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BEST'S MARKET SEGMENT REPORT

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Reinsurers Meet Cost of Capital for First Time in Four Years

Reinsurers generated returns well above the cost of capital in 2023 due to positive underwriting results, driven by repricing and portfolio de-risking

Principal Takeaways

- Reinsurers met their cost of capital for the first time in four years, thanks to a rebound in capital gains and underwriting profits.
- High interest rates, equity market volatility, and economic uncertainty resulted in another increase in the cost of capital.
- Reinsurers that balance long-term strategies with effective tactical decisions and sound risk management can still meet or exceed return expectations.

Sound risk management, strategic use of technology, and a maturing partnership with alternative capital have subdued the cyclical nature of the reinsurance market by narrowing the extremes. To meet or go above the cost of capital, reinsurers must remain flexible with regard to market conditions and balance opportunistic moves (taking advantage of market conditions, retreating when pricing is not right) over the short term, with strategic long-term goals (maintaining relationships, building expertise, and being relevant and dependable over the long run).

Rising interest rates and stock market volatility, as well as weather events and inflation, have raised the cost of both debt and equity in recent years. The reinsurance industry's weighted average cost of capital had decreased from 9.5% in 2010 to 6.25% in 2019, before spiking up to 9.31% in 2021. After falling in 2022, it rose again in 2023 to 8.12%. However, in 2023, reinsurers generated returns well above the cost of capital due to positive underwriting results, driven by repricing and de-risking of reinsurance portfolios.

The current hard market came about due to prolonged underperformance and economic and social inflation, and despite a relative abundance of capital, due to the prolonged low interest rate environment. Rate increases are slowing down—Guy Carpenter calculated a 5.4% increase in Rate-On-Line (ROL) at January 1, 2024, for both US and European property catastrophe reinsurers, compared with nearly 30% in 2023—but reinsurers have also implemented thorough de-risking measures such as tightening terms and conditions and sharply increasing attachment points, which are unlikely to be relaxed. The hardened market has led to more sustainable pricing momentum, enhancing reinsurers' ability to meet their cost of capital over the medium term.

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Rebounding Capital Gains Drive High Returns

For reinsurers that take on high severity risks, meeting their cost of capital during years of severe catastrophe losses is a challenge (**Exhibit 1a**), which is especially evident when comparing the median return on capital employed (ROCE) and the median weighted average cost of capital (WACC). WACC measures a company's cost of both debt and equity, whereby the weights are the relative proportion of financing based in each source. ROCE measures how well a company generates profits from its capital, including both debt and equity. ROCE is calculated by

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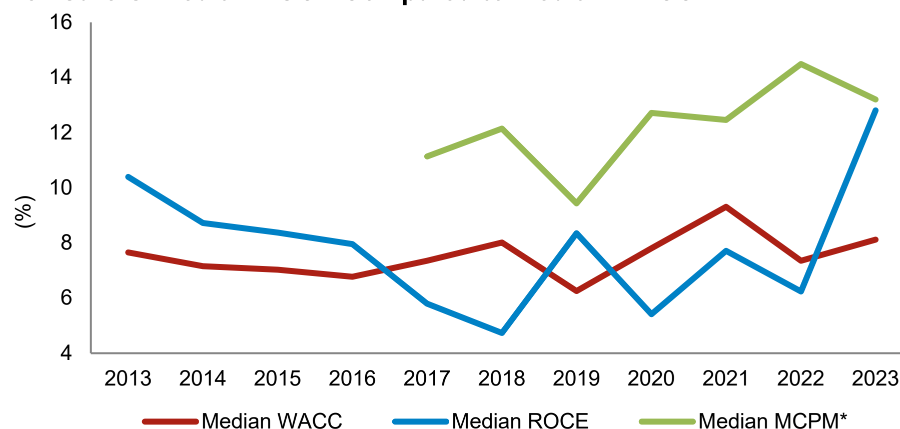
dividing earnings before interest and taxes (EBIT) by capital employed, whereby capital employed is equal to total assets minus current liabilities.

