BEST'S MARKET SEGMENT REPORT

February 7, 2019

Reinsurance: Will Investor Losses Lead to a Rising Tide for Pricing?

Both pricing and profitability in the reinsurance segment remain disappointing following January 1 renewals

As 2018 vanishes in the rear view mirror, the reinsurance industry remains uninspiring, in terms of both pricing and profitability. Most in the industry thought that, once the losses of the last 15 months were tallied, the January 1, 2019, renewals would provide a well-earned respite from insufficient pricing adjustments, but this did not happen. Furthermore, renewal rates were mostly flat, and in some cases ranging from up 5% to 10% and mostly in US property catastrophe (depending on geography and loss experience), which proved a letdown for most. Companies tried to maintain discipline, with a few walking away from poorly priced business, while others, particularly larger players, continued to focus on market share, willing to write inadequately priced risks.

Given insured catastrophe losses for full year 2018 in excess of $70 billion, as well as the ongoing loss creep from 2017, expectations were that reinsurers would react swiftly and adjust their pricing in an effort to reverse the segment's depressed performance. However, these expectations did not materialize during the latest renewals, which saw mild to nil rate increases on average, with only the third-party-dominated retro space showing a meaningful adjustment. Additionally, in contrast to prior cycles, when reinsurance pricing provided the lead in business trends, some primary lines have experienced larger rate increases than is the case for reinsurance.

Disappointing Renewal Pricing

Whether the impact of past losses will have a more positive influence on mid-year renewals remains to be seen, but the January 1 renewals don't offer much hope. Property programs affected by losses (including wildfire losses) saw the largest pricing increases, of as much as 20%. Given the substantial losses of recent years, reinsurers are increasingly recognizing the importance of wildfire risk and focusing more on the definition of wildfire occurrence during negotiations. The January renewal rates were flat to up 10% for accounts affected by non-cat losses during 2018. Loss-free programs have also been flat, with no more than 5% rate movements for cat perils, while pricing conditions for non-cat risks have further deteriorated.

Casualty and specialty reinsurance saw some mild price increases; companies understand that rates are at unsustainable levels and that they need rate increases on a number of lines—such as commercial auto—following multiple years of losses and rate declines. Pricing in the working layers of the workers' compensation segment has generally increased by single digits, in response to primary rate declines and a higher frequency of large losses.

The brightest spot for the January 1, 2019, renewals was the property cat retrocession segment, which is controlled largely by third-party capital managers, and for which pricing rose between 10% and 20%, with peaks of 35% on loss-affected accounts. A major contributor to the rise—besides the 2018 cat losses—was the capacity crunch in the collateralized retro space. The crunch was due to investors seeking higher returns as well as tightening terms, given that their funds remained trapped to cover the development of 2017-2018 losses. The pricing gap between treaty reinsurance and retrocession has thus widened further, and reinsurers will have to bridge that gap to keep their earnings profile afloat.

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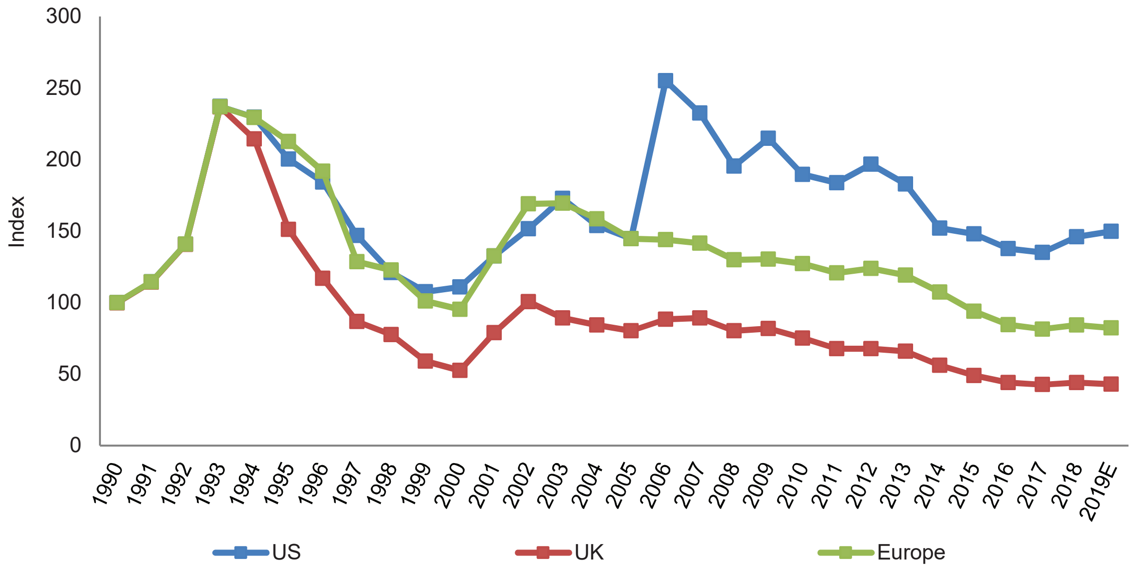
Exhibit 1
Regional Property Catastrophe Rate-on-Line Index



