January 1, 2020 Reinsurance Renewal: An Asymmetrical Market

- The reinsurance market is healthy and responsive overall.
- Dedicated reinsurance capital remains abundant, with a modest increase over last year-end, driven by rated capital.
- Market adjustments are occurring in select segments, as risk profiles shift.
- Climate change assessment is a growing consideration.
- Renewal outcomes varied widely across individual programs, even within the same lines of business and geographies.
- While capital levels remain robust, allocated capacity tightened notably in stressed classes.
- Guy Carpenter's Global Property Catastrophe Rate-on-Line (ROL) index increased approximately 5 percent, based on preliminary calculations.
- The US casualty market saw more consistent firming than the property market, with additional signs of hardening in some non-US regions.
- Non-loss-impacted specialty programs renewed broadly flat or slightly reduced, while loss-impacted programs in lines of business that suffered sizeable losses through 2019, such as aviation, saw pockets of (in some cases significant) rate increases.
- The market faces a call to action – as the world becomes a riskier place, capital providers, underwriters and brokers are focusing on solutions that move the global marketplace forward.

Dedicated Reinsurance Capital ≈+2%

Guy Carpenter Global Property Catastrophe ROL Index ≈+5%

Reinsurance renewals at January 1, 2020 were shaped by deteriorating loss experience, a lack of new capital inflows and increasingly challenged environments in the primary insurance and retrocession markets. While reinsurance supply was largely sufficient to meet demand in all but the most constrained areas during the renewal, outcomes varied significantly by geography, business line and cedent, with performance one of the key differentiators.

The loss environment and shifting views (and appetites) of risk have been a catalyst in changing market sentiment. The impact of risk reassessments has initiated derisking exercises throughout many segments of both the primary and reinsurance markets. As a result, many participants have scaled back or withdrawn capacity from several (underperforming) lines of business, creating a notable impact.

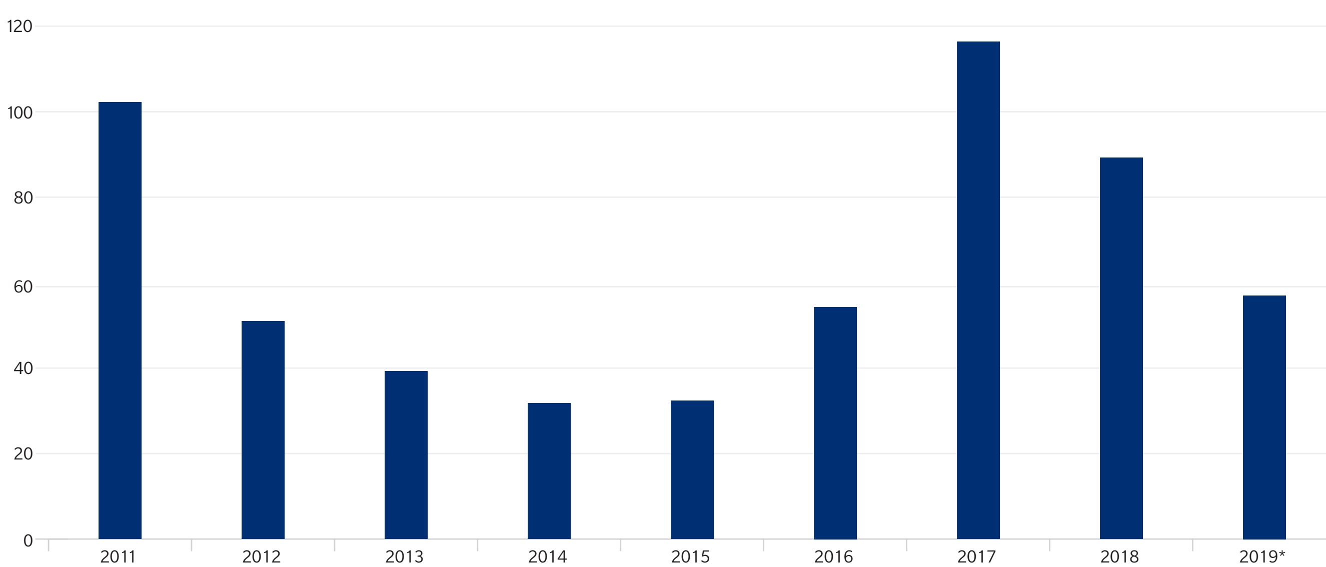
An Asymmetrical Market

Market conditions remain favorable in the reinsurance sector, which continues, in the main, to operate in an environment of abundant capital and capacity. But this is certainly not a one-size-fits-all market. Classes where underlying performance remains positive and profitable often resulted in renewals as expiring renewals, or in some cases modest rate decreases, at January 1, 2020. On the other hand, those with more strained operating conditions faced market corrections, some significant. The most pronounced rate increases were localized to specific regions or markets, typically led by successive years of losses, deterioration in performance and/or changing risk perceptions.

