Oxbow Partners

LONDON MARKET CYCLES

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The hard market – how long will it last?

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Executive summary

It is a good time to be a corporate and specialty insurer. The market has been hard for several years and there are no signs that the market is going to turn any time soon. Market rate movements ultimately come down to the balance of demand and supply and it is clear that demand currently outstrips supply in the corporate and specialty market.

But how long can the good times last? Sadly we all know it cannot be forever. Noting that the speciality market is not a single, homogeneous whole but a collection of classes of business which all perform to their own micro-cycles (as we argued in an **article in 2022**), we believe that there are another 12-24 months to run. Property CAT is likely to be towards the longer end of the scale (and maybe beyond that depending on hurricane activity) whereas smaller specialty lines such as Cyber are likely to be softening by renewal in 2024.

Some carriers will think that 12-24 months is a comfortable buffer. However, carriers need to think carefully about their level of preparedness for the inevitable downturn. Industry executives need to be confident they have in place a soft market 'playbook'. For many the playbook will likely highlight gaps in operational or technological capability. Given often lengthy change and transformation cycles, 12-24 months starts to look like a very short window.

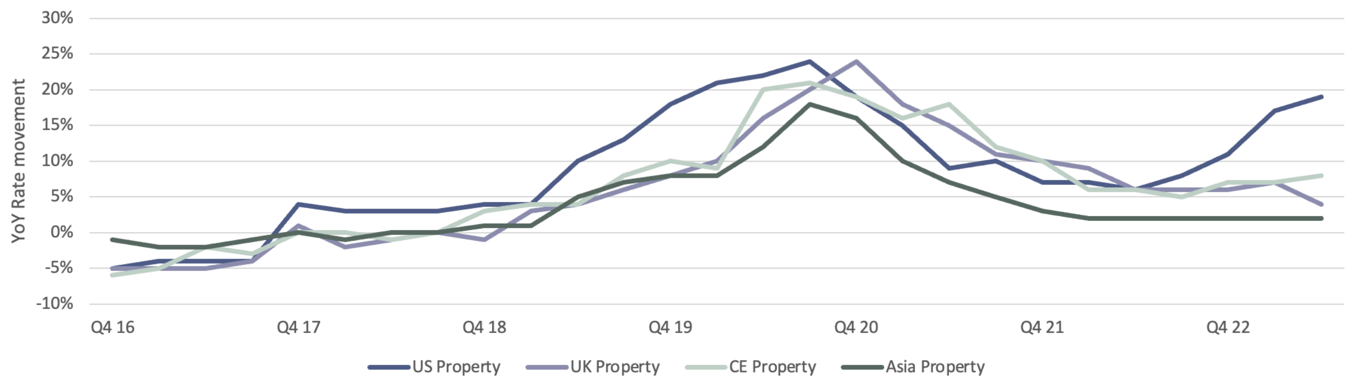
In this report we look at the supply and demand factors driving the current market cycle and make predictions for how long the market will last.

Overview of the current market

The market has been hard since 2018/2019, rising strongly until the end of 2020 when in some classes the rate movements began declining. Looking a little closer at the different parts of the global P&C insurance market, it is primarily property that is driving the hard market. Over the last 12 months US property rates, driven by high catastrophe losses, have seen another sustained period of hardening not seen in the other major geographies: US property rate movements have pushed up by around 20% YoY in Q2 2023. Property CAT, a major class of business for the London Market, is currently seeing strong positive momentum in rates with rate on line up 30% year on year.

This is largely driven by the market continuing to reassess the impact of ever-increasing insured losses from major events whilst also reacting to inflation and high interest rates. Given climate change and global economic factors we would expect this to continue into the foreseeable future.

