A Hardening Reinsurance Market : How to mitigate the adverse impact

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1. Hardening Reinsurance Market Drivers

What contributed to it?

The Hardening Reinsurance Market

What contributed to it

Significant upward movement of reinsurance/retro pricing were driven by several factors

Emerging Covid-19 related losses and the uncertainty around them

Elevated natural catastrophe event losses

Global warming and its impact especially on catastrophe prone markets

Increasing loss frequency and severity of liability classes with loss cost trending higher with social inflation

Prior years' loss development on liability classes

Challenges of low investment returns on the back of the lower interest rate environment

The erosion of industry prices over the last dozen years

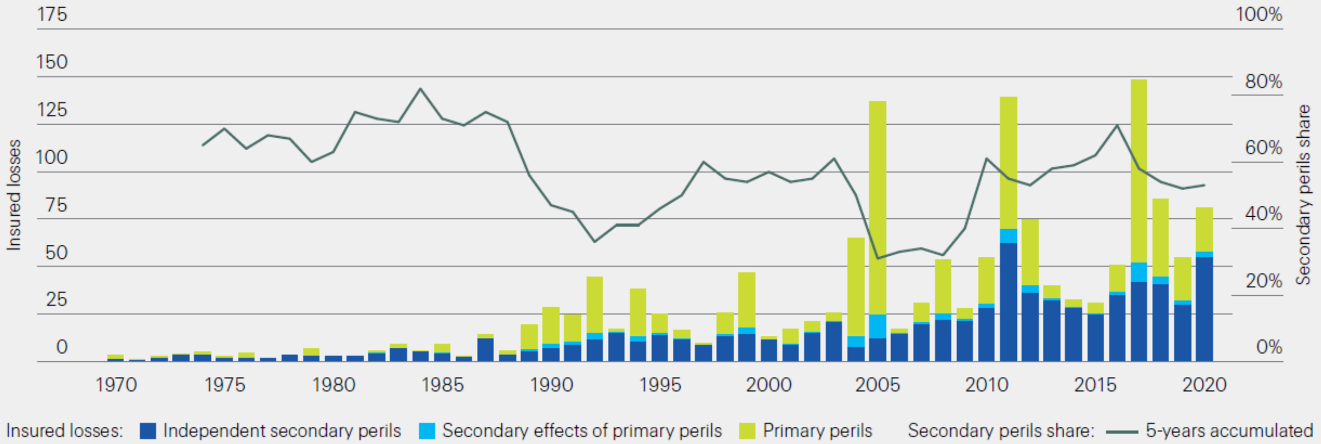
Hardening Market Drivers

Catastrophe Event Losses

According to Swiss Re Institute's Sigma 2020*, the global insurance industry insured catastrophe losses amounted to USD 81 billion in 2020, making it the fifth costliest on record.

**Estimates are for property damage and exclude Covid-19 related claims*

Annual primary and secondary peril insured losses since 1970 (USD billion) at 2020 prices, and share of secondary peril in total insured losses (five-years accumulated)



Source: Swiss Re Institute

Hardening Market Drivers
Catastrophe Event Losses

Severe thunderstorms and wildfires in the US as well as other secondary peril events around the world accounted for 71% of the USD 81 billion insured natural catastrophe losses.

44% of economic losses in 2020 are covered by the insurance industry, up from 2019's of 42% and a 10-year average of 36%.

Total Economic and Insured losses

USD bilion (in 2020 prices)	2020	2019	% Change	Previous 10-year average
Natural Catastrophe	190	140	36%	
Man-made	12	10	20%	
Economic Losses (Total)	**202**	**150**	**35%**	**222**
Natural Catastrophe	81	54	50%	
Man-made	8	9	-11%	
Insured Losses (Total)	**89**	**63**	**41%**	**79**
% of losses covered by insurance industry	**44%**	**42%**		**36%**

Source: Swiss Re Institute

Above average catastrophe losses in 2020 and major catastrophe losses so far in 2021 have put upward pressure on pricing.

