Insurers Hunt for Diminishing Opportunities in a Market Laden with Challenges

Over the past decade the insurance industry has been faced with numerous tests, including major catastrophe losses, the global financial crisis, regulatory changes and more recently uncertainty created by political events (see Exhibit 1). Despite the challenging operating environment, with companies navigating through a liquidity and sovereign debt crisis in addition to a sustained period of low interest rates, the (re)insurance industry has emerged relatively unscathed and in a position of greater financial strength.

Exhibit 1
Recent Events

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Lessons have been learnt from the past, with insurers and reinsurers adopting more robust risk practices to ensure balance sheets are better equipped to absorb the challenges that potentially lie ahead. However, the extended pressures of diminishing investment returns, dwindling loss reserves and intense competition are beginning to erode industry fundamentals. And in an increasingly complex, interconnected world, the potential for risk accumulation and unexpected correlations has never been higher.

But it is not all doom and gloom for the industry. Risk has always been about the upsides as well as the downsides and where there are challenges, there are also opportunities. Devising new solutions and products to help close the protection gap, making better use of data and exposure management tools, and pursuing growth with control and discipline are some of the areas in which insurers and reinsurers can create competitive advantage and prosper in an otherwise difficult operating environment.

In this special report, A.M. Best will focus on the threats and opportunities posed by accumulation risk, pandemic, low interest rates, energy prices and adverse reserve development.
Nevertheless, A.M. Best remains mindful that there are many other threats and opportunities that insurance and reinsurance market participants must consider going forward.

**Managing accumulation risk amidst growing complexities and interdependencies**

Globalisation and technological advances are creating a world where there is greater interconnectivity and interdependencies. As a result, the potential for significant accumulation of risk is growing. At the same time, increased complexity is making the detection and management of accumulations within portfolios more challenging, particularly for casualty books of business.

Nevertheless, there are still surprises on the property side, particularly in relation to business interruption and contingent business interruption. The Tianjin explosion in China was the industry’s biggest loss in 2015 with claims up to USD 3.5 billion. The port disaster impacted multiple lines of business, disrupted supply chains and highlighted the accumulation issues present in large transportation hubs. While in 2011, the majority of the USD 16 billion in insurance losses emanating from the Thai floods related to direct and indirect business interruption, reflecting increasingly global supply chains, with multiple tiers of suppliers and sometimes unforeseen aggregations.

At the same time, lean manufacturing techniques, such as just-in-time, have reduced the ability of supply chains to absorb disruption. It is likely that in the future such costs will escalate if the growing trend towards globalisation of production and trade persists. The ease of coordination and collaboration along today’s supply chains offers operating efficiencies but also introduces new, more complex risks, whereby one company’s exposure can spread to its suppliers, partners and service providers.

Casualty accumulations are not geographically defined in the same manner as property risks. They are likely to be driven by more esoteric factors, such as the interaction of legal and socio-economic factors. While the industry has been developing tools and techniques to better understand casualty clash and casualty catastrophes (see Exhibit 2), at present probabilistic models are not widely used.

**Exhibit 2**

**Accumulation Risk – Casualty**

[Diagram showing various strategies for managing casualty accumulations]

- Identify supply and distribution chains
- Application of big data
- Emerging risk analysis
- Expert knowledge
- Scenario analysis
- Advancements in modelling techniques
- Event footprints
- Enhanced policy information

Source: A.M. Best research
Casualty clash events are those that involve a significant loss to multiple policies or insureds from a single event, while casualty catastrophes can impact multiple companies, geographies and lines of business. They are events, activities or products that result in a number of lawsuits from multiple plaintiffs alleging damages that impact multiple insureds, coverages and/or time periods.

Industry capital models challenge insurance and reinsurance companies to put in place sophisticated property catastrophe risk management systems and controls, and to provide stronger capitalisation to support the risk. However, casualty catastrophe risk could surpass property catastrophe risk for many companies.

As part of its rating analysis, A.M. Best reviews the way that insurers stress test their portfolios to establish whether they have the necessary capital to support these exposures.