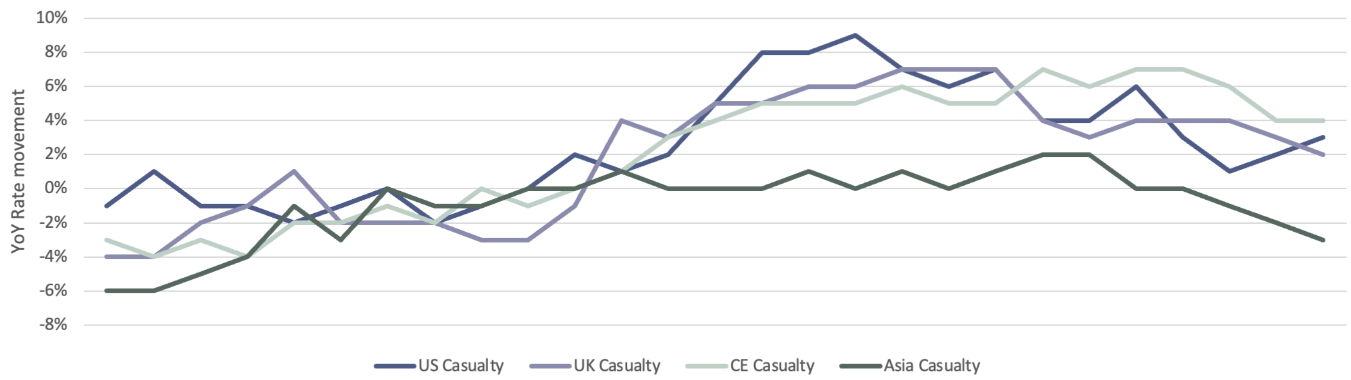
Figure 1: US property rates have hardened significantly in the last 12 months



Source: Marsh

In contrast, casualty rate movements peaked at 9% YoY (US casualty) at the end of 2020. The key markets of the US, UK and Continental Europe are all still seeing positive rate movements in casualty, though these have reduced to 2-4%, arguably lower than would be required to cover inflation. In Asia casualty rates are already softening.

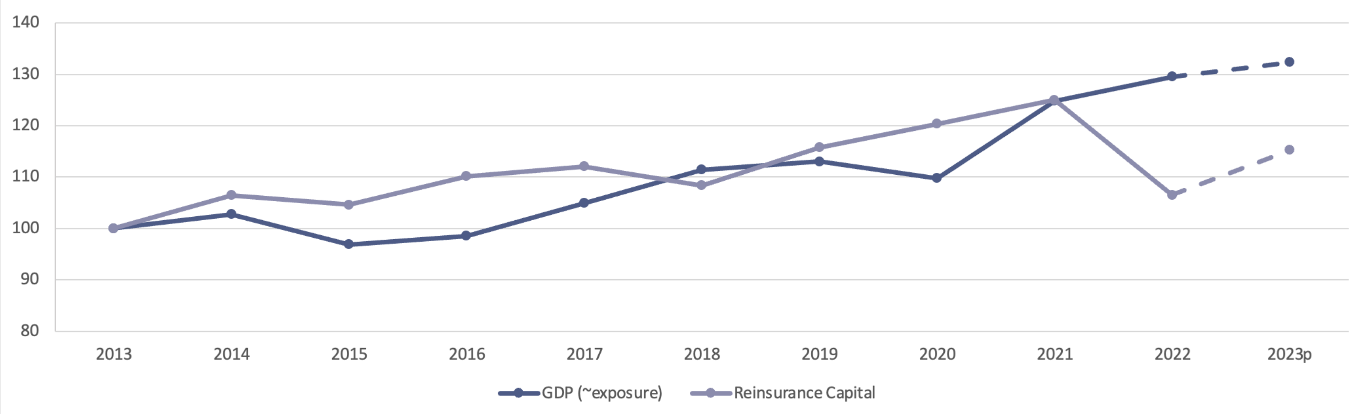
Figure 2: Casualty rates remain slightly positive in key markets



Source: Marsh

Market rate movements ultimately come down to the balance of supply and demand and it is clear that demand currently outstrips supply in the specialty market. Taking reinsurance capital as a proxy for specialty risk appetite due to public data constraints, it is evident how supply has become constrained in the last year. In the chart below we use global GDP growth as a proxy for the growth in reinsurance exposure.

Figure 3: Exposure (demand) is exceeding reinsurance capital (supply) in the global reinsurance market

