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Meeting Cost of Capital Elusive for South and Southeast Asian Reinsurers Despite Improved Underwriting Performance

Inflationary pressures may diminish the underwriting improvements made by reinsurers

Principal Takeaways

- Underwriting performance improved in 2021, but return-on-equity declined due to weakened investment returns.
- Reinsurers continue to be well-capitalised albeit capacity was provided selectively and remained constrained for poor performing accounts during 2022 renewals.
- The impact of persistent inflation on underwriting performance could outstrip increases in investment returns, which may add to challenges in meeting cost of capital.

Strong competition and excess capacity have challenged the technical profitability of South and Southeast Asia (S/SEA) reinsurance markets for many years. Nonetheless, the underwriting performance of reinsurance players in the region has exhibited improving trends recently, driven by focus on disciplined underwriting, improved pricing conditions and manageable losses from catastrophe activity. However, volatile investment returns and expectations of a prolonged inflationary environment may weaken profitability. Although AM Best expects the segment to see stable growth, supported by the expansion of primary insurance markets with economic recovery and increased insurance penetration, S/SEA reinsurers are likely to face headwinds in meeting their cost of capital over the intermediate term.

Reinsurance Demand Supported by Domestic and International Capacity

The growth of primary insurance markets over recent years and elevated natural catastrophe exposure in parts of S/SEA have driven the increased demand for reinsurance protection in the region, which has been met by both domestic and international reinsurance players.

A number of S/SEA reinsurers were established in line with government mandates to provide reinsurance capacity to domestic cedents, as well as retain more insurance risk in the country. These reinsurers often benefit from compulsory cessions or at least preferential access to local business (**Exhibit 1**). However, the level of compulsory cessions have seen a gradual reduction over the years in many markets, creating a more level playing field and allowing for the participation of regional and foreign reinsurers. Most recently in April 2022, India's insurance regulator reduced the obligatory cession for general insurance business to General Insurance Corporation of India from 5% to 4%.

In 2021, there was a contraction of capacity in the S/SEA reinsurance market, with several players not renewing loss-making accounts and undertaking portfolio pruning actions to improve technical profitability. Nonetheless, new capacity was added in the region with Himalayan Reinsurance Limited starting operations in Nepal in 2021. In addition, promoters of Fairfax group and Go Digit General Insurance have recently applied to the regulator for approval to set up a private domestic reinsurance company in India. If approved, the new

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Exhibit 1

S/SEA Domestic Cession Arrangements

Country	Nature of Cession	Recipient Reinsurers
Philippines	At least 10% of the outward reinsurance placed with foreign reinsurers must first be offered for cession to the National Reinsurance Corporation of the Philippines	National Reinsurance Corp of the Philippines
Malaysia	"Voluntary" cession of 2.5% by local insurers	Malaysian Reinsurance Berhad
India	“Obligatory” cession of 4% by local insurers. In addition, General Insurance Corporation of India benefits from the right of first refusal on the remaining reinsurance business placed in India.	General Insurance Corporation of India
Indonesia	Local insurers required to cede a sizable portion to domestic reinsurers, although a phased reduction to obligatory cessions (for some risk types) is expected to take place over the next few years.	Domestic reinsurers
Nepal	“Mandatory” cession of at least 20% (in total) by local insurers to the two Nepalese reinsurers with provision to seek further reinsurance support if required. However, mandatory cession rates are expected to dimish over the medium to long term.	Nepal Re-Insurance Company Ltd, Himalayan Reinsurance Limited

Source: AM Best data and research

entity will be the second domestic reinsurance company and the only privately owned reinsurer in India. Considering that the addition of new capacity and portfolio pruning activities are largely completed, AM Best expects stable growth of the regional reinsurance market over the medium to long term.

International reinsurance players have also supported the development of the S/SEA reinsurance market as they consider Asia-Pacific instrumental to their growth and portfolio diversification strategies. International reinsurers remain crucial for supporting large property, engineering and marine risks, which even the largest of regional reinsurers in S/SEA can still typically only seek to take a share of, given the size of these gross exposures.