Hardening Market Drivers

Covid-19 Related Losses

Publicly reported Covid-19 related losses and reserves for insurers and reinsurers stand at USD 37.38 billion as at June 2021*.

Covid-19 loss development is expected to continue into 2021/22 and losses are expected to be uncertain.

With litigations in various parts of the world Covid-19 related loss development and uncertainty of losses were factors in renewals in 2020/21.

Covid-19 Losses and Reserves Estimates for Insurers/Reinsurers

	Company	COVID-19 loss & reserves estimate (US$m)	Last updated DD/MM/YYYY
1	Lloyd's	4,956	31/3/2021
2	Swiss Re	4,493	30/4/2021
3	Munich Re	4,469	6/5/2021
4	AXA	1,830	4/5/2021
5	Hannover Re	1631.3	5/5/2021
6	Allianz	1576	12/5/2021
7	Berkshire Hathaway	1401	1/5/2021
8	Chubb	1378	27/4/2021
9	AIG	1133	6/5/2021
10	Insurance Australia Group (IAG)	884	20/11/2020
11	SCOR	883	28/4/2021
12	Zurich (P&C only)	821	12/5/2021
13	QBE	785	5/5/2021
14	The Hartford	728	22/4/2021
15	Fairfax Financial Holdings	682.6	29/4/2021
16	Liberty Mutual	680	6/5/2021
17	MS&AD (incl. MS Amlin)	605.8	20/5/2021

*Source: https://www.reinsurancene.ws/covid-19-insurer-reinsurer-loss-reports/

Hardening Market Drivers

Investment Market Performance

Reinsurers' investment income have been badly hit particularly in 2020.

Therefore, to compensate for the shortfall in investment income and the inability to meet the cost of capital, higher technical underwriting profit margins were required leading to an upward pricing momentum in 2020 and so far in 2021.

With governments responding with various stimulus packages during the early part of pandemic and other measures, economies have rebounded and equity markets have quickly recovered with some indexes reaching record highs.

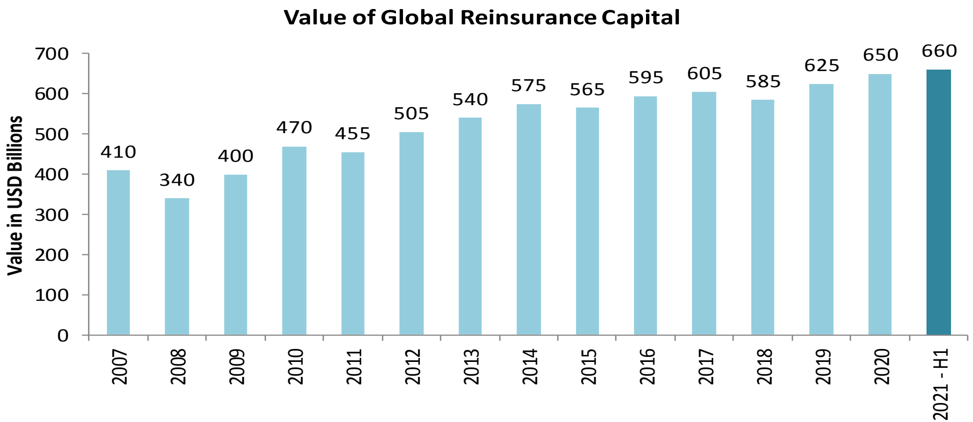
However, reinsurers are generally conservative with their investment strategy. Any material gain in stock markets is unlikely to change the investment strategy of most of the reinsurers.

Prevailing low interest rate environment and the volatility of equity markets compelled reinsurers to focus more on underwriting discipline and technical underwriting margins than any recent investment gains.

2. Notable Observations

Markets throughout 2020/21 Reinsurance Renewals

Reinsurance capital base has been intact. In fact, it has grown over the last 2 years.



