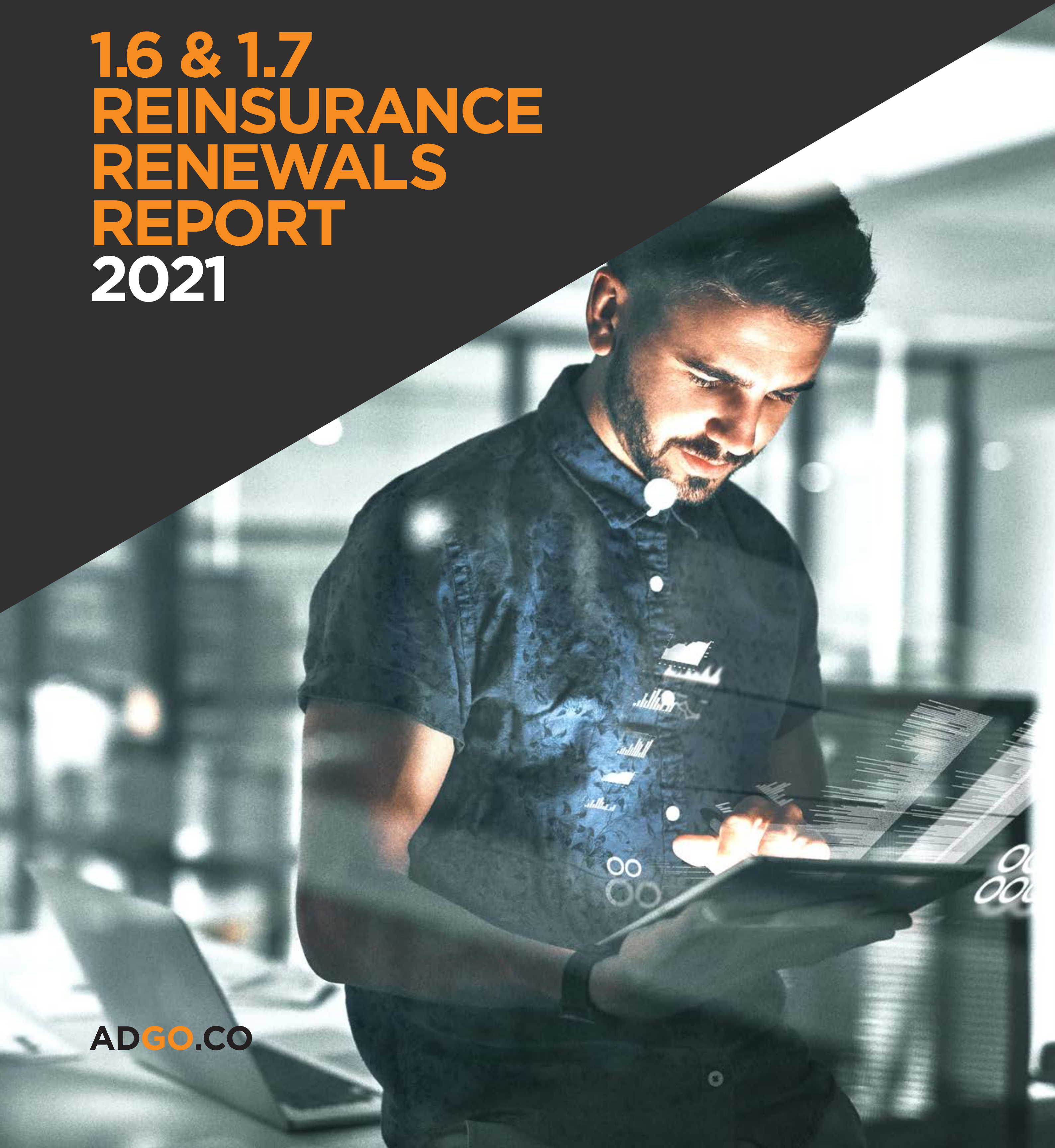
1.6 & 1.7 REINSURANCE RENEWALS REPORT 2021



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MAINTAINING MOMENTUM

ADRIAN MORGAN
GLOBAL HEAD OF ADVANTAGEGO

Is it sustainable? That's the question that's at the heart of the matter as discussions continue in earnest as we approach the important 1.6 and 1.7 reinsurance renewals, a key period for the North American (re)insurance market. And by 'it', of course, we are talking about a truly meaningful hard market – something of a rarity in recent years.

As this year started, the feedback was certainly encouraging for carriers. According to Willis Re, prices for loss-affected property catastrophe accounts rose across all regions at 1.1, with US business reporting the strongest price gains from 10%-25%, while loss-free US property catastrophe accounts increased less, from 5%-15%.