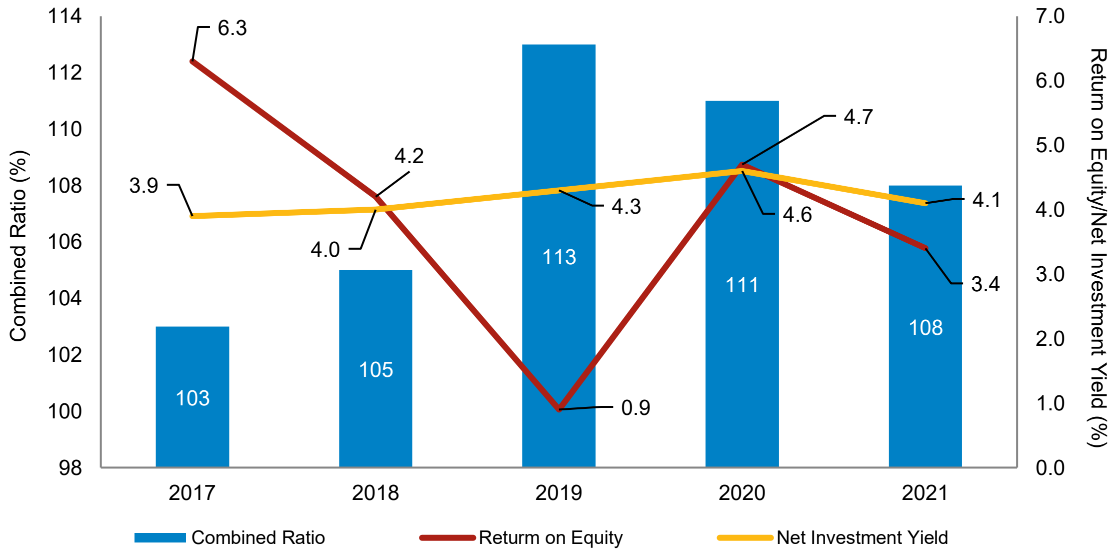
Due to the scale of their operations, large international reinsurers have more resources to devote to innovation than smaller local and regional S/SEA players. As a result, they have typically led the way in developing more advanced insurance covers, and the use of alternative reinsurance structures. In 2021 and 2022, MS Amlin launched Singapore-domiciled special purpose reinsurance vehicles (SPRVs), Phoenix 1 and Phoenix 2, to provide capacity to a select reinsurance portfolio written via its underwriting platform in Singapore. Both SPRVs were launched using the Monetary Authority of Singapore’s insurance-linked securities grant scheme.

Improved Loss Experience During the Pandemic

The attritional loss experience of S/SEA primary insurance markets improved in 2020 and 2021 due to a decline in travel, motor and workers compensation claims, which were attributed to movement restrictions during the pandemic. S/SEA reinsurers benefitted from the performance of these lines and experienced a negligible to manageable impact from COVID-19 related business interruption claims as most reinsurers in Asia had incorporated such exclusions in policy wordings following the 2003 severe acute respiratory syndrome (SARS) outbreak.

However in 2021, improvements in underwriting performance of these lines were partly offset by higher frequency and severity of health claims observed in several countries, particularly in Thailand and India due to the highly transmissible waves of COVID-19 emerging during the year. In addition, the technical performance of Indonesian reinsurers was weakened due to the negative impact of credit insurance claims arising from higher default rates given the economic fallout from the pandemic.

Exhibit 2
S/SEA Reinsurers' Operating Performance



Note: The scope of study covers select non-life focused reinsurers domiciled in S/SEA (excludes business written by branches and subsidiaries of international reinsurers). Combined ratio excludes life underwriting profit/loss, which accounts for a relatively small proportion of the total underwriting results.
Source: AM Best data and research

With respect to cat losses, 2020 and 2021 were manageable years for S/SEA reinsurers given the measures taken in recent years to manage down exposures. Few regional reinsurers in S/SEA have maintained diversified underwriting portfolios with cat exposures spread across Asia and internationally. After elevated loss incidence in 2018 and 2019, largely from Japanese and global cats, many reinsurers in the region have reduced capacity provided to cat exposed business in recent years and have heavily relied on retrocession to protect underwriting profitability and capital. The market also saw significant rate increases on loss impacted accounts during the 2021 renewal seasons. Given these measures, regional S/SEA reinsurance companies were not materially impacted by recent significant events, such as the Tohoku earthquake (Japan) and the Henan floods (China). The impacts of cat events reported in the Philippines (Typhoon Rai), India (Cyclone Tauktae) and Malaysia floods were largely limited to local reinsurers of these countries.

Given the improved attritional and cat claims experience, S/SEA reinsurers demonstrated improvement in the overall combined ratio for 2020 and 2021, compared to 2018 and 2019 (**Exhibit 2**). However, underwriting performance remains pressured with continued reliance on investments to achieve bottom line profitability.