Exhibit 1a

Reinsurers' Median ROCE Compared to Median WACC

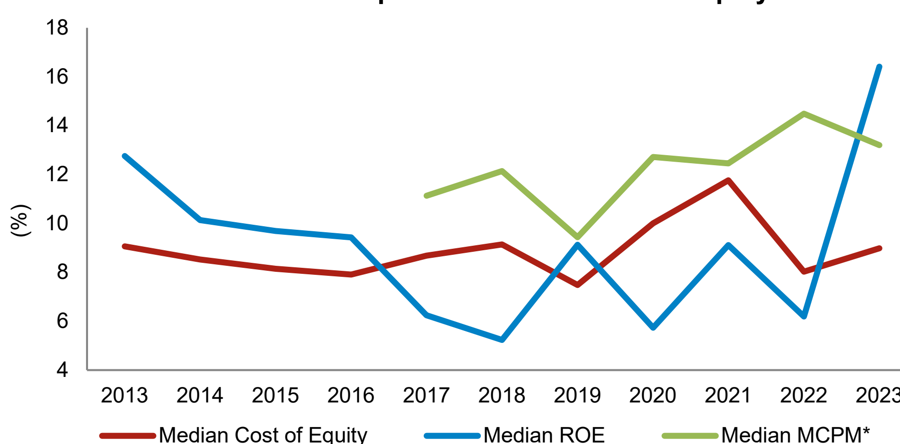


* MCPM is based on a smaller sample size and has limited years due to availability of data.
Source: Bloomberg

The years when returns exceed the cost of capital are generally the ones with a lower frequency and severity of natural disasters. According to Swiss Re, 2023 marked the third year in a row in which global insured losses exceeded USD 100 billion. However, the insured losses were due mainly to numerous small to medium-sized events and, owing to higher attachment points, most of the impact was retained by primary insurers.

Exhibit 1b

Reinsurers' Median ROE Compared to Median Cost of Equity



* MCPM is based on a smaller sample size and has limited years due to availability of data.
Source: Bloomberg

Despite the higher median WACC, reinsurers met the cost of capital in 2023 for the first time in four years, as well as the median return on equity (ROE) compared to the cost of equity (**Exhibit 1b**). ROE is another measure of how efficiently a company generates profits. Unlike ROCE, ROE does not take debt into account—it is calculated by dividing net income by average shareholders' equity.

Most reinsurance players had an excellent ROE in 2023, with a median of 16.41%—the highest in 12 years by a margin of about 3.7 percentage points. These returns are due to ongoing positive underwriting results, as well as recoupment of unrealized investment losses from previous years thanks to higher reinvestment rates. The exceptional ROE in 2023 is unlikely to be repeated, although reinsurers are expected to maintain underwriting discipline over the near term.

During the prolonged low interest rate environment, investors' interest in reinsurance through traditional equity, third-party capital, and insurance-linked securities (ILS) grew, as investors diversified their portfolios. However, reinsurers' failure to meet their cost of capital consistently in recent years has tested investors' risk appetite. Moreover, ILS capacity, flat for the last five years, has shown signs of expanding, driven by the record issuance of catastrophe bonds in 2023.

MCPM Suggests Higher True Cost of Capital

There are multiple methods used to estimate the cost of equity, the most popular of which is the Capital Asset Pricing Model (CAPM). The CAPM divides risk into systematic risk (the risk of being in the market) and unsystematic risk. Systematic risk is measured by beta, a portfolio's relationship to the overall market, and cannot be diversified. Unsystematic risk is specific to a company's fortunes and can be mitigated through appropriate diversification, making beta the more important factor in the CAPM. The cost of debt is simpler to calculate: Averaging the yield to maturity for a company's outstanding debt.

By contrast, the Market-Derived Capital Pricing Model (MCPM) uses the price of options rather than historical data to estimate future volatility. MCPM relies on the same forward-looking market expectations that are built into a company's stock price and may provide a more accurate figure for firms to use when making decisions about capital allocations.

For global reinsurers for which options data was available, the MCPM cost of capital differed markedly from the CAPM cost of capital (**Exhibit 2**). The average CAPM cost of capital for these reinsurers was 7.4%, versus the MCPM's 16.6%. A majority of reinsurers generated returns that met or exceeded their MCPM cost of capital in 2023, but with a narrower margin compared to the CAPM cost of capital.

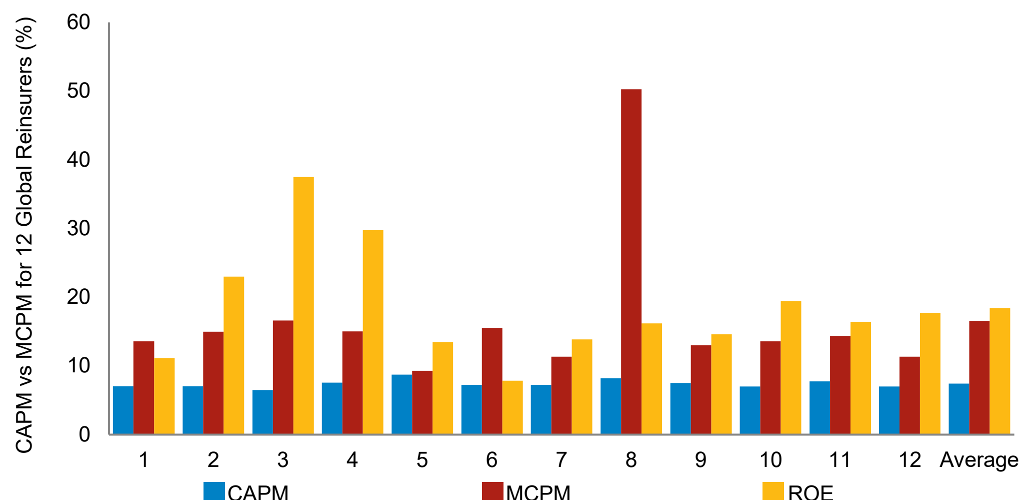
Dispersion of Returns Reflects Differences in Risk Management

The spreads on ROCE have varied the past 12 years. In 2011, a severe tornado season in the United States, earthquakes in New Zealand and Japan, and floods in Thailand resulted in global insurance losses of approximately USD 150 Billion. Between 2011 and 2016, the reinsurance industry's ROCE was pretty steady, despite Superstorm Sandy in 2012.

Generally, in years when losses were more severe, the variance in the spread of returns was wider (**Exhibit 3**). In 2022, a year with high catastrophe losses, returns ranged from -15% to 16%. Similarly, in 2017 (industry losses estimated at more than USD 150 billion), the variance was wide, between -8% and 17%. By contrast, in years such as 2014, when global insured catastrophe losses were below average (less than USD 35 billion according to various estimates), the range of returns was between

