November 29, 2023

Market Segment Outlook: Global Reinsurance

The outlook for the segment remains at Stable in light of rate improvements and growing demand, countered by concerns about underlying risks

AM Best is maintaining its outlook for the global reinsurance industry at Stable. Key factors supporting the outlook include the following:

- Substantial rate improvement, primarily in property lines, with higher average attachment points expected to result in widening profit margins
- Increased demand for coverage due to heightened catastrophic loss activity as well as general economic uncertainty
- Rising investment income, as new money yields on fixed-income investments have more than doubled
- Strong demand for life and annuity reinsurance from US-domiciled insurers, as well as continued strong flow of capital to support new L/A reinsurance entrants

Factors countering these positives include the following:

- Persistent, growing uncertainty about underlying risks, including frequency and severity of weather-related activities and evolving risk profiles
- Cautious new capital, despite improved market conditions
- Concerns about economic and social inflation
- Higher post-COVID-19 mortality in certain markets

Weather and Loss Trends Persist, While Reinsurers Benefit from Hardening Market

The insurance market was off to another fast start in terms of catastrophic loss activity in 2023. Consistent with recent history, insurers have been plagued by elevated weather-related losses, including secondary perils. Rising sea surface temperatures and elevated coastal property values continue to adversely impact modeled loss projections. These factors have caused many reinsurers to retract significant amounts of capacity in the property reinsurance market. The remaining reinsurers have benefitted from the reduced supply via drastically higher attachment points and higher risk-adjusted rates on line. Despite some disparity between primary insurers' and reinsurers' underwriting returns through the year, AM Best believes reinsurers won't be relaxing their stance for some time. The market is currently working in favor of reinsurers, but investors' appetites had already been stressed for an extended period before the market shift.

Some casualty reinsurers have reported pockets of adverse reserve development, triggered mainly by social inflation in the US. Some larger players reduced their exposures, particularly in public D&O (directors and officers) and excess casualty. Reinsurers will need to maintain prudent loss reserving methodologies to account for the impact of social inflation, as well as general inflation, in the years to come.

Although the global life reinsurers have reported an improvement in mortality since the height of the pandemic, non-COVID mortality experience generally remains higher than expected—life

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reinsurers have noted an uptick in deaths related to liver disease, drug use, and diabetes—and whether mortality will revert to pre-COVID levels remains to be seen. In addition, questions remain about the near and long-term impacts of pandemic-related mortality experience on assumptions and future pricing.

Re-Redefining the Function of Reinsurance

Reinsurance was originally created with one goal in mind: capital preservation. Over time, that goal has shifted, as new players entered and exited and business strategies evolved. In more recent history, many primary insurers have used reinsurance to manage earnings in addition to preserving capital, including the use of lower-level catastrophe covers and aggregate reinsurance. As the soft market in reinsurance persisted, primary insurers became reliant on this coverage and priced/managed their portfolios on the expectation of this coverage being provided. Recently, these types of products have essentially disappeared from the market, leaving many primary insurers with a substantial mismatch between their risk tolerances and current portfolios.

Nowadays, reinsurance is again being viewed as a capital preservation product, but some might question if reinsurance could once again be used for earnings management. There remains demand for it, and innovators look to create products where demand exists. However, (re)insurers have created issues in the past and, more recently, by providing insurance for sub-optimal exposures. Whether the market eventually sees lower level/aggregate covers again remains to be seen, as it may take a few years before the market is comfortable enough to even consider these options.

Insurability Being Challenged

One of the less emphasized issues in the current insurance market is insurability and the adverse trends surrounding it. Particularly in the US, coastal property values continue to rise as more and more property owners flock to catastrophe-exposed areas. Government- and state-sponsored entities/programs providing coverage of last resort, as well as price regulation, have created perverse incentives, counteracting the market risk signals that should have prevented continued property development on flood plains and other adverse terrains. Similar issues are affecting wildfire-exposed regions. Insurers see themselves challenged between prudent risk management and the desire to retain market share.

Different Rates, Different Problems

The rise in interest rates has caused some stir, particularly with regard to unrealized investment losses. However, the mark-to-market losses many reinsurers experienced were not substantial enough to result in a strategic shift in business to reduce capital burdens. Property/casualty reinsurers retained adequate liquidity and were able to recoup much of their losses as their fixed-income investments matured. Moreover, despite lingering unrealized losses, many reinsurers anticipate recouping these losses rather soon, given an average portfolio duration of three to five years. As older instruments mature, insurers are re-investing in new, higher-yielding issuances, typically with yields that are double, or even triple, the prior issuances.