Reinsurance capital as at mid-2021 is 1.5% above that of 2020, which is the highest in the period 2007 to 2021.

New capital raised both by incumbents and new entrants contributed to the total.

However, there was also returning of capital to shareholders.

Many believe Covid-19 is not a capital event as the capital base has been left largely intact by the pandemic.

Source: https://www.statista.com/statistics/273529/global-reinsurance-capital-from-2007/

Observations
Pricing Changes

Modest Rate Increases

- Reinsurance rate increases were generally reported to be in the 5% to 15% range risk adjusted basis.
- This compared favourably to the earlier expectations back in late 2020 where a range of 5% to 35% was predicted.
- Overall it was a moderate increase not the huge jump expected.

Performance Mattered

- Reinsurance programs incurring claims in 2020/21 have been particularly hard hit with significant price increases.
- Profitable reinsurance programs to reinsurers had a cost advantage even though they were not spared the impact of price increases.

Observations
Structural Changes

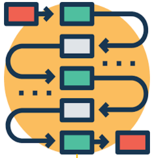
Expiring reinsurance/retro structures have also seen changes in order to address pricing concerns.

The following are some of the measures taken by insurers/reinsurers to mitigate the impact of increase in pricing:

- Increase in deductibles
- Introduction of Annual Aggregate Deductibles (AAD) features
- Loaded reinstatements to reduce upfront reinsurance cost
- Separation of layers by loss type (e.g. risk only layers)

The renewal process was longer than usual

Early start to renewal process



Quoting process has been slow and more complex as reinsurers were following strict underwriting guidelines and reinsurance programs were closely scrutinized

Rigorous contract review process with exclusion clauses and wordings

As a result signing process was later than usual

Terms and Conditions and contract wordings have been a major focus with the renewals in 2020 and 2021 and formed a significant component of negotiations.

There has been an intense push from reinsurers for exclusions to be applied and the more prevalent of these are:

Communicable Disease Exclusions

- Various versions including but not limited to: LMA 5391, LMA 5393, LMA 5394, LMA 5395, JX 2020-009A, Communicable Disease Exclusion (differing versions as approved by reinsurers), Broad Pandemic/Infectious Disease Exclusion Clause.

Cyber Exclusions

- Cyber Loss Limited Exclusion Clause No. 1 LMA 5410 to replace Cyber Risk Exclusion Clause NMA 2915.
- Joint Excess Loss Cyber Losses Clause JX 2020-007, to replace the original Cyber Attack Exclusion Clause under the Joint Excess Loss Committee Clause CL 380.

3. How to mitigate the adverse impact

Data Quality

- The data quality has always been and will be paramount for the policy renewal process regardless of the stage of market cycle the reinsurance industry is in.

- The hardening market has put more emphasis on the data quality.

- Reinsurers tend to penalise insurers for poor data quality as they would have to deal with information asymmetry and more uncertainty within the pricing analysis, which inevitably add to further price increases on top of any hardening rates.

Therefore, improving data quality is a vital first step to dampen the adverse impact of a hardening reinsurance market.

Mitigation Measures
Reinsurance Structural Changes

The main objective of Reinsurance structural changes is to provide reinsurance cost savings.

Increase in Deductible

- Increasing the deductible of non-proportional reinsurance programs can provide reinsurance cost savings.
- With an increased deductible, insurers retain more working losses.
- A proper cost-benefit analysis is always recommended to find an appropriate level of retention.

Annual Aggregate Deductible

- For non-proportional reinsurance programs, consider an Annual Aggregate Deductible (AAD) feature.
- Under AAD insurers retain more losses up to the AAD limit before subsequent losses can be recovered.
- Insurers with the intention of maintaining their expiring levels of deductible but looking for cost savings can consider introducing an AAD feature.

