent years and continues to experience a significant flight to quality when allocating capital.

Anticipated rate increases started to attract new capital in 2019, based on the expectation that natural catastrophe activity would subside and return to average historical levels—which has been negated by the devastating Hurricane Ian, estimated to be one of the costliest insured events in recent history. But even without major catastrophic events, the accumulation of

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small to medium-sized events has had a material impact on claims ratios, sometimes at unexpected times of the year (e.g., Winter Storm Uri in Texas) or outside their usual geographical scope (e.g., Hurricane Ida, affecting areas as far north as Canada). Extremely unusual events (such as the Bernd system floods in Western Europe) are occurring, as wildfires and floods increase in frequency and severity worldwide.

The perception of volatility and uncertainty has been magnified for reinsurers, on the asset and liability side of the balance sheet as well as on the bottom line. Investors may not feel as comfortable as they did before these issues emerged—and this is even truer for catastrophe risks, which were traditionally considered high severity, low frequency. But when the frequency component rises beyond a certain tolerance threshold—which seems to be the case after five years of losses—investors will naturally reassess their positions and their return expectations.

Theoretically, at least, there should be a price high enough to compensate for that level of uncertainty, but few reinsurers feel that rate increases have reached that point yet, although the impact of Hurricane Ian is likely to accelerate pricing momentum at the January renewals. What's more, reinsurers strongly prefer stable results over the potential for larger but volatile profit margins. For the last two to three years, reinsurers have been shifting covers to higher layers of protection, raising deductibles, lowering limits, adding explicit exclusions, avoiding aggregate covers, restricting specific perils and geographies, and generally becoming more selective with their cedents to mitigate adverse selection and credit risk—all this at a time when cedents themselves are craving more stable results and have put protecting their balance sheets at the top of their priority list.

Some companies have been actively shrinking their property cat exposures or even modifying their organizational structures and exiting altogether, although a few players—including some of the largest European reinsurers—seem to see the current environment as an opportunity to improve profit margins and consolidate their market positions even further. Although the largest European reinsurance groups remain more cautious when it comes to risk selection, their longer-term views on catastrophe risks tend to be influenced by much greater risk diversification (including their life and primary businesses), size, and financial flexibility, supported by less of a reliance on the currently constrained retro markets or by better access to ILS capital.

Pricing Continues To Improve—But Is It Enough?

No one questions the improvement in global reinsurance rates since 2018. As in any other previous cycle, the pace at which rates continue to rise varies widely depending on the class of business or territory, and whether a particular account has experienced recent losses. Generally, reinsurers—particularly property cat writers—have been lagging primary carriers and retro providers.

The pace at which pricing continues to harden for property catastrophe exposures, however, seems to be accelerating. Guy Carpenter has calculated a rise of 15% for its US Property Catastrophe Rate-On-Line (ROL) index between January and July 2022. Such an increase has not been seen since 2006 and is leading to speculation that the end-of-year renewals may witness a "true" hardening that eventually turns the corner for reinsurers. The recent losses from Hurricane Ian may strengthen those expectations.

However, we also need to acknowledge that the index itself is just catching up with levels last seen in 2009. Conditions in Florida—where problems stem from the low credit quality of cedents, concerns about widespread fraud, litigiousness, and a challenging regulatory environment—cannot be wholly attributed to the growing volatility of property catastrophe perils. Florida's pricing movements may not necessarily be a good indicator of what's expected for other cat-exposed

territories in the next renewal cycle. For example, price improvements in Europe have been more modest, despite the unexpected impact of the Bernd floods last year, as well as the more recent hailstorms in France.

Pricing for property cat seems likely to continue rising sharply into next year. An increase in demand is also expected to reflect the effects from inflation and higher sums insured. Primary carriers feel the pressure—even more than reinsurers—to stabilize their results and protect their balance sheets. As such, demand for reinsurance continues to grow.

Rate improvements in casualty and specialty lines, however, have slowed down. Margins remain attractive given the recent claims experience. Due to attractive pricing conditions, interest for cyber risks remains strong but is still typically accompanied by cautious growth and strict control of cover limits.

The big question at the moment is about the potential impact that inflation—which remains stubbornly high across the world—may have on ultimate claims. A problem that was originally considered temporary (caused mainly by pandemic-related supply chain disruptions) has become more of a long-term concern. This has led, as expected, to steep and ongoing increases in interest rates, with their consequential impact on the stock and credit markets, as well as on economic activity in general.

Global Reinsurance Segment Remains Well Capitalized But Deployment Is Cautious And Unrealized Investment Losses Are Significant

AM Best's estimates for available traditional capital for the global reinsurance segment indicated another year of expansion in 2021 after a period of stagnation between 2016 and 2018. One of the key drivers for this growth was the increase in investment values during 2021, mainly in equities. For year-end 2022—based on how the investment markets have reacted so far to the interest rate hikes, as well as fears of sustained inflation and a potential recession—we expect a decline in overall available capital. Since a significant proportion of this decline is explained by unrealized investment losses on fixed-income instruments, a careful assessment of a company's liquidity needs and its ability to hold assets to maturity is crucial as part of their balance sheet strength assessment.

Although the segment remains well capitalized, an important distinction has to be made between "available" and "dedicated" or "deployed" capital—"available" does not translate automatically into "dedicated." That available capital has been plentiful—over the last five years less than 85% was needed to support a BCAR (Best's Capital Adequacy Ratio) assessment of "Strongest"—has fortunately not translated into a lack of underwriting discipline. Reinsurers remain focused on stabilizing results and consistently working to meet their cost of capital—which still constitutes a mixed bag. Given the current market uncertainty, most players feel the need to keep a material amount of dry powder to protect their balance sheets against market fluctuations and to deploy resources prudently when the right opportunities arise

Unlike previous hardening cycles, new capital has not had a material impact on market conditions. After early signs of enthusiasm and the emergence of a few start-ups since 2019, execution has been slow and inconsistent. Regulatory and recruitment delays have played a role. Business plans have been downsized or changed suddenly based on opportunistic deals rather than on solid strategies. Several projects have not yet seen the light of day. Crucially, investors remain extremely cautious.

Third-party capital, while typically is expected to react more swiftly to market conditions, seems subject to the same level of skepticism. More restrictive covers, terms, and conditions

are commonplace. Despite higher demand and improved pricing, the volatility of recent claims remains the key issue. Issues with regard to trapped capital have not gone away completely. "Loss creep" remains well within the memory of investors.

Will the 2023 renewals mark a turning point for a true hardening market, able to attract new capital in droves and expand supply? Will third-party capital providers move first, as they have in previous cycles, taking advantage of the current retrenchment from traditional players and driving a new softening trend? Trying to predict the future is even more complicated nowadays, because how the year-end renewals go will depend heavily on actual claims activity and on where the global economy goes.

Given the elevated catastrophe activity experienced this year, asset market volatility, continued geo-political angst, inflationary pressures and recession fears, uncertainty could remain so high that few investors will feel comfortable deploying capital regardless of the price. A few new entrants will still try, but their impact is likely to be limited in a market in which rates could continue to rise in response to more limited dedicated capacity.

The importance of property cat risks and cyber is likely to continue to grow even further, in a world exposed to worrying climate trends and expanding digitization. Robust modelling, adequate pricing, and strong risk management tools for both risk categories remain a clear challenge. They are essential for (re)insurers to feel comfortable with their pricing and risk selection—even to determine what they consider insurable or not. In the short term, exiting certain risks and restricting covers may be justified and likely the only course of action. Long term, however, if the reinsurance segment does not develop more innovative solutions, its role and its relevance to the broader economy may be dramatically diminished.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

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