Specifically, capacity deployment strategies were realigned in a select number of US liability classes at January 1, 2020, as reinsurers reacted to pockets of heightened loss ratios and an increasingly difficult legal environment (both of which are being countered by significant positive rate momentum and underwriting actions within cedents' primary portfolios). These increased loss dynamics are being driven in large part by rising social inflation and a more aggressive plaintiffs' bar, fueled in some instances by the growing influence of litigation finance.

There was no respite from natural and man-made catastrophes in 2019 (see Figure 1). Another year of sizeable insured losses – provisionally estimated at close to USD 60 billion emanating in large part from Hurricane Dorian (United States) and Typhoons Faxai and Hagibis (Japan) – came on top of the costliest two-year period ever for insured catastrophe losses in 2017-2018. More importantly, it is not just about the quantum of the losses: virtually all significant events over the last three years have brought unanticipated or unmodeled loss components and a longer average development tail than expected. Growing concerns relative to the quantification of climate change impacts and model credibility have also led to more cautious catastrophe allocation strategies. As property margins come under increasing pressure, all other underperforming classes face additional scrutiny.

Figure 1. **Significant Insured Losses: 2011– 2019 in USD Billions**



** Estimated* *Sources: Press releases, PCS, Perils, Guy Carpenter*

January 1, 2020 Renewal

Retrocession

Reinsurers have ceded increased levels of premium into the retrocession market in recent years by leveraging strong market competition brought by new capital inflows. However, the environment in the retrocession market was challenged at January 1, 2020, characterized by trapped capital, a lack of new capital and continued redemptions from third-party providers. Just as increasing capital levels and retrocessional reinsurance purchasing contributed to attractive pricing and products in previous years, constrained capacity and robust demand set the scene for a complicated renewal this year, particularly for collateralized quota share and sidecar vehicles.

- The quantum of 2019 catastrophe losses, coinciding with continued loss deterioration for certain 2017 and 2018 events (Hurricanes Irma and Michael and Typhoon Jebi especially), eroded or trapped capital for a third year in a row.
- Frequency covers once again bore the brunt of losses last year, prompting some investors to review their allocations to the sector.
- Capacity dedicated to earnings protection (for example, pillared and aggregate transactions) was particularly scarce at January 1, 2020.
- Increased participations from traditional carriers partially offset trapped third-party capital, but only within certain price parameters.
- The impact of climate change was an important factor during negotiations, as the frequency and severity of natural catastrophe events is putting considerable focus on pricing adequacy.

All these shifting market dynamics prompted retrocession buyers to weigh the alternatives of accepting enhanced volatility potential or considering alternative vehicles, such as catastrophe bonds. These concomitant factors culminated in significant retrocession rate increases across several types of coverage at January 1, 2020, albeit with marked distinctions depending on products, structures, relationships, risk tolerances, loss experiences and performance.

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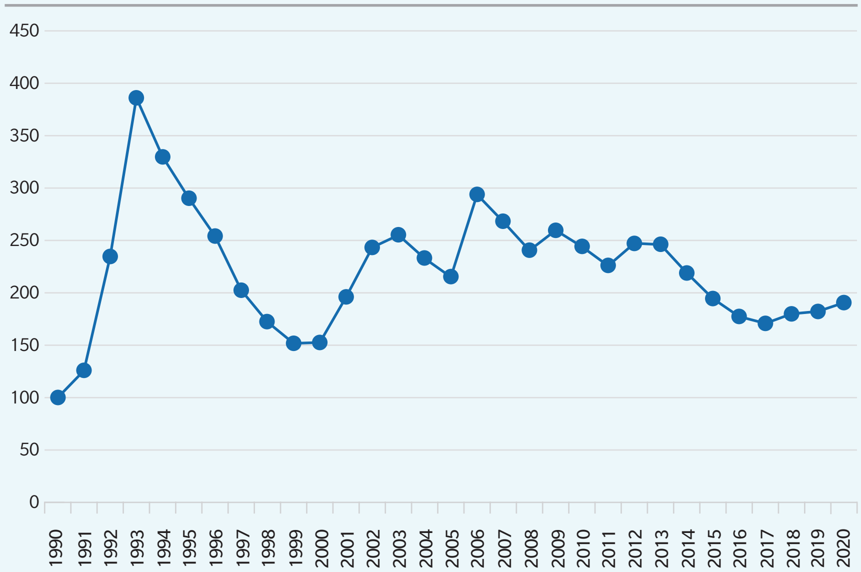
Property Catastrophe Reinsurance