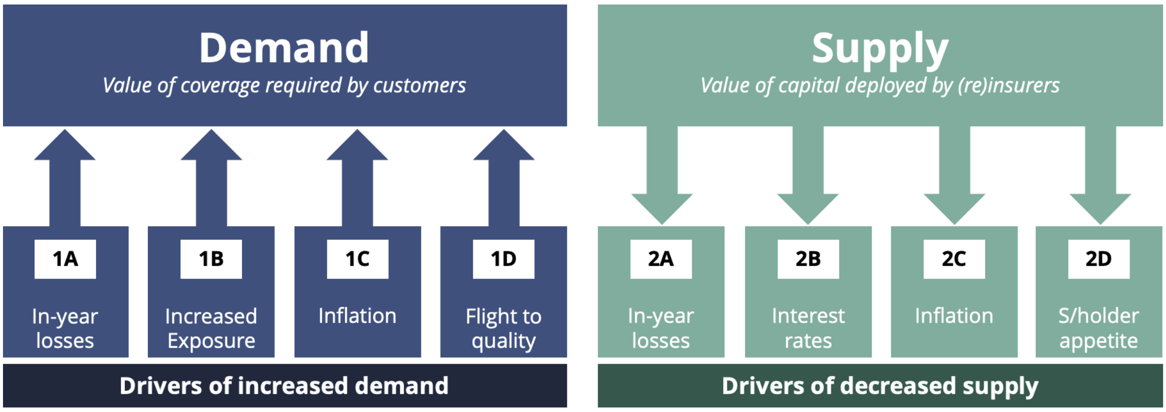


Source: Aon, World Bank (2013 indexed at 100)

Macro trends such as climate change and inflation would point to a continuation of the hard market. However, there are many forces that combine to define the market 'clearing price' and our overall view is that the market will begin to soften in 12-24 months.

Below we consider these drivers individually.

Figure 4: Factors driving the supply-demand equation



Source: Oxbow Partners Analysis

Demand

1a. In year losses – Significant recent losses have increased demand for insurance

Despite price rises, the last few years have been tough for several players. This has obviously been true in property CAT given recent named storms such as Ian in 2022 and Ida in 2021.

In-year losses are a driver of short-term changes in market demand. If we have another year of elevated large loss activity in 2023, this will further increase the demand for coverage in 2024 and beyond. Conversely, a relatively benign year for losses could rapidly reduce the demand for insurance as customers.

So far 2023 looks set to be another year of US$100bn losses despite relatively benign impacts from named storms in the Atlantic. According to RMS, the recent Hurricane Idalia is estimated to have generated around $5bn of insured losses, significantly lower than the $60bn of insured losses resulting from Hurricane Ian in 2022. Having said that, 2023 is not over yet so there is scope for further large losses to come.

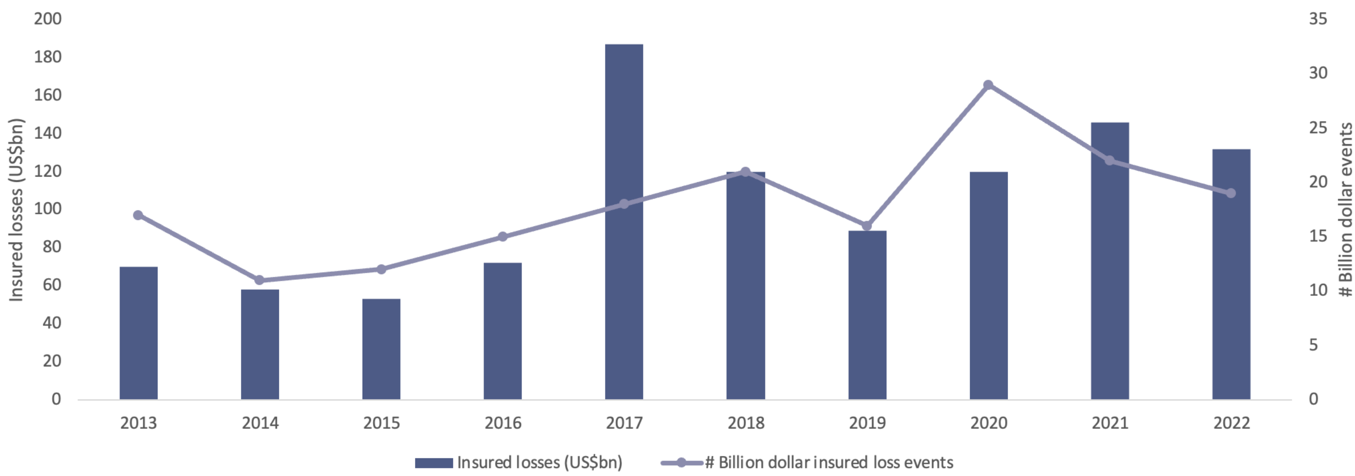
We have already seen the speed at which pricing can turn in other specialty markets. Initially there was a short-term increase in demand in the D&O liability and cyber insurance segments after rising loss ratios. Later, as the loss ratios normalised, the two segments entered a downward cycle within a year.