**How equipped are insurers to withstand a severe global pandemic?**

A global pandemic is one example of an event that could spark a casualty catastrophe and a threat that is often overlooked amidst the many, more common, perils that impact insurer and reinsurer balance sheets. While less common than hurricanes, earthquakes and other natural catastrophes, a severe influenza pandemic would be a global shock with wide-ranging ramifications.

To some extent, the threat severity of a global pandemic has been countered by the development of new vaccines, globally coordinated responses and a healthier, better immunised global population. However, macro trends such as population growth, urbanisation, increased global travel (with international tourist numbers up 4% in 2016 to 1.2 billion) and the mutation of diseases (resulting in new strains with greater resistance to drugs) also means diseases have the ability to spread more quickly through society.

It is always difficult to estimate the impact of a pandemic, as it is a rare event, with a reoccurrence rate of 30-50 years. Whilst the direct impact of a pandemic can have major consequences for life and health insurers and reinsurers, there can also be secondary effects, with repercussions to industries and communities. Following the 2003 SARS epidemic, Hong Kong's GDP fell by 2.6% and it also experienced deflation and unemployment. Tourism was one of the hardest hit sectors, with the World Health Organization warning against non-essential travel to Hong Kong. Shops, restaurants, hotels and cinemas suffered sustained business interruption, very little of which was covered under conventional business interruption policies.

In its São Paolo Virus Pandemic Scenario, the Cambridge Centre for Risk Studies considers the impact of the fictional strain of “H8N8” influenza, a 1-in-100 pandemic. Globally, the economic impact of such a virus would be between USD 7 trillion and USD 17 trillion of GDP over five years, it estimates, with numerous classes of both life and non-life insurance impacted.

Under such a scenario, insurers would be faced with both underwriting and investment losses as well as operational challenges, such as workforce absenteeism. Life and health insurance companies would inevitably bear the brunt of a major outbreak, with insurance losses coming in at between USD 190 billion and USD 265 billion according to the Centre’s hypothetical case study. One of the biggest unknowns with any new pandemic is the length of time it would take to prepare a new vaccine.

While there is a threat to the financial strength of insurers and reinsurers, the risk of pandemics is also an opportunity for the industry. Improved modelling capabilities and confidence in medical advances may offer the market the tools it needs to develop new products to help close the significant gap that exists between economic and insurance costs arising from major pandemics.
Preparing for the economic consequences of prolonged low interest rates

The balance sheet pressures that insurance and reinsurance companies have been feeling for several years, resulting from low interest rates, volatile energy markets and softening rates on line, are unlikely to disappear in the near term. However, the election of Donald Trump in the United States Presidential Election and the United Kingdom’s referendum decision to exit the European Union (EU) are among the factors that have introduced a significant element of uncertainty into the near-term economic outlook.

On the one hand, while there is the risk that the low interest rate environment will continue, A.M. Best believes that insurance companies should also consider how their investment portfolios would respond to a sudden interest rate spike.

Fixed income securities tend to dominate insurers’ investment portfolios, and as yield spreads and bond prices move in opposite directions, a sharp rate rise would mean that unrealised gains accumulated during the years of a low-rate environment would suddenly become unrealised losses. Companies adjusting their business models in response to the extended period of low interest rates could be disproportionately disadvantaged if rates suddenly move upwards.

In particular, A.M. Best notes that life insurers and reinsurers, with their longer duration products and assets, would struggle following an interest rate spike as they would need to wait for assets to mature before being in a position to reinvest and take advantage of the higher rates. Also, a rapid rise in rates could tempt policyholders to switch to other products that offer higher returns. The resultant increase in surrenders could weaken the liquidity and financial profiles of some insurers if they are forced to realise the losses on their bond portfolios. Non-life companies could react more quickly, but it would still take some time to adjust their investment portfolios.

The low interest rate environment has already continued for a much longer period than many observers had predicted, with a growing concern that this might be the “new normal”. If so, A.M. Best notes that this would have significant implications for the profitability, solvency and business models of insurers. For non-life insurers, low interest rates are primarily an investment concern. A high proportion of investments are in interest rate-sensitive assets such as bonds and this has resulted in a prolonged period of low investment returns.