Mitigation Measures

Reinsurance Structural Changes

Loaded Reinstatements

- With non-proportional reinsurance programs, an insurer pays an upfront premium.
- One of the components that determines upfront premium is the reinstatement factor, which is used as a discounting factor (the higher the reinstatement factor, the lower the upfront premium and vice versa).
- Typically, the reinstatement factor is set at 100%, which implies that reinstatement premium is 100% of upfront premium.
- To provide cost savings with the upfront premium, the reinstatement factor can be set above 100% to have a greater discounting effect.
- This measure is particularly suitable for reinsurance programs having loss free experience.

Option to buy additional cover only when needed

- Insurers targeting growth in their portfolios need to cater for possible growth in risk exposure.
- This in turn requires increased protection with reinsurance coverage.
- With uncertainty in market conditions it may be challenging to achieve growth expectations.
- Therefore, instead of purchasing an increased cover limit at the start of coverage, insurers can opt for such an increase midway depending on the growth achieved.

Mitigation Measures

Reinsurance Structural Changes

Separation of layers by cover type

- With non-proportional reinsurance programs, layers can be separated by loss type (i.e., risk only or catastrophe loss only layers).
- This is particularly beneficial when there is no loss experience from a particular type of loss.

Multi-year deals to lock in pricing

- In a hardening reinsurance market in anticipation of further rate increases in the future, insurers can consider multi-year structured deals.
- With a multi-year deal, coverage is purchased for more than one year (e.g., for two or three years) with price fixed at the start of the deal.
- Such deals also incentivise insurers for favourable loss experience at the end of the deal by sharing profits through profit commissions.

Revise Event Limits, Commission terms, and other features

- With proportional reinsurance programs, finding reinsurers to support has become difficult in certain markets as some reinsurers withdrew support or reduced capacity.
- Insurers with adverse loss experience in their proportional reinsurance programs may find it even more difficult to find support.
- Therefore, to deal with such situations, changes to coverage terms and conditions may be required.
- Some measures include lower event limits for catastrophe losses, reduced commissions and the introduction of more onerous clauses on insurers such as Loss Participation Clauses (LPC).

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Mitigation Measures
Engagement with Brokers

Closer engagement with brokers

- A closer engagement with reinsurance brokers has never been more critical than now in the current market conditions.
- Insurers can leverage on the analytical services offered by brokers to optimise their reinsurance structures to provide cost savings with optimal coverage.
- Brokers have deep market knowledge and close relationships with reinsurers, which can benefit insurers.
- Brokers can identify quoting reinsurers who have provided competitive pricing in the past renewals and collaborate with them to find out their willingness to support.
- Brokers can engage with existing reinsurers in an insurer’s panel and if required, secure additional capacity in case of a shortfall in coverage.
- There are reinsurers planning to enter new markets or looking for growth in certain markets. Brokers are in a better position to identify and engage with them for support.

Mitigation Measures
Early Start

Early start

- The entire reinsurance renewal process in recent renewals was longer than usual.
- An early start allows more time for reinsurers to analyse and price, brokers to negotiate with reinsurers on pricing and terms and conditions, and to find support for reinsurance coverage.
- Therefore, it is prudent to start the renewal process early.
- The last thing an insurer wants is a shortfall in its reinsurance coverage.

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4. Conclusion

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Conclusion

After experiencing more than a decade of soft market conditions, the reinsurance market has begun to harden. Many factors including the following have contributed to the hardening of the market.

- Elevated natural catastrophe losses.
- Covid-19 related loss development particularly related to business interruption.
- Low interest rate environment compelling reinsurers to focus more on underwriting discipline and technical underwriting margins.

The hardening market is expected to prevail. To mitigate the adverse impact insurers can take steps including the following.

- **Improving the quality of renewal data**
- **Possible reinsurance structural changes to provide cost savings**
- **A closer engagement with brokers**
- **An early start to the reinsurance policy renewal process**

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The End

Thank You

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