Casualty reinsurance prices also saw broad-based increases, with rates for loss-affected accounts up 10%-25% in Europe and up to 30% for certain US liability lines, according to the broker.

More recently, the feedback has continued to show rating increases. Hannover Re, in its commentary on Q1 results, noted that "prices and conditions in property and casualty reinsurance are continuing to improve", while Munich Re, commenting on 1.4 renewals, said that prices for reinsurance cover rose considerably in some places, including Japan, with overall prices for the Munich Re portfolio increasing by 2.4% and a positive outlook for this summer, suggesting that "the market environment will improve year on year in the next renewal round in July, as was the case with previous renewals".

AGGREGATE LOSSES

The sustainability of rating increases is "one of the big questions in the industry" according to Mike Van Slooten, head of business intelligence for Aon's Reinsurance Solutions Division. "Obviously, all of the recent focus has been on COVID, which overshadowed the industry's results last year, but the way that I think about it is you really have to look at the period since 2017. We have had those big losses in the US, three hurricanes that generated close to $100bn of losses and a lot of activity since then, with lots of typhoons in Japan and generally a high level of frequency."

"So, when you look at that period in the aggregate it's been a record period for natural catastrophe losses, with over $400bn of losses according to our data. Losses always make people reappraise what is going on, and there are a lot of investors looking at the level of losses coming from secondary perils and asking themselves about the impact of climate change and what it all means."

Van Slooten suggests that it's not only a difficult loss experience that is part of the pricing mix going into these renewals- other factors contributing to a continuing hard market are considerable:

"It's against that backdrop that you have to think about what may happen going forward; the loss activity has been significant but alongside that you've got reserves developing less favourably than they did, with quite a lot of focus on casualty reserving, particularly in the US with the whole social inflation narrative."

"You've got higher retrocessional costs for reinsurers, which again is related to the higher nat cat activity, with some of the investors pausing what they are doing. And then, of course overshadowing everything you have the impact of low interest rates. So, when you add all that together, over that four-year period the average combined ratio for the combined group of companies we look at is something like 102%. So, the sector as a whole has lost money on the underwriting side for quite an extended period of time now. And investment returns are also under pressure as well."

RATE ADEQUACY

There is no doubt that the market is definitely firming and continues to do so, according to Mark Wheeler, market veteran and co-founder of Bermudian start-up Mosaic Insurance. But the real issue underlying the current market dynamics, he says, "is rate adequacy, not rate change, when all is said and done."

"Some massive steps have been made in that sense and really right across all markets and all products. I've certainly worked in environments that have higher levels of rate adequacy than we are seeing today –notwithstanding the correction – which is why I think there's quite a bit more momentum to go. There has been too long a period of inadequately priced business being booked. It coalesces more in certain areas... so US D&O or excess casualty at the moment are extreme hard markets. If you take those lines in isolation, they are at least as hard as they were back in the mid 1980s casualty crisis. And there are still enough players cutting back what they are doing."

Besides, as Aon's Van Slooten points out, the average ROE is just below 5%, which is not what investors and rating agencies expect, placing pressure on the earnings front and likely to maintain underwriting discipline in the industry:

"We have seen pricing adjusting in areas in response to losses. I think at the Jan renewals the pressure had got to a point where we were even starting to see pricing moving on business that hasn't been affected by losses, which is a bit of a change. I think generally with quite small adjustments, but it's an indication of the building pressure I think."

EARNINGS PRESSURE v CAPITAL PRESSURE

Naturally, the one significant statistic that runs counter to such arguments is the level of capitalisation of the industry, which remains – despite some local adjustments in particular markets and lines of business – extremely well capitalised. Indeed, according to Aon's Reinsurance Aggregate (which represents just over 50% of the world's life and non-life reinsurance premiums and is therefore a reasonable proxy for the sector as a whole), estimated global reinsurer capital increased to a new high of $650bn at the end of 2020, driven by strong capital market recovery from the COVID-19 'shock' in the first quarter, new equity issuance and US dollar depreciation. The calculation is a broad measure of the capital available for insurers to trade risk with and includes both traditional and alternative forms of reinsurer capital.

"Our data shows that after the shock of Q1 last year when there was tremendous volatility in the market and the stock market of the companies we track in that study almost halved in a five-week period, which is unprecedented really, the market has recovered strongly," says Van Slooten.

"We are back to pretty much peak levels in the US, and that has supported the overall capital position of the industry. A number of the reinsurers were able to demonstrate access to capital last year, so quite a few companies raised new equity- in some cases to fill holes, but in other cases because they could see a better market ahead. And a lot of those companies also issued debt, and not just debt to replace old debt but actually to take on more leverage, to expand their underwriting."