In the life sector, those insurers with large government bond portfolios and high guarantees to policyholders are most at risk. German life insurers are particularly vulnerable, as high guarantees are a feature of the market and the fall in German government bond rates has been particularly pronounced, with Germany becoming the second G7 nation after Japan to issue 10-year bonds with a negative yield. High guarantee rates are capital intensive under regimes such as Solvency II and will become harder to service over time.

As insurance liabilities tend to have a longer duration than assets, particularly in the life sector, if interest rates fall still further, the increase in insurers’ liabilities will be greater than the increase in the value of assets. This will have a negative impact on solvency under regulatory regimes such as Solvency II, where there is market consistent valuation.

Net profits, and ultimately capital through retained earnings, will be affected by a fall in net investment income as cash flows from premium income and maturing investments are reinvested at lower rates. This may be offset, at least initially, by unrealised gains on bonds flowing through the income statement.
The sensitivity of both assets and liabilities should interest rates remain low will depend on their duration. Impact will also differ depending on individual business models. For life insurance companies, product changes could help to cushion the impact of a lengthy period of low interest rates.

This could be achieved by offering lower guarantee rates on new business and by reducing dependence on investment income and savings-type products. However, products could be less attractive to consumers as a result. Sensitivity to investment risk can be reduced by writing a more diverse portfolio of business, focusing on pure risk covers or by increasing the proportion of unit-linked business written.

Life and non-life insurance companies are already pursuing a number of investment changes in response to ongoing challenges. These include more closely matching their assets and liabilities, taking on more credit risk or increasing duration. Also, alternative investments such as infrastructure, commercial real estate and direct lending may boost returns. But higher risk assets will attract higher capital charges from A.M. Best within its capital model (Best’s Capital Adequacy Ratio) and under regulatory regimes such as Solvency II.

The impact of product and investment adjustments will take time. How rapidly insurers are able to adjust their books of business will depend on the existing business models and regulatory constraints. While it is difficult to see the pockets of opportunity, insurers are in a position to take advantage of favourable pricing to refinance debt and lower their cost of capital.

**Insurers feel the impact of plummeting energy prices**

Few experts could have predicted that oil prices would have dropped from a high of approximately USD 120 a barrel in January 2013 to USD 30 a barrel at the beginning of 2016 (see Exhibit 4). Such a dramatic slump in the price of crude oil has had economic ramifications in both mature and emerging markets, with the oil rich economies feeling the brunt of the impact. Energy is a key component of inflation indexes, with the low oil price suppressing inflation in mature markets.

However for economies dependent on oil revenues, sustainable economic development is dependent on a much higher fiscal breakeven price. Many countries are running current account...
deficits and utilising existing surpluses to fund growth, which is inevitably placing greater strains on their economies. As a result, many oil dependent markets are undergoing austerity measures and experiencing government cutbacks on subsidies on key essential commodities.

The energy insurance sector has seen capacity increase three-fold over the past ten years. At the same time, both upstream and downstream energy classes have seen a continuous reduction in premium rates. With the increased level of competition in the energy sector, underwriting margins have consistently been squeezed, and the fall in the price of oil has further intensified the situation. Many projects have become uneconomical and been cancelled, while investments in new projects have been limited. A.M. Best notes that this is likely is further reduce premium volumes and place greater pressure on managing costs as companies rationalise the benefits of continuing to underwrite energy risks.

Of greater concern is the uncertainty over the future price of crude oil. This has been largely influenced by over-supply, and while the Organisation of Petroleum Exporting Countries (OPEC) is looking to control supply in an effort to boost prices, a significant proportion of oil producers are non-OPEC members. Meanwhile, a further reduction in demand from major oil importing economies, such as China, and/or increased supply, with the growth in shale oil extraction and the prospect of Iran re-entering the market as a major supplier, could keep prices lower for longer.

Insurance companies could also be impacted by depressed oil prices indirectly as a result of political unrest in fragile oil-dependent countries, as previously seen during the Arab Spring. Geopolitical risks are likely to persist in parts of the Middle East, Africa and Eastern Europe, particularly in countries which are currently experiencing instability and conflict.

The economic impact has been more detrimental to insurers operating in oil-rich emerging markets. One of the concerns is the immature nature of financial markets in emerging economies, with many insurers having material exposure to equity and real estate markets. A.M. Best notes
that in some cases insurers have up to 70% of investments dedicated to these asset classes.