Expected impact: Given that we have already had US$50bn+ of losses in H1 2023, it would be reasonable to expect that 2023 is going to be another year of US$100bn+ global losses. As a result, we expect market demand to be an upwards force for market strength in the next 12-24 months.

1b. Increased exposure – Major risks have been trending upwards causing a step-change in demand
There has been a fundamental review of the underlying risk in some lines of business. In property CAT reinsurance, the combination of climate change (more large events) and greater urbanisation of at-risk areas (such as Florida) has significantly increased risk exposure to large catastrophe events.

Overall, insured losses have been increasing steadily over time with the average annual cost now standing at $105bn.

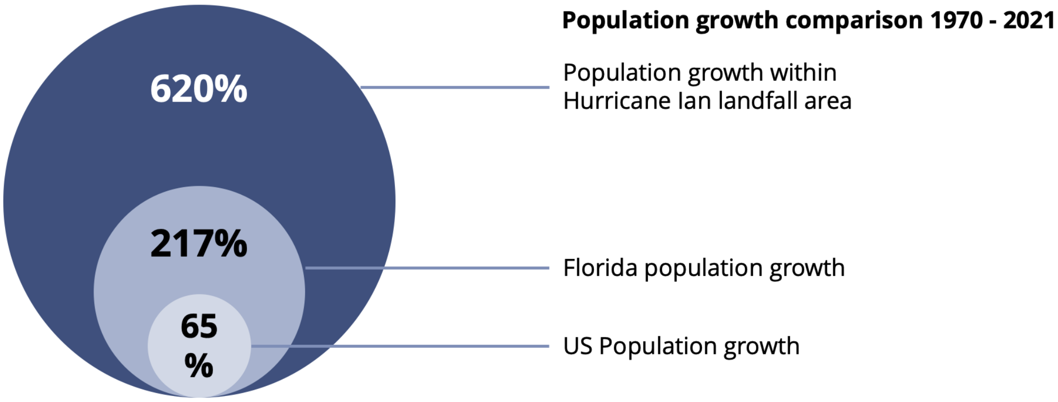
Figure 5: Average insured loss over the last decade has been c.US$105bn



Source: Aon

Looking just at the US, populations living in high-risk areas are growing disproportionately compared to other areas. For example, the population living within the Hurricane Ian landfall area has grown 620% since 1970 compared with just a 65% for the whole population of the US.

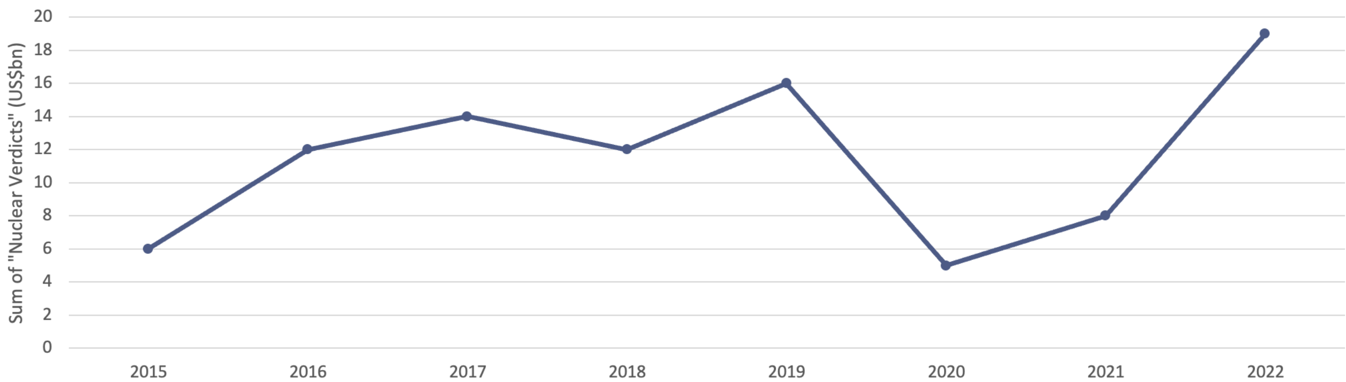
Figure 6: There is an increase in population in regions susceptible to natural hazards



Source: Swiss Re

Other classes have also seen increasing exposure, for example casualty where the number of "nuclear verdicts" (as Munich Re referred to them in their recent Monte Carlo press conference) is increasing.

