Insight and intelligence on the 2023 American Property Casualty Insurance Association meeting

insurance insider

APCIA

Day Three

Hurricane Otis a further reminder of costly cat trends

Hurricane Otis will kick off Q4 cat losses at a point in the year in which reinsurers are starting to hope they have locked in a much-needed strong result, after years of underperformance.

While the market was still digesting the loss ahead of the APCIA gathering, initial high-level expectations were that this would be another medium-sized loss.

This follows a catastrophe loss year that supports the thesis that a $100bn loss year is now the norm for catastrophe markets, and that it is only the distribution or shape of loss events that may vary more notably amid increased values at risk and urbanisation.

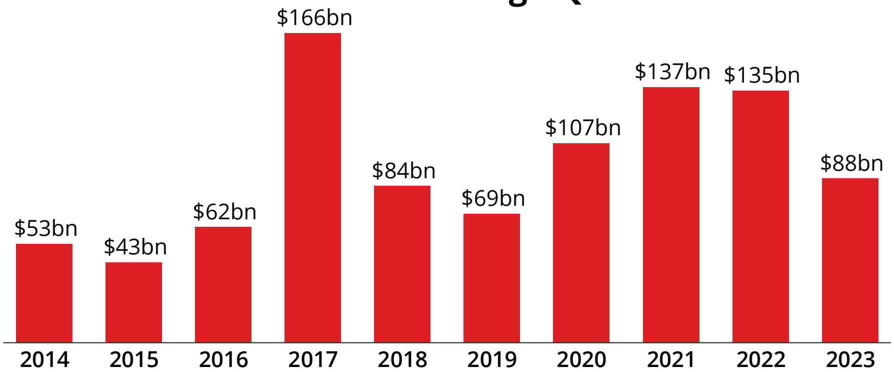
It is debatable how well 2023 serves as a test case for reinsurers to prove to investors that the reset of rates and attachment points in 2023 has fixed their cat portfolios. Many of this year's events were not typical of the kind of losses that would have unlocked major reinsurance claims, even in 2022.

However, the sheer volume of losses throughout the year, and the fact that the attachment point hikes have cleared reinsurers from the 2023 cat loss 'noise', is no doubt acting as a strong initial proof point in favour of reinsurers having dampened down their levels of assumed volatility.

Everest head of reinsurance Jim Williamson, responding to a question on how the reinsurance portfolio would have fared with a repeat of the 2022 losses, said it would still have been "meaningfully lower... that's because of attachment points. It's because of portfolio management, it's because of aggregation, it's all those things laddering up".

According to Aon data, insured cat losses for the first nine months of 2023 reached $88bn, which is 17% higher than the Q1-Q3 annual average of $75bn, but lower than figures for 2020-2022.

Global insured cat losses through Q3



Source: Aon

Severe convective storms (SCS) accounted for roughly 70% of global insured losses between January and September this year, compared to an average of 34%. For the first time, SCS losses surpassed $50bn.

Restructures and aggregates

The greater proportion of cat losses being borne by insurers this year, versus their reinsurers, is expected to be a fraught topic of debate in the run-up to 2024 reinsurance renewals.

One of the topics that has come up for debate during conference season – for which there was no clear answer – was how far reinsurers would be willing to offer some form of aggregate protections in 2024 or beyond.

As Aon's head of global reinsurance clients Dave Nicholson told this title, in isolation, some of the 2023 events "may not be the type of volatility that reinsurers like to cover, but at the level they have occurred this year, it certainly becomes the volatility that we believe reinsurers need to be responding to in order to add value to insurers".

Other sources suggested that brokers may look to create "synthetic" aggregates by structuring occurrence deals that would respond on an occurrence basis for third- or fourth-event triggers.

In terms of how insurers are justifying their reinsurance tactics, there were few direct questions during Q3 earnings on whether carriers had the right programmes in place. The focus instead is on how insurers are seeking to drive primary rates.

Many of the listed nationwides already had typically higher retentions, and new coverage has often gone towards top-end protection that is not an immediate benefit to the losses occurring this year.

However, on Travelers' Q3 call, the firm argