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A New Reinsurance Paradigm

The global reinsurance industry has been battered by several years of serial under performance. It has been impacted by natural catastrophe losses, modelled and unmodelled, social inflation, declining investment returns, dimished reserve releases and is now facing an unprecedented globally systemic loss in Covid 19. Have we now reached the point where the global reinsurance market can morph into a new paradigm allowing a new more responsible and sustainable market to emerge? Or are we seeing a reworking of old approaches that have failed to deliver the sustainable efficient solutions that primary insurers, policyholders and increasingly society seek. Moments like this do not come often and arguably the last opportunity for a reset was 20 years ago in the aftermath of the 9/11 tragedy. So, what has gone wrong and how can we build back better.

Firstly, the harsh fact is that with a consistent weighted cost of capital in the 7% to 8% range the global reinsurance industry has not covered its cost of capital for the last 6 years. A prolonged soft market has led to under reserving on many long tail lines which is being exaggerated by social inflationary pressures. Over reliance on pricing models that have proved unreliable with hindsight has led to unsustainably low pricing which eventually requires significant and disruptive correction. Despite the unsatisfactory performance capital has continued to flow into the global reinsurance market most notably in the very significant expansion in ILS capacity over the last ten years but also through retained earnings on existing reinsurers which have been bolstered by investment returns. Without the constraints of capital limitation to control excessive competition the inevitable result has been underperformance as reinsurers chased top line growth at the expense of profit.

Fortunately, the reinsurance industry remains well capitalised with capital levels above the end of 2018 and only slightly reduced on the capital levels at the end of 2019. Since capital constraint is clearly not going to limit pricing competition, we must look elsewhere for other drivers that will help to put discipline and structure around achieving sustainable adequate returns. Here the role of investment income offers a potential solution. Unlike any previous hard markets when investment rates were at much higher levels, current investment rates remain pitifully low and with the fiscal expansion being pursued by nearly all governments as a result of Covid 19, are likely to remain so for many years. On the basis that most reinsurers investment holding periods are in the range of 4 to 6 years they are having to face the reality that the current low investment returns will continue into the foreseeable future.

Faced with the loss of the investment crutch reinsurers have no option but to concentrate their efforts on improving their underwriting results to generate enough margin to reward their capital. With a 7% to 8% cost of capital and ROE targets in the region of 9% to 10% reinsurers now need to run combined ratios in the low 90’s, something the industry has not achieved for many years. This requires a back to basics underwriting approach to ensure that each unit of risk accepted is appropriately priced within a reinsurer’s overall portfolio. This inevitably means rate increases along with changes to terms and conditions neither of which will be easy to achieve in a global recessionary environment where many policyholders are under significant financial stress. This is a delicate path to navigate successfully but the strong capital position of the industry should be able to ensure that risk is appropriately differentiated, and pricing corrections are applied on a case by case basis in a sustainable fashion that clients can manage.

But more importantly than addressing the current immediate short-term issues if the global reinsurance industry is to avoid the mistakes of the past and build a better future by enhancing its value to society it must find and support ways to build long term demand that will help to underpin sustainable long-term growth. Here the Covid 19 situation is helpful as it has moved the discussions about uncorrelated tail risk from theory to practice and with it the demand for reinsurance. At the same time the increased reliance on underwriting profitability is putting an emphasis on volatility management where again reinsurance plays a major role. Risks such as Cyber and Climate Change also fall into the uncorrelated tail risk category and again reinsurers have a pivotal role to play. Finally, there is the enormous opportunity represented by the uninsured economic gap. Finding innovative solutions to help society narrow the gap will lead to a complete reframing of the reinsurance market. Achieving this will require dedication, long term vision and the ability to build partnerships with organisations and bodies that the reinsurance market has never interacted with before, many in innovative public private partnerships.

The opportunity to build back a better reinsurance market is clearly before us. The test will be whetherreinsurers can bridge the gap between capital that requires reasonable sustainable returns and new growing risks that threaten society through the development and distribution of transparent solutions. If the reinsurance industry fails to grasp this opportunity it will be doomed to suffer the fate of so many with the current generation repeating the mistakes of their predecessors