He points out that we also have some new players that have formed as well, so the question on people's minds concerns the hardening of the market which very unusually has been driven by earnings pressure rather than capital pressure and people are asking themselves how long can this continue, particularly when they see signs of new capital coming into the industry at the same time.

"I don't necessarily have an answer to that, but my assessment at the moment would be that the earnings pressure is sufficient to outweigh the incremental capital that we have seen from new start-ups and I would expect to see continuing adjustment on pricing, certainly on business that has been affected by losses," he comments.

"It's questionable whether it will be to the same degree that we have seen because some of the business that was affected by losses in 2017 in the US has been through two or three rounds of renewals since, so there has been some adjustment. Obviously, we've had another reminder with the Q1 storms in Texas which have generated quite a lot of losses for the industry. Then you have the lingering impacts of COVID and all the uncertainties there as well, so my general sense is that discipline will be maintained for a while longer."

MANAGING EXPECTATIONS

So the general sentiment as we approach these renewals is that, yes, the hardening momentum can be maintained. As Carlos Wong-Fupuy, senior director for Global Reinsurance Ratings at rating agency AM Best suggests, the main drivers behind the positive pricing momentum remain in force. However – and this point is key – he goes on to say that AM Best does not necessarily foresee a generalised increase in rates much more pronounced than what we have already seen in January and April renewals, with other factors besides rate coming into play:

"The perceived rise in uncertainty regarding underwriting risks, in general, is already being factored in higher risk margins. Major reinsurers are adjusting their strategies not only based on price, but also re-balancing their portfolios by reducing their property cat exposures, moving away from working layers and making more active use of ILS retro capacity. Aggregate property covers have become more difficult to place as reinsurers take a more conservative view of secondary perils, such as wildfire."

Wong-Fupuy also suggests that expected rate increases at the forthcoming renewals are unlikely to be uniform:

"It is fair to say that price improvements continue to be led by primary specialty lines, rather than a catastrophe-driven squeeze on capacity in the reinsurance sector," he says. "Given the direct benefit to reinsurers from proportional business, attempts to reduce ceding commissions materially have been unsuccessful. Reinsurance rates for excess of loss business in general are catching up and we believe that trend will continue. The unusual catastrophe losses experience of the first quarter of this year may add to that momentum."

Despite the positive trends in liability lines, there are still a number of segments where rate increases are considered insufficient, he adds, noting that given the persistent concerns regarding social inflation, AM Best believes this is an area where more meaningful adjustments are likely.

This point is echoed by a Bermudian property reinsurance broker who suggests that we need to be more realistic about what can be achieved in terms of property cat pricing adjustments at upcoming renewals, and that while some people have been speaking of mid to high single rate digit increases for programmes, he thinks that the reality will be more measured. "I can't speak for casualty programmes, but from the discussions I'm having the market should adjust its expectations [on the property cat side]," he observes.

US CASUALTY PRICING

Swiss Re, Keith Wolfe, president Swiss Re P&C US, speaking in a recent episode of AdvantageGo-sponsored The Voice of Insurance, is particularly pertinent with regard to the changes taking place on US casualty lines at present, suggesting that this is very much an insurance-driven hard market at present – particularly with regard to the US financial lines space:

"The rates in the underlying market are significant in terms of the increase, with strong double digit increases that we've seen, some of them north of 50% on portfolio metrics, which is quite staggering when you think about it… the improvement is necessary even at that magnitude, but we're not convinced it's enough, which is scary."

He says that med mal is also a very interesting market: "I think that med mal right now is most concerning because of a combination of the pandemic and a lot of litigation that has been postponed, and people [that had delayed medical care] are now finally getting back in to see physicians. There are going to be a lot of arguments over that, and I think there is going to be a problem in the med mal space going forward… and naturally some liability with misdiagnosis related to COVID." Indeed, Wolfe adds that there is a lot of drag or potential headwinds in the med mal line of business "that we have yet to see in the actual results of most of the insurance portfolios".

On the broader topic of whether these renewals will be led by the front or back end, he was clear that insurers are now in the driving seat: "A decade or two decades ago reinsurance drove the hard market, but we haven't seen that since the financial crisis. I actually like that it's the people writing the cheques who are deciding what the price for the products is." However, he noted that it was "a bit disturbing that primary rate for casualty has not really flowed through to reinsurance even on proportional deals… we've seen transactions on proportional deals where ceding commissions are increasing."