Figure 7: There has been an increase in "Nuclear Verdicts" (>US$10m) in US casualty claims



Source: Munich Re

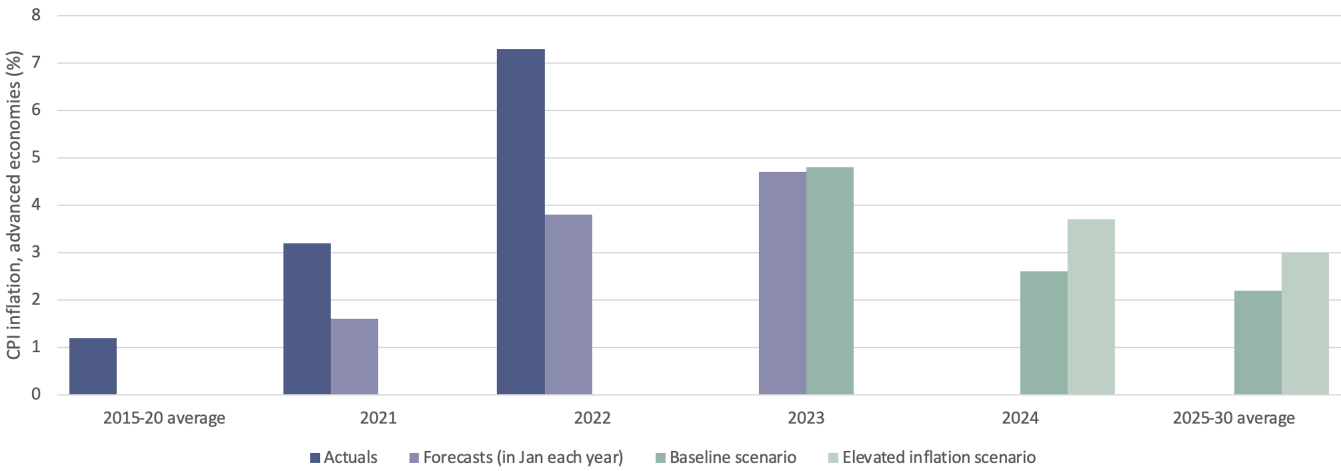
These verdicts generate adverse development of claims and increase the expected exposure to future claims, effectively driving up the demand on casualty business.

Expected impact: There is unlikely to be any let-up in demand for insurance coverage over the medium to long-term. Global losses across property and casualty are trending higher and these trends are set to continue in our view. This will maintain upward pressure on rates, even in the event of a low loss year in 2024.

1c. Inflation – Global increase in inflation has significantly increased the value at risk

Global inflation, in part triggered by the war in Ukraine, has amplified the demand within the market as clients and insurers are acutely aware of rising costs and the need for more coverage. While this could be a temporary phenomenon it is unlikely to dissipate any time soon and so continues to drive insurance prices higher.

Figure 8: Inflation has increased significantly and is expected to remain elevated



Source: Munich Re Economic Research (August 2023)

Expected impact: Market expectations are that inflation should normalise over the next 12-18 months. While this could ease pressure on insurance rates over the long-term, there will still be a heightened inflationary environment in the near term which will continue to drive up demand for insurance coverage and put upward pressure on rates.

1d. Flight to quality – Customers are willing to pay more for better rated counterparties
The final boost to demand is an ongoing flight to quality from insurers and insureds. Incidents such as the Vesttoo LoC allegations will have increased cedents' desire to work with only the highest quality counterparties such as those in the London Market. There is also a weakening sentiment in the use of LoCs as a financial backstop to fulfil obligations.

Primary insurers are competing to secure high-quality capacity in the market, contributing to the rate increases during the renewal season. The growing lack of confidence in alternative forms of capital is leading insurers and clients to be more willing to pay premium rates for the best capacity.

"There is a global flight to quality happening, and we think we'll continue to benefit from that at 1/1, where we'll have an opportunity to help our clients clean up those panels with a much higher quality underwriter" – ***Jim Williamson, Group COO, Everest Group***[1]

Expected impact: The market has had a few shocks and has been looking for high quality sources of capital that come at a premium price. This is likely to continue over the near term and will increase upward pressure on rates. Longer-term we expect that alternative forms of capital will come back into favour, particularly as some insureds are priced out of using their preferred level of counterparties – though we are not there yet.