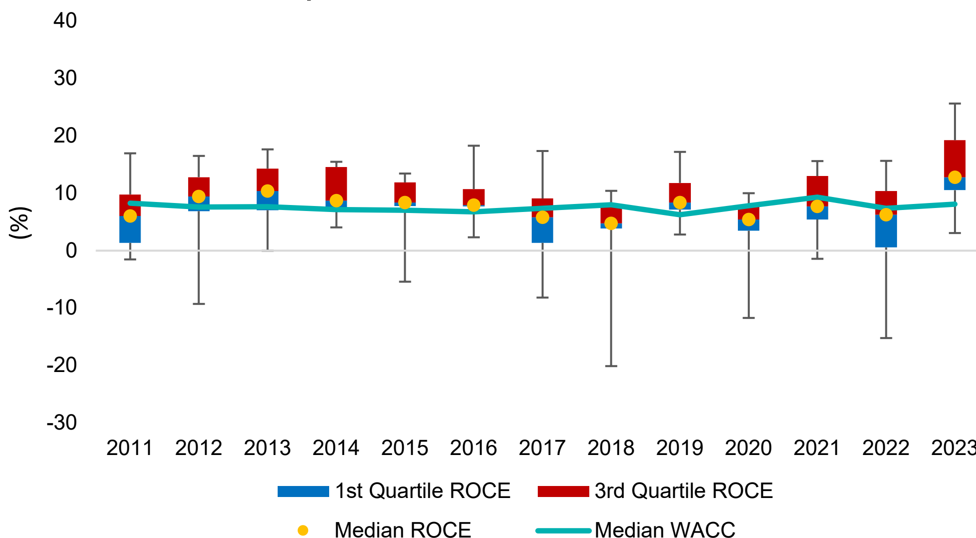
Exhibit 2

2024 YTD* Cost of Capital for 12 Reinsurers – CAPM vs MCPM



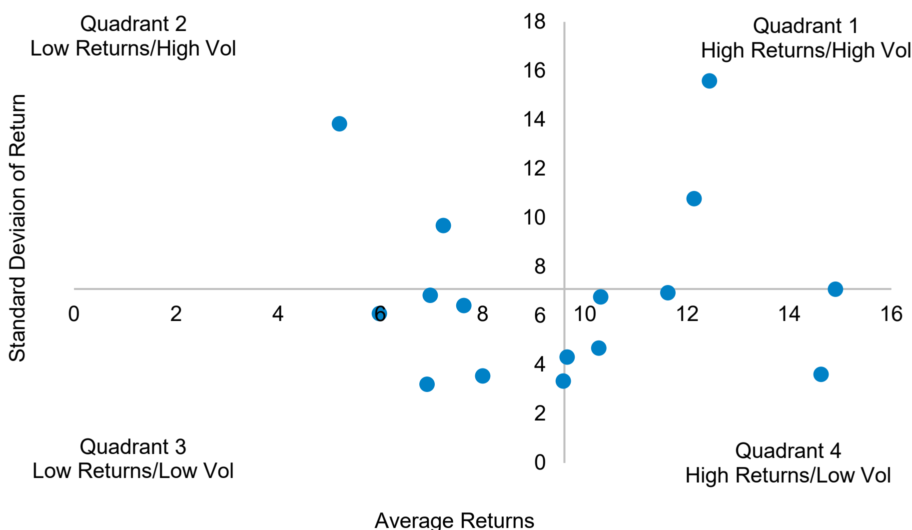
* Data as of June 3, 2024.
Source: Bloomberg

Exhibit 3
Reinsurers -- ROCE Dispersion



Source: Bloomberg

Exhibit 4
Average Returns vs. Volatility of Returns



Source: Bloomberg

4% and 15%. The year 2023 was an exception, when the wider spread was due not to higher losses but to a few exceptional returns, with the minimum being 3% and the maximum being 26%.

Reinsurers in the third quartile experienced more volatility in these cases, due to the lack of effective risk management and exposures to risk outside investors' risk appetite. In contrast, reinsurers in the first quartile tend to rely on effective risk management, appropriate portfolio concentration, and diversification. They are more likely to see a narrower spread of returns, often meeting or exceeding the cost of capital. These reinsurers do a much better job of communicating their risk profiles to investors. When losses occur, investors are not surprised.

Managing Risk/Return Trade-Off Impacts Cost of Capital

Reinsurers look to optimize their cost of capital and maximize their returns while taking risks commensurate with their risk appetites. Significant volatility in returns can indicate inefficiencies with regard to managing risk, resulting in a higher cost of capital. **Exhibit 4** shows 16 reinsurers and their returns. Only a handful of companies have been able to attain high returns while exhibiting low volatility of those returns, placing them in a coveted spot in Quadrant 4.

An insurer's ability to raise capital (especially in times of stress) and the potential cost of capital are important considerations in the ratings process. When assessing operating performance, we look at an insurer's returns on equity in comparison to its peers and vis-à-vis cost of capital, as well as return on revenue, combined ratio, return on assets, and underwriting expenses. We also examine the absolute level of these metrics and their historic volatility.

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