FLORIDA SEGMENTATION

As ever, as Guy Carpenter's CEO Peter Hearn noted on an earnings call following its Q1 results, it is important to demarcate Floridian renewals in the upcoming season:

"We have to separate Florida from the rest of our portfolio because it's a different animal in a lot of different ways, not only from a regulatory environment, not only from a capital environment, not only from a capacity environment, not only from a legal environment."

Hearn observed that the state has undergone not only significant recent losses but also an underlying erosion of capital due to heightened litigation, resulting in demand that is actually going to be less because people are re-underwriting their books of business to deal with some of the spikes and exposure that they have: "Overall, I would say there is more than enough capacity in Florida... and for the non-frequency layers and more capacity layers, there will be plenty of capacity. And for the lower down, higher risk layers, pricing will go up. We are still unsure as to what the dimensions are."

THE BERMUDIAN MARKET

Historically, the Bermudian reinsurance market has played an important part in the 1.6 and 1.7 renewals and talk of a renaissance for Bermuda is not unwarranted, suggests Mosaic's Mark Wheeler:

"I don't think that's too fanciful a term. I think there's a number being bandied around of $19bn being raised for the class of 2021 - that's a big number. I think it a validation. It's also interesting that it's not just greenfield start-ups like Mosaic... it's Ark, Canopius, and even big cats like Catlin." And it's not just limited to the carriers, he adds: "A number of brokers have said to me their firm is thinking of setting up an office in Bermuda. And they are firms that I wouldn't necessarily have expected to be looking at Bermuda."

"I'm not a Bermuda groupie as I've only been here two years, but I've been really surprised by Bermuda in the sense of how much client footfall there is and therefore how much attachment those clients place to the market," Wheeler adds. "They are only going to go there if there is a separate capital pool that they want to tap into."

"There is so much going on there. Just over 48% of Lloyd's capacity is housed in Bermuda; it has a third of the global reinsurance premium. I don't think it's fanciful to be bullish about it and to speak about its importance. By definition it will continue to go on playing a really important role in that sense."

Not that we should become carried away here, according to AM Best's Wong-Fupuy, who notes that compared to their main European rivals, Bermudian reinsurers tend to be less diversified. Not only is their participation as a whole in life risks negligible, but their exposures to catastrophe risks are more significant as a share of their risk portfolios, he says, while historically they have shown more volatility in results, both from an underwriting and investment point of view.

Nonetheless, there are distinct signs of targeted growth from the Bermudian market, he says: "As part of their overall strategies, we see some initiatives aimed at smoothing results. We are seeing some cautious initiatives to expand their participation in casualty lines, develop their primary business and reinforce their ILS platforms."

"Bermuda has reached a point where sheer capacity and capital levels makes it important: in terms of global insurers and reinsurers the estimate is a third of the global P&C market," says John Huff, CEO at the Association of Bermuda Insurers & Reinsurers (ABIR). "So, whether we are talking about 1.4 Japan renewals, the mid-year renewals... or anything in between, then if Bermuda chooses to participate than it will be an important participant in the market."

He adds that the ABIR talks about Bermuda being a great place for start-ups and scale-ups, and it is fair to say that the capital that has gravitated towards Bermuda has been a genuine flight to quality: "Even recent start-ups are seasoned players with strong histories of running successful companies."

Huff also understandably stresses the strength of the London-Bermuda axis, noting that there continues to be a great deal of synergy between Bermuda and London, with ABIR members providing some 50% of London's capacity at present.

VARIED OUTCOMES

Naturally at this stage there is still much to play for and we won't know the detailed outcomes of the summer renewals for some time, but whatever the breakdown is, looking for uniformity when it comes to rate is not helpful, says Van Slooten:

"I know everybody likes to say 'it's up 5%' or whatever it may be, but the reality is you get very differentiated outcomes in today's market. If you are a small Floridian company and you have experienced significant losses in the recent period, and maybe some of those losses are still developing and you really need to buy that reinsurance protection, you are going to be in a very different position to a smaller company, maybe positioned somewhere else in the US, who perhaps has experienced no losses at all. There's a huge range of experience out there."

What's is different now, he adds, is that the data in the industry is so much better than it used to be, and reinsurers are being far more discerning about how they deploy their capital: "They know where they are making their money; they know they have strategic relationships they want to support and those companies will potentially get better outcomes than those who have perhaps have delivered unwelcome surprises or perhaps have not invested enough time in managing those relationships."

Better data, the psychological and financial scaring from recent loss experience, continuing below par investment returns and the spectre of social inflation mean that these renewals really do have the potential to deliver continuing substantive rate increases for the market. But don't expect uniformity- if experience teaches us one thing it is to expect a distinctly variegated set of renewals at this forthcoming fascinating renewal season.


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