[1] *reinsurancene.ws/current-hard-market-has-surpassed-the-post-andrew-market-everest-ceo-andrade/*

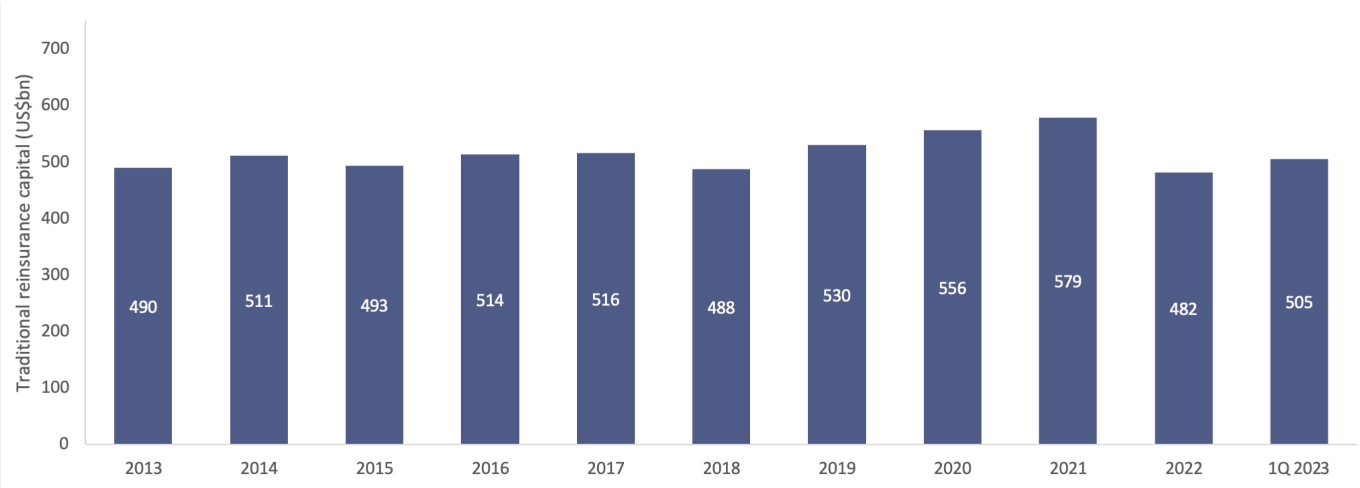
Supply

2a. In year losses - Significant recent losses have decreased insurance capital

Traditional insurers and reinsurers have borne the brunt of losses in recent years. Losses in excess of expectations will have an impact on available capital, reducing the potential supply from traditional players. Indeed, a number of primary insurers in the US have stopped offering cover in some of the most catastrophe prone areas such as Florida. The ILS market which attracted investors due to high attachment points, has been significantly impacted by the recent slew of NatCat events such as Hurricane Ian in 2022. Consequently, this has dampened the capital influx from new ILS investors.

Looking again at reinsurance capital as an example, in 2022 the losses from Hurricane Ian, coupled with higher interest rates, reduced the available reinsurance capital by 17%. This restriction in supply put upward pressure on rates.

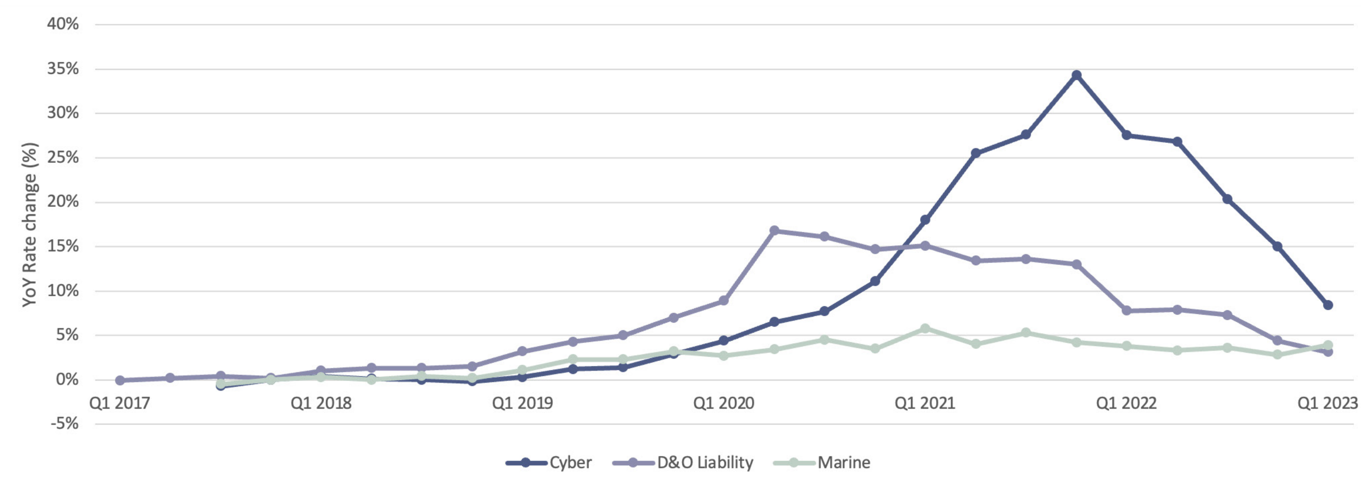
Figure 9: Traditional reinsurance capital undergoing recovery after significant decline in 2022