Inflation to Exacerbate Pressures in Meeting Cost of Capital

Despite the improvement in technical performance, the overall return on equity declined in 2021, due to low investment yields amid a prolonged low interest rate environment in most S/SEA markets. Although investment returns are expected to increase over the near term alongside a recovery in interest rates, rising inflation in the region is likely to pose challenges in meeting the cost of capital prospectively. Inflation-related impacts on underwriting performance could outstrip any benefits from higher investment yields. AM Best expects social inflation to have a low impact on S/SEA reinsurers; however, their non-life portfolios are largely exposed to the increase in claims severity due to a rise in wages, repair costs and medical inflation. Although these impacts are likely to be managed through rate increases by both primary insurers and reinsurers, the impact on long-tail businesses may be more pronounced, with persistent inflation leading to reserve deficiencies.

In general, the management teams of S/SEA reinsurers are aware of the challenges posed by inflation and will be able to take steps to mitigate its impact on operating performance. These include strengthening expense management, as well as maintaining disciplined underwriting, pricing and reserving.

S/SEA Reinsurance 2022 Renewals

The S/SEA reinsurers have approached key renewal seasons in 2022 with a focus on achieving technical profitability, due to expectations of a challenging investment landscape and an inflationary environment. Following several years of soft market conditions, and persistent pressure on the underwriting performance of many reinsurers, the S/SEA reinsurance market appeared to have reached a market correction phase in 2021; during this time, adjustments to terms, conditions and pricing had been largely corrective in nature and focused on loss-affected accounts. The focus of renewal negotiations in 2022 was therefore to achieve further improvement in pricing, despite robust traditional capital supporting abundant reinsurance capacity.

Property remains the dominant line of business for treaty reinsurance in S/SEA. January 2022 renewals largely saw low single digit risk adjusted rate increases for loss-free excess of loss renewals in the property class, while loss-hit accounts saw notable rate increases, in some instances exceeding 10%.

During the April 2022 renewal season, loss-free property excess-of-loss programmes in Philippines saw a low single digit increase in average risk-adjusted rates, with loss-hit accounts seeing significant rate increases exceeding 20%. In India, pricing discipline was evident with flat to risk adjusted rate increases of up to 20% for both loss-free and loss-hit accounts. Given that in recent periods, price increases for the property line were observed in the primary insurance market as well, AM Best is of the view that the recent rate increases are likely to benefit the underwriting performance of S/SEA reinsurers. However, the overall 2022 renewal experience may continue to fall short of achieving hard market conditions, mainly due to inflationary trends.

The year 2021 proved to be another year of high loss incidence, particularly due to secondary perils, and limited capacity in the global retrocession market. Consequently, the retrocession

Exhibit 3

S/SEA Reinsurers – AM Best-Rated Companies

Ratings as of 5 August 2022

Financial Size Category	AMB#	AMB Company Name	Country of Domicile	Best's Long-Term Issuer Credit Rating (ICR)	Best's Financial Strength Rating (FSR)	Best's ICR & FSR Action	Best's ICR and FSR Outlook	Rating Effective Date
VI ($25 million to $50 million)	91541	PVI Reinsurance Joint-stock Corporation	Vietnam	bbb	B++	Affirmed	Stable	2/11/2022
VI ($25 million to $50 million)	91691	Thaire Life Assurance Public Co Ltd	Thailand	a-	A-	Affirmed	Negative	7/22/2021
VII ($50 million to $100 million)	85568	Asian Reinsurance Corporation	Thailand	bbb-	B+	Affirmed	Stable	5/20/2022
VII ($50 million to $100 million)	74846	Himalayan Reinsurance Limited	Nepal	bb+	B	Assigned	Stable	2/11/2022
VIII ($100 million to $250 million)	86771	National Reinsurance Corp of Philippines	Philippines	bbb	B++	Affirmed	Stable	6/10/2022
VIII ($100 million to $250 million)	86913	Labuan Reinsurance (L) Ltd	Malaysia	a-	A-	Affirmed	Stable	12/8/2021
VIII ($100 million to $250 million)	91508	Vietnam National Reinsurance Corp	Vietnam	bbb+	B++	Affirmed	Stable	4/22/2022
VIII ($100 million to $250 million)	85224	Singapore Reinsurance Corp Ltd	Singapore	a	A	Upgraded	Stable	8/5/2022
IX ($250 million to $500 million)	78303	Malaysian Reinsurance Berhad	Malaysia	a-	A-	Affirmed	Stable	9/12/2021
XV ($2 billion or greater)	86041	General Insurance Corporation of India	India	bbb+	B++	Affirmed	Stable	9/17/2021

Note: Table excludes branches and subsidiaries of international groups that are assigned the group (g) affiliation code.