Source: Guy Carpenter

According to the most recent Guy Carpenter Rate-on-Line (RoL) Index (**Exhibit 1**), which confirmed what we are hearing from the January 2019 renewals, the overall impact of catastrophe losses on global property rates was essentially flat. The RoL index rose only 1.1%, despite two years of significant losses globally. Europe, the Middle East, and Africa saw the largest overall decline, with rates down an average of 2.5%. The US experienced the best rates, with average increases of 2.6%. Although January renewals did not proffer the price increases that were expected following the nearly $200 billion in losses of the past 18 months, the upcoming renewal seasons of April (in Japan) and June/July (in the US—Florida and the gulf) will shed more light on the impact of recent typhoon, hurricane, and wildfire losses on rates for the remainder of 2019.

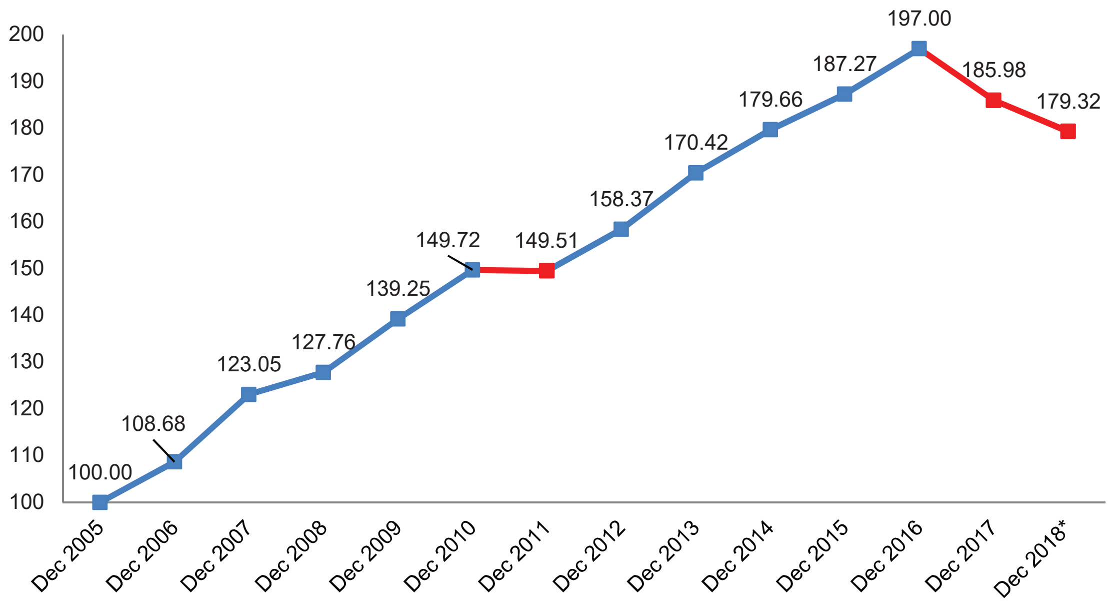
Despite Setbacks, Third-party Capital to Remain an Important Source of Capacity

The third-party capital segment has experienced a significant accumulation of losses over the past 18 months and a material portion of fund managers' assets under management remains trapped in collateral trusts to pay potential losses. However, this capital nonetheless remains influential in the reinsurance segment and, in particular, the property-cat space. For the January 1 renewals, however, most fund managers were not able to replenish above their trapped capital.

Following two straight years of losses, the need to raise rates to garner long-term returns sufficient to satisfy investors is taking on greater importance. In the wake of the numerous wildfires in California the last two years—particularly, the devastating Camp Fire—third-party capital investors have backed away given the unpredictability and difficulty of modeling this risk. The large losses of the past 18 months have driven investors to demand higher returns and have made them more cautious of certain risk exposures.

Third-party investors seem to have become increasingly skeptical following the 2018 cat season, as they have seen their capital trapped for a second consecutive year. For the first time, fund managers are struggling to attract new investors and convince existing ones to reinstate their

Exhibit 2
ILS Fund Index



* As of February 4, 2019.
Source: Eurekahedge

positions. Their skepticism can be explained by looking at the Eurekahedge ILS Advisers Index (**Exhibit 2**), active since January 2006, which tracks the aggregate performance of ILS funds.