Source: Aon

Despite a hard market in many areas there are some lines of business, like cyber insurance, that have already started softening. This is due to the influx of new players entering the cyber liability market, bringing more capital and competition (increased supply). The market has also experienced lower claims than previous years emboldening players to offer more capacity (increased supply) while customers are negotiating harder (reduced demand).

Figure 10: Amongst specialty lines, Cyber and D&O liability have started showing signs of softening



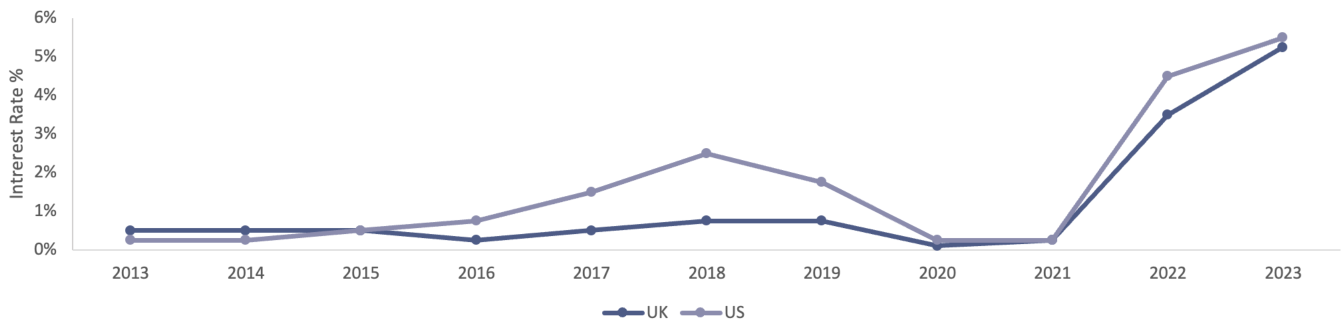
Source: CIAB

Expected impact: From a supply point of view, we expect another year of US$100bn+ losses has already been built into property CAT pricing and therefore even a significant year of losses in 2023 is unlikely to restrict supply dramatically. In specialty lines the outcome is less clear. In Cyber and D&O there has been an influx of capital at lower rates, so a major loss event could cause a sharp turn in pricing in our view.

2b. Interest rates – Increase in interest rates shifting investment away from insurance
The rise in interest rates has created new attractive investment opportunities reducing the relative attractiveness of insurance for investors including ILS. It also increases the cost of capital for traditional insurers, who will increase rates to offset the costs.

The sharp rise in interest rates has also led to unrealised losses to traditional (re)insurers' bond-heavy portfolios. This is one of the main drivers of the lower level of reinsurance capacity in 2022 shown in figure 9 above. If interest rates stabilise over the coming years capacity should come back as the bonds mature and are reinvested.

Figure 11: Until the recent spike, real interest rates have been historically low



Source: Focus Economics (UK: Bank of England Rate, US: Federal Funds Rate)

Expected impact: We expect interest rates to remain elevated for the next 12-24 months (exceeding c.5%) though the number of increases should reduce assuming inflation comes under control. Higher, stable investment returns will increase insurance capacity for traditional players but could also reduce the attractiveness of alternative capacity options for outside investors. We expect the net impact to be neutral in terms of rates.

2c. Inflation – Uncertainty over claims reduces capacity
A high inflation environment brings additional uncertainty to underwriting as the actual cost of claims is harder to predict at the outset. As such (re)insurers will build greater margin into their pricing and implicitly reduce the absolute amount of business they are willing to write.