As evidenced over the past year, there have been market shocks as a direct result of the fall in oil price, with stock markets in Eastern Europe, Africa and the Middle East showing substantial drops. This has created greater volatility in insurers’ operating performance and balance sheet strength. Moreover, as a result of the economic strains, some countries have also suffered significant depreciations in their currencies. This combined effect has created stress on both investment and insurance activities, particularly in Russia and Nigeria, and in some cases has resulted in negative rating pressure.

Both countries are highly-dependent on oil revenue, while economic sanctions (in the case of Russia) are aggravating the deteriorating situation. The longer that oil prices remain low, the greater the economic difficulties these countries, and their domestic insurers, will be faced with. There is also the real risk over the medium term that some currencies that are pegged to the US dollar may be unpegged if the economic situation does not improve.

**Warning! Risk of adverse reserve development**

Over the past five years, insurers and reinsurers in the United States, European and London markets have become increasingly dependent on bolstering results with sizable reserve releases. To a large extent this has masked the industry’s deteriorating fundamentals.

Taking into account below-average natural catastrophe loss activity in recent years, it is increasingly apparent the industry’s underlying profitability is weakening. In A.M. Best’s view, it will become increasingly difficult to sustain the current level of reserve releases that are being used to support earnings. More worryingly, there are signs companies may need to guard against possible reserve deficiencies in order to avoid a material depletion of capital

The closely-linked combination of deficient loss reserves and inadequate pricing is the principal cause of insurer impairments. In the U.S. property casualty (P/C) market, for instance, during the period 2000-2015, almost three-quarters of company impairments can be attributed to general business failure principally arising from a combination of deficient loss reserves and inadequate pricing (see Exhibit 5).

**Exhibit 5**

**U.S. Property/Casualty Impairment Causes Noted**


**Exhibit 6** shows 10-year reserve development in the U.S. P/C market over the past two decades. The dark blue line is the first year of development, while the light green line is the ninth. Where the line moves above zero, the accident year has developed unfavourably and where it moves below zero, it has developed favourably. For example, the initial reserve set up for the year 2000 had deteriorated by over 10% by year nine. In contrast, the year 2004 has seen strong favourable development. Movements have slowed considerably in recent years, and while still largely positive, it is reasonable to assume that, for the U.S. P/C market at least, the contribution of reserve releases to overall earnings will diminish going forward.

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In the London market, a large proportion of releases in recent years have come from short-tail property reserves as benign large loss experience has allowed the release of catastrophe loadings. There are also indications in the broader U.K. market that reserve redundancies at the level seen in recent years are unsustainable. For the U.K. non-life sector, reserve releases have represented between 2.5% and 7.5% of reserves brought forward over the past ten years, with 2015 close to the top end at just over 6%, according to data extracted from companies' Prudential Regulation Authority (PRA) returns (and with various outliers removed). What A.M. Best finds concerning is the possibility that reserves have been released to support underwriting profitability, reducing confidence levels in reserves across the industry.

Historically, there has been a strong correlation between reserve development and the pricing cycle and A.M. Best believes that it is reasonable to assume that this will continue to be the case. Some carriers across Europe and the U.S. have taken reserve charges due to adverse development over the past year. Insurance companies with low reserve buffers are likely to follow suit. Weak pricing dynamics, the potential for above-average catastrophe losses and reserve shrinkage together pose a significant threat to companies' financial strength, a factor that A.M. Best is monitoring closely.

However, A.M. Best also notes there are potential opportunities for those companies that emerge relatively unscathed from a period where the industry is reporting materially deficient reserves as they will be in a stronger position to take advantage of subsequent rate increases. Companies least likely to be affected by reserve deficiencies are those that have strong data management and analytical capabilities, with robust feedback loops to ensure rapid action is taken in respect of reserving, pricing and wordings in response to emerging claims trends.
Is insurance growth wise in an industry faced with myriad pressures?