The rise in new money yields improves overall operating returns substantially via higher net investment income. However, the rise in risk-free rates also results in a materially higher cost of capital for reinsurers. Some of the established franchises have still been able to raise capital to support new business, while others have had some difficulty.

The long-duration liabilities of global life reinsurers require investing in assets of similar duration to prevent a mismatch. As a result, life reinsurers reported much larger unrealized losses, given that these long-duration assets are more sensitive to changes in interest rates. These assets also take longer to reinvest into higher-yielding securities without having to realize significant losses due to the large unrealized loss positions.

Nonetheless, life reinsurers have experienced rising investment yields over the past year because of the rising interest rate environment. In addition, reinsurers in the US life segment have reduced credit risk in their investment portfolios by increasing their allocation to NAIC-1 bonds, as higher rates have made the corporate bond market more attractive. However, many Bermuda- and Cayman Island-based reinsurers continue to take on additional investment risk through private credit and other structured securities that provide an illiquidity premium. In many cases, these securities are sourced from the parent company that specializes in these types of investments. AM Best will continue to monitor the generally higher level of investment risk in offshore-domiciled life reinsurers.

Established Capital Remains Supportive, New Capital Remains Cautious

An important distinction must be made between "available" and "deployed" capital, as all "available" capital does not translate automatically into "deployed" capital. Despite all the noise around unrealized investment losses and elevated catastrophe losses, the segment maintains sufficient capital to support its current ratings. Some reinsurers have reported temporary reductions in capital buffers, although this is likely to revert in the near term as assets backing reserves and investments begin to benefit from higher fixed-income rates. Moreover, some reinsurers have chosen to divert capital from property reinsurance and deploy it into primary/specialty lines of business, effectively reducing the total deployed capital. Furthermore, reinsurers continue to partner with third-party capital providers to optimize risk limits on their balance sheet.

At year-end 2022, reinsurance capital had declined roughly 8.6% from 2021, most of which we expect will be recouped throughout 2023. Through the first half of 2023, prior year unrealized losses had eroded significantly. The S&P 500 was up 16.9%, while fixed-income values continued to benefit from bond issues pulling to par as they approached maturity dates. Shareholders' equity was up 10% on average among global reinsurers at mid-year 2023, with some up over 30% after raising capital earlier in the year. Net investment income for the segment is already approaching—and in some cases has even exceeded—the prior year's total. Additionally, reinsurers have reported improved underwriting results across the board. Although the third quarter is typically the loss-making quarter for reinsurers in the US market, many primary insurers have reported substantial catastrophe activity at mid-year 2023 that hasn't impacted reinsurers.

Some of those that remain in the reinsurance market have looked to fill the gap created by those that have exited the market. However, raising capital in the current economic environment has proven difficult for some. Established, high-quality, and diversified organizations have been able to raise capital to support expansion efforts through the hard cycle. New entrants, despite varying business plans and strong management teams supporting them, have had more difficulty obtaining funding. Although new entrants could eventually obtain funding, they are unlikely to obtain enough to move the market in a meaningful way.

New capital continues to flow into the life reinsurance market, as demand remains strong thanks to a record level of annuity sales in the US and the continued divestment of large blocks of capital-intensive and interest rate-sensitive business by the large publicly traded companies in the US and Canada. Private-equity and asset managers have been the primary source of capital for new entrants in both the annuity and block reinsurance markets in the US, Bermuda, and Cayman Islands. The surge of new entrants in recent years has resulted in greater competition for block annuity deals. As a result, more L/A reinsurers have been seeking flow reinsurance deals, as well as looking to diversify their business profile by entering the retail L/A market. Several Bermuda-domiciled reinsurers have also entered into deals in international markets such as Japan, where regulatory changes and low interest rates have increased the demand for reinsurance.

Opportunity and Risk Balance

The current global reinsurance market has been referred to as a “generational” opportunity for reinsurers. Pricing trends and restrictions in terms and conditions are at all-time highs. However, uncertainty continues to mount. Aside from the convergence of social inflation, climate change, and lack of insurability, reinsurers need to adapt to a high inflationary environment, something many of their actuaries and underwriters have never experienced. Uncertainty surrounding the market’s ability to quickly adapt to these new market dynamics and capitalize on pricing remains elevated as well.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies.

A Best's Market Segment Outlook can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
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We update our market segment outlooks annually but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

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