Source: AM Best data and research

price hardening trend continued during January 2022 renewals with double-digit increases seen in risk-adjusted retrocession rates for loss-hit accounts. S/SEA reinsurers have not significantly amended their retrocession strategies and continue to rely on traditional forms of retrocession, despite increasing costs. Instead, market players have sought to focus on prudent exposure management while maintaining or moderately increasing retention levels in view of these retrocession conditions.

Rating Considerations

All AM Best rated reinsurers domiciled in S/SEA have Financial Strength Ratings (FSRs) of at least "B" (**Exhibit 3**). Capital requirements for reinsurers in the region are typically driven by underwriting risk, although some market participants have opted for more aggressive investment strategies, which can also be a significant driver of required capital. Counterparty credit risk emanating from retrocession is typically a small component of required capital, reflecting the use of well-rated international retrocessionaires.

Operating performance volatility is generally the key area of pressure for many rated reinsurers in the region, however, with improvements in underwriting profitability, rating outlooks for a few reinsurers have been revised to stable from negative over the past 12 months.

Nonetheless, robust capitalisation remains a strength for most reinsurers in the region. Almost all of the AM Best-rated reinsurers domiciled in S/SEA have risk-adjusted capitalisation that is assessed to be at the strongest level, as measured by Best's Capital Adequacy Ratio (BCAR).

Prospective Challenges and Expectations

Overall, AM Best expects the S/SEA reinsurance market to face several headwinds over the medium term. More recent market dynamics including a challenging investment landscape and a high inflationary environment could weaken reinsurers' prospective operating performance.

Even with rate improvements seen in the 2021 and 2022 renewal seasons, AM Best is of the view that pricing increases may not be sufficient for S/SEA reinsurers to achieve significant improvements in technical profitability given expected increase in loss costs, if an inflationary environment persists over the medium term. In addition with rising retrocession costs and lacklustre investment returns, reinsurers may continue to struggle to meet their cost of capital. As such, to achieve improvements in operating performance over the medium term, reinsurers will need a prudent investment and retrocession strategy, along with continued underwriting discipline.

Reinsurance Solutions Supporting Disaster Financing in Under-penetrated S/SEA Countries

According to Swiss Re Institute's natural catastrophe resilience index, emerging Asia-Pacific is the least resilient region, with around 95% of cat losses unprotected by insurance. Indonesia, India and the Philippines are among the least resilient to natural catastrophes as only five to seven percent of physical assets are estimated to be insured against major natural perils. Governments and insurance regulators across S/SEA have launched initiatives with the support of reinsurers aimed at narrowing the insurance protection gap for cat and other large risks.

Philippines, one of the most cat prone countries in the S/SEA region is developing the Philippines Catastrophe Insurance Facility (PCIF) for non-life insurers in the country to redirect cat risks to the facility. The PCIF will then share the pooled risks with participating companies. In January 2020, the Philippines' Insurance Commission, together with the Philippine Insurers and Reinsurers Association and the National Reinsurance Corporation of the Philippines signed a Memorandum of Understanding to formalise the PCIF and review minimum cat risk insurance rates.

In 2022, the Philippines government also received a USD52.5 million payout under its World Bank issued cat bond, after calculation agent AIR Worldwide determined that super typhoon Rai breached the trigger for wind. Swiss Re and Munich Re are understood to have been the structuring agents, placement agents and joint managers for this cat bond issuance.

Similar to Philippines, Malaysia is also looking to develop disaster financing solutions, particularly after the December 2021 floods for which economic losses have been estimated to exceed USD1 billion with insurance covering less than a quarter of it. In recognising that the burden of disaster financing largely falls on the government, the country's National Disaster Management Agency has approached Malaysian Re to devise solutions for managing flood risk, including a potential flood pool.

Indonesia launched an earthquake pool in 2003, in which participation was made mandatory for all insurers and reinsurers. In 2004, the pool vehicle was converted into a company, PT. Asuransi MAIPARK Indonesia. Since then, besides its function as a reinsurer, the company engages in research support, educating the public about natural disasters, risk mitigation and more stringent and safer construction standards and building codes.

India is another example, wherein the state government of Nagaland is devising a public-private disaster risk insurance scheme with domestic insurer TATA AIG Insurance Company Ltd, and reinsurance partner Swiss Re. The scheme will cover implementation of parametric insurance solutions for the monsoon season and earthquakes in the state. In addition, the country's state owned reinsurer, GIC Re, leads a terrorism pool along with several general insurers, providing cover for over USD125 million.

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