Most insurance companies will at some point in time need to grow in order to remain relevant in the marketplace, to meet shareholder expectations (in the case of publicly-listed firms) and to ensure they can absorb costs in the future. However, prospects for growth are not as plentiful as they once were. Insurance and reinsurance markets are highly competitive, awash with capacity after several years of benign loss activity and rate pressure in many territories and lines of business.

When companies experience growth above market rates, it is normally due to an aggressive pricing strategy. This can ultimately affect a company’s operating performance through mispricing or under-reserving, which in turn, can affect their balance sheet strength. The bid for market share above underwriting profitability can be a feature when insurers enter new markets, however, now more than ever, this can be viewed as a risky strategy to embark upon.

A.M. Best has seen many instances, in both mature and emerging markets, where companies have encountered difficulties through sustained rapid growth and as such, have had to pull back and/or restructure operations. Whereas some carriers have struggled to grow in markets such as Turkey, Brazil and India, others have thrived, suggesting that there are still opportunities to be gleaned for those able to expand prudently.

Brand remains an important factor for success. Those carriers that start out with a more established position are typically better able to leverage this to their advantage. Given that the performance has been mixed, A.M. Best sees more of a consolidation period at present, with companies moving out of underperforming segments and countries and focusing their energies where they have better performance and stronger footholds.

At a time when it has been difficult to grow organically, mergers and acquisitions (M&A) have been the obvious route to growth. Recent mergers have focused on cost reduction and synergies as a way of improving short-term results. M&A activity dipped slightly in 2016 following a heady consolidation period in 2014 and 2015. Recent tie-ups include the USD 235m acquisition of Bermuda-based reinsurer Ariel Re by Argo Group in November 2016 and the USD 3.4 billion buyout of AIG’s United Guaranty Corp by Arch Capital.

**Exhibit 7**


![Graph showing growth rates for Non-Life and Life insurance in mature versus emerging markets from 2010 to 2015.]

Source: A.M. Best data and research
While less plentiful, A.M. Best believes that there are further opportunities for consolidation in the industry and megadeals in 2017 cannot be ruled out. Meanwhile, emerging markets continue to see strong insurance premium growth, indicative of lower penetration rates and the introduction, in some countries, of compulsory lines. However, the size of many emerging markets is generally small in comparison to mature ones, and insurance growth does not necessarily translate into profitability.

**Exhibit 8**

**Non-life – Movement in Premiums Compared to Combined Ratios**

There is no doubt that the (re)insurance industry is entering a highly challenging period in its history. It is a time when margins are coming under increasing pressure at all levels of the industry and return on equities that were in double digits just two years ago are now in high single digits. If tested by a major event or series of events, and with diminishing reserve releases to fall back on, industry fundamentals could begin to deteriorate.

Faced with these substantial pressures it is unlikely that all companies will be in a position to prosper. Those best-placed to ride out the storm are taking steps to reduce their cost of capital, maximise underwriting returns without taking on additional risk, underwrite with discipline and better manage portfolio accumulations by leveraging data and sophisticated exposure management tools. Strong players are also investing in technology, maximising digital channels, differentiating their offerings and getting closer to the original risk where they can.

A.M. Best notes that there is no one-size-fits-all solution, and that success will vary depending on sector, size, market and risk appetite, among other factors (see **Exhibit 9**). However, A.M. Best observes that the strategies identified above are some of the characteristics its most highly-rated insurers and reinsurers share in common.
Exhibit 9

Threats and Opportunities

Source: A.M. Best data and research
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SPECIAL REPORT

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A.M. Best Rating Services, Inc.
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EXECUTIVE VICE PRESIDENT Matthew C. Mosher

SENIOR MANAGING DIRECTORS Douglas A. Collett, Edward H. Easop, Stefan W. Holzberger, James F. Snee

WORLD HEADQUARTERS
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

WASHINGTON
830 National Press Building, 529 14th Street N.W., Washington, DC 20045
Phone: +1 202 347 3090

MEXICO CITY
Paseo de la Reforma 412, Piso 23, Mexico City, Mexico
Phone: +52 55 1102 2720

LONDON
12 Arthur Street, 6th Floor London, UK EC4R 9AB
Phone: +44 20 7626 6254

DUBAI* Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780

HONG KONG
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
6 Battery Road, #40-02B, Singapore
Phone: +65 6569 8400

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