Pricing corrections in the property catastrophe reinsurance market over the last few years have been localized, and mitigated to some extent by sufficient levels of capacity. These traits, along with the fact that the mix of loss-affected and non-loss-affected business up for renewal at January 1 is more diverse than at mid-year, created a wide range of outcomes, including within regions.

Pricing adjustments for loss-impacted programs in peak zones were significant in some cases, whereas non-loss-impacted accounts in other geographies trended flat to marginally down. Given the weighting of peak zone limit up for renewal at January 1, Guy Carpenter's Global Property Catastrophe ROL Index rose by approximately 5 percent, based on preliminary calculations (see Figure 2). This leaves the index near pricing levels recorded in 2015.

Figure 2. Guy Carpenter Property Catastrophe ROL Index – 1990 to 2020[1]



Source: Guy Carpenter

1. Guy Carpenter's Property Catastrophe ROL index shows the measure of change in catastrophe premium dollars paid year-on-year. All data points shown in the chart apply to January 1.

Property Catastrophe Reinsurance (continued)

- Property catastrophe renewals displayed an extremely wide degree of variation depending on program specifics such as losses, geographies and exposures.
- Increased pricing on loss-impacted programs in US zones where risk assessment is shifting was material to the movement in the Global ROL index.
- Although Japan suffered significant damage from typhoon events for a second consecutive year, relatively benign loss activity elsewhere in Asia resulted in negligible risk-adjusted pricing pressure for the territories that renewed at January 1.
- Property catastrophe renewals in Europe, which experienced another relatively quiet year in 2019, were generally flat to down moderately on loss-free programs due to more than sufficient levels of capacity and strong competition.

Pricing corrections in the property catastrophe reinsurance market over the last couple of years have been localized, and mitigated by sufficient levels of capacity.

Casualty

The backdrop to casualty reinsurance renewals at January 1, 2020 was more difficult, as heightened litigation costs, more generous jury verdicts and shifting attitudes in the United States forced reinsurers to adopt more cautious underwriting positions. Higher loss cost trends, increased frequency of severity and loss development beyond reinsurers' expectations led to market tightening in specific areas in some select segments, and in particular for the US liability market. While above expected loss emergence has so far been prevalent in the United States primary market, some reinsurers are also experiencing similar adverse results.

- Pressure was once again particularly acute in the US commercial auto market, but prior year loss development can now be seen in other liability classes, including directors and officers, medical professional and general liability.
- Higher loss cost expectations and weakened balance sheet reserves, arriving after years of competitive pricing and benign claims activity, are the driving forces behind the firming market conditions.
- As a result, excess of loss programs at January 1, 2020 saw rates typically up in the single-digit range for non-loss-impacted programs. Loss-impacted programs often saw more pronounced pricing pressure.
- Ceding commissions for proportional business varied by performance, but in general, commission levels remained stable as reinsurers benefited from significantly higher rates on underlying business, often exceeding original projections.
- A firming liability environment was also realized in several regions outside the United States. This is a result of deteriorating performance beginning to filter into the reinsurance market.

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A Smooth Transition

The (re)insurance sector is undergoing a period of transition: views of risk are changing and risk appetites are responding accordingly. This shift has manifested itself more acutely in the primary market, as underperformance across multiple lines of business over several years has led to market hardening. This is evidenced by Marsh's Global Insurance Market Index, which shows global commercial insurance pricing (all lines of business and all regions) rose by 8 percent in the third quarter of 2019.[2] This was the eighth consecutive quarter of price increases and it represents the largest rise since the index was initiated in 2012.