The segment had not seen an unprofitable year since 2011, when the index recorded a marginally negative return of -0.14%, until 2017 and 2018, which saw annualized returns of -5.60% and -3.58%, respectively. In 2018, the ILS Index reported negative returns for four months straight from September to December, with November representing the worst performing month on record, at -3.68%.

Contributing to this downturn were not just the cat losses, but also the sell-off of CAT bonds, with fund managers seeking to free up capital and deploy liquidity for the renewal of collateralized reinsurance deals. Because of the approaching deadline, several trades were precipitously executed below par, which impaired the ILS funds' returns at a time when both fund managers and investors were chasing better earnings. Furthermore, this took place at the same time as the write-downs of some CAT bonds, with the California wildfires exposing the Cal Phoenix Re Cat bond towards the end of 2018. We note, however, that, given the differences in both investment products and targeted risk layers, individual performance can vary greatly across the funds tracked by the ILS Index.

Investors, mindful of the poor results in 2017 and 2018, have started demanding higher returns and reallocating their portfolios to support renewing investments more selectively, which has diminished the inflows of capital into the property cat retrocession space, and has thus pushed renewal rates up into the double digits.

Despite the impact of the recent losses on third-party capital, this market is likely to remain an important source of capacity for the industry. The efficiency of these funds makes them attractive to investors and traditional capacity providers alike, as is evident in the recent number of acquisitions by traditional (re)insurers in the space. Renaissance Re has been in this

Exhibit 3
ILS Fund Managers' Assets, January 2019

($ millions)

	Assets*	Funds Location	ILS Fund Managers Acquisitions
Nephila Capital	$12,300	Bermuda	Purchased by Markel 2018
Credit Suisse Insurance Linked Strategies Ltd.	9,000	Zurich, Switzerland	
RenaissanceRe Holdings Ltd.*	8,200	Bermuda	
LGT ILS Partners Ltd.	7,900	Pfaeffikon, Switzerland	
Stone Ridge Asset Management	6,980	New York	
Markel CATCo Investment Management	6,800	Bermuda	Purchased by Markel 2015
Securis Investment Partners LLP	6,700	London, England	Northill bought out Swiss Re in 2012
Fermat Capital Management, LLC	6,200	Westport, CT	
Leadenhall Capital Partners LLP	5,200	London, England	Purchased by MS Amlin 2014**
Twelve Capital AG	4,500	Zurich, Switzerland	
Aeolus Capital Management Ltd	4,000	Hamilton, Bermuda	Purchased by Elliott in 2016
Elementum Advisors, LLC	4,000	Chicago, IL	
AlphaCat Managers	3,500	Bermuda	Purchased by AIG in 2018
Schroder Investment Management	3,040	London, England	
Amundi Pioneer	2,300	Boston, MA	
Top 15 Fund Managers	**$90,620**		

* Renaissance Re includes Top Layer, DaVinci, Langhorn, Vermeer and Medici.
** MS&AD purchased the stake in Leadenhall from its subsidiary, MS Amlin, in 2019.
Source: Artemis and AM Best data and research

market for many years and has become one of the segment's principal players, with the reputation and expertise to attract significant amounts of capital from third-party sources, including the most recent entity to enter the market, which was created with capital from the Dutch PGGM Pension Fund Manager, Vermeer Reinsurance, to write top-layer US property cat risks.

Others have also recently made significant acquisitions—for example, Markel's acquisition of CAT Co in 2015 and more recently Nephila and AIG's acquisition of Validus and Alpha CAT. This trend shows that, as traditional players struggle to cover their cost of capital, third-party capital provides a bit of relief, helping improve their average cost of capital deployed, given the lower costs compared with traditional capacity.

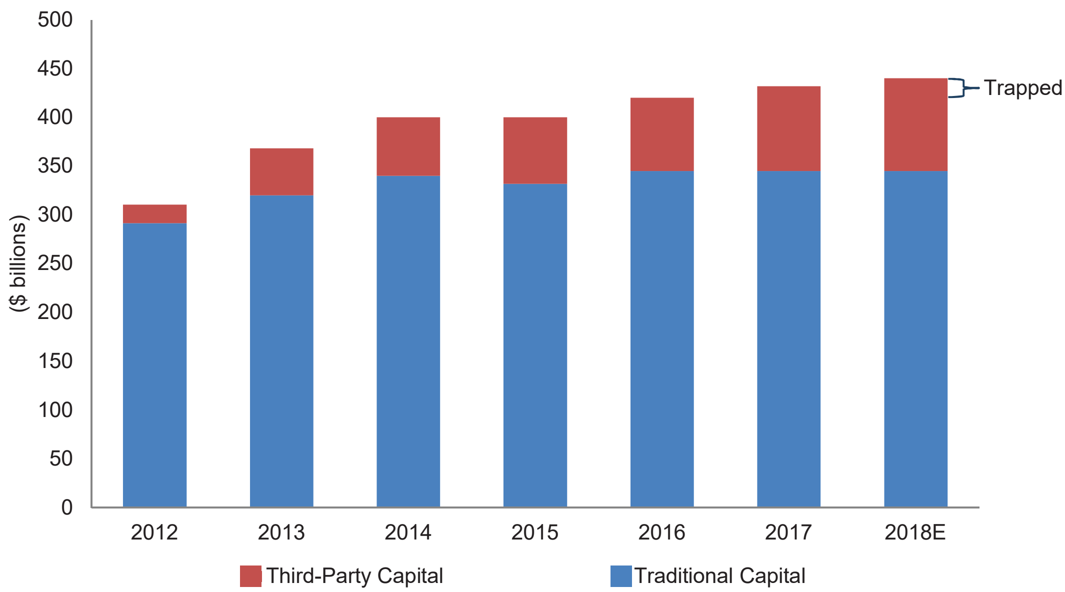
Hope for the April and June/July Renewals?