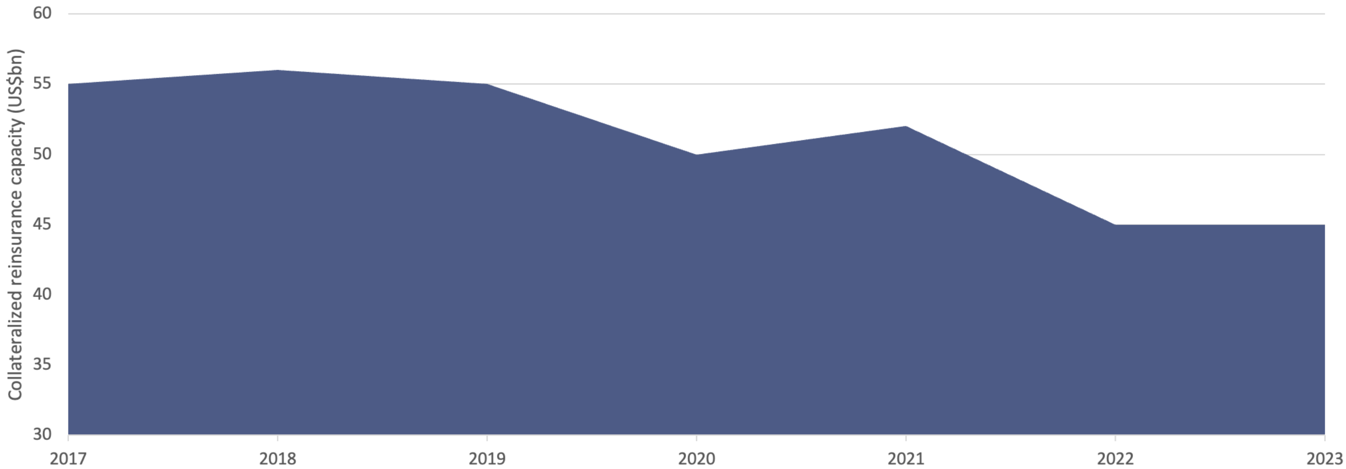
Expected impact: As noted above, we believe that over the next 12 months inflation will start declining but will remain elevated compared to pre-2019 levels. This could reduce appetite for long tail business such as casualty insurance which should drive up rates.

2d. Shareholder appetite – Shareholders are focused on returns

Shareholders have taken the current market environment as an opportunity to push for better returns and rate adequacy rather than topline growth. The flight to quality described earlier in 1d has also made it possible for quality participants to focus on underwriting performance when deploying capital.

Alternative capital (comprising of cat bonds, sidecars and collateralised reinsurance and others) has plateaued over the last five years despite rising demand for insurance. While there has been a significant increase in the cat bond market (so far in 2023 the new issues are in line with the whole of 2022 at c.$10bn), collateralised reinsurance capital has been declining since 2019.

Figure 12: Collateralised reinsurance has decreased over the last five years



Source: Oxbow Partners Analysis, Aon

Expected impact: Overall, we expect increased shareholder appetite for insurance in response to the hard market which should put some downward pressure on rates, though not enough to outweigh the other drivers listed above.

Expected impact on rates – 1-2 year view
Momentum in Property CAT pricing has largely been driven by the market continuing to reassess the impact of ever-increasing insured losses from major events whilst also reacting to inflation and high interest rates. Given climate change and global economic factors we would expect this to continue into the foreseeable future.

If you look beyond Property, other markets do seem to have already ridden the market cycle. For example, Cyber rates are already softening. After a brief period of strong increases in 2020/21, rate movements have tailed off quickly in 2022 and 2023. If this trend continues, we expect that there will be rate reductions within the next six months. Casualty, D&O and Marine are equally not seeing the same level of hardening as some of the property lines.

Stepping back and considering the market as a whole, it appears that the demand vs supply equation will continue to be weighted towards over-demand. This clearly means a continued hard market in the near term. Over the medium term we expect that the inflation and climate-related risks can be priced in. As the market becomes more stable and profitable it will attract further capital from new and existing players, driving up the supply and causing rates to soften.

		Property CAT	Casualty	Specialty
Demand	1A In year losses	↗	→	→
	1B Increased exposure	↗	↗	→
	1C Inflation	→	→	→
	1D Flight to quality	↗	↗	↗
Supply	2A In year losses	↗	→	→
	2B Interest rates	→	→	→
	2C Inflation	→	→	→
	2D Shareholder appetite	↘	↘	→
	Overall rate movement	↗	→	→

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