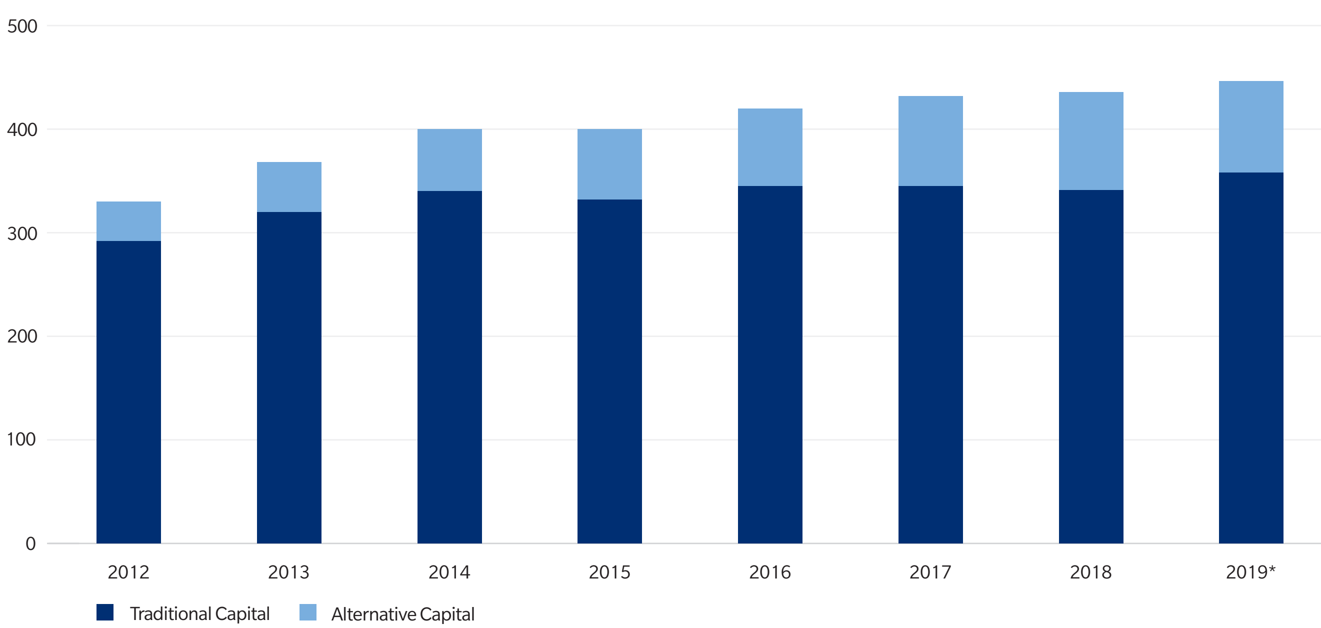
The response of the reinsurance market has been more measured overall due to more than sufficient levels of capital relative to risk for most renewal placements, even as reinsurers navigate elevated loss activity and adjust underwriting assumptions to reflect changing perceptions of risk. No doubt, conditions have clearly tightened in the retrocession market as a function of a significant slowdown in capital inflows affecting the balance of supply and demand.

Preliminary estimates calculated by Guy Carpenter and A.M. Best indicate that total dedicated reinsurance capital was up by approximately 2 percent at year-end, driven by increases in rated capital of close to 5 percent (see Figure 3). Alternative capital contracted by approximately 7 percent as investors were more cautious with new investments after assessing market dynamics and pricing adequacy. When accounting for trapped capital that remains unavailable for immediate deployment due to funding for previous years' loss requirements, dedicated reinsurance capital was effectively flat compared to a year ago.

While corrections in pricing and structure are occurring, the reinsurance market enters 2020 in a solid position. Capacity will continue to be deployed cautiously, with cedents' performance and loss experiences scrutinized closely. Yet, the sector remains well capitalized overall and additional capital may be deployed in the coming year should the pricing environment become more appealing to investors.

The (re)insurance sector is undergoing a period of transition.

Figure 3. Estimated Dedicated Reinsurance Sector Capital – 2012 to 2019 in USD Billions



* Estimated

Source: Guy Carpenter, A.M. Best

2. https://www.marsh.com/us/insights/research/global-insurance-market-index-third-quarter-2019.html

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