The steadfast commitment of third-party investors was further highlighted by the growth of capacity in 2018. Working in conjunction with Guy Carpenter, AM Best estimates that the increase in third-party capital from $87 billion in 2017 to approximately $95 billion in 2018 was the principal driver for the 2% annual growth in dedicated reinsurance capital (**Exhibit 4**). In contrast, traditional capital is likely to remain flat, owing to underwriting losses and unrealized capital losses incurred mainly in the second half of 2018.

Approximately 20% of the 2018 total third-party capital is currently trapped in the funds and will not be released until insurance loss estimates have been finalized. This locking mechanism is a key factor in the assessment of companies' risk-adjusted capitalization using our proprietary capital model, Best's Capital Adequacy Ratio (BCAR). Depending on the extent and quality of the collateral, the credit risk associated with a certain recoverable position is either partly or fully offset in the calculation, materially benefiting the BCAR scores of (re)insurers that purchase third-party capital protection from unrated structures, which would normally attract a 100% risk charge. Therefore, AM Best closely monitors the terms and conditions that regulate the release of the collateral and view favorably any strengthening of terms that diminishes uncertainty over such release.

Overall, the January 1, 2019, renewal pricing was disappointing and far from being a turning point for the reinsurance segment. Additionally, rate increases were often accompanied by a growth in the exposures underwritten, resulting in largely unchanged premium rates on a risk-adjusted basis.

Exhibit 4
Estimated Total Dedicated Reinsurance Capital



Source: Guy Carpenter and AM Best data and research

The estimated dedicated reinsurance capital is not a simple aggregation of the shareholders' equity of all companies writing reinsurance, given that their capital may also be allocated to other lines of business. AM Best and Guy Carpenter have estimated the amount of dedicated reinsurance capital using AM Best's BCAR and reviewing line-of-business allocations for the majority of the top 50 reinsurance organizations. Consideration was also given to reinsurance capacity offered by smaller participants. The amount of financed capital (debt) in a company's capital structure was also taken into account. Using the aggregated BCAR outcomes for all companies provides a clearer indication of the capital allocated to reinsurance operations.

Although the January 2019 renewals may suggest that third-party capital has become more concerned about returns, AM Best believes that investors will continue to invest in third-party capital and that the alignment between third-party and traditional capital will endure, guaranteeing an abundance of capacity for the (re)insurance segment. One main reason is that reinsurance investments constitute a minor portion in the portfolios of institutional investors and pension funds, and therefore do not have a major impact on their overall performance. In addition, investors are especially attracted to reinsurance capital solutions for their minimum correlation with capital markets rather than potential returns. However, AM Best notes that, although profitability is not the only feature, reinsurance as an asset class has proven moderately profitable over the long term, as evidenced by the ILS Index's aggregate cumulative return of nearly 80% for the 12 years from January 2006 to December 2018 (**Exhibit 2**), corresponding to annualized aggregate returns of approximately 4.5%.

That said, investors in 2018 experienced losses across all asset classes (except cash), given the collapse of the capital markets toward the end of the year, continued negative development on 2017 events, high losses in 2018, and diminished returns on fixed assets owing to an uptick in interest rates, which led to an increase in realized and unrealized losses. Third-party capital is uncorrelated with other asset classes, which doesn't mean that uncorrelated losses can't occur simultaneously—which could influence how investors will look at these uncorrelated investments in the future. Still, we think it is fair to say that 2019 will likely see a decline in the allocation of this type of capital to risk, owing to trapped capital, the hesitation of some to double down, and the possibility that in a rising interest rate environment investors will be able to find other investments—with more stable returns—in which to invest their capital. How 2019 ultimately develops will depend on losses and the potential for improved rates for the April and June renewals. What pricing will do at these two major renewal seasons is unclear, even with expectations for increases despite what was seen at the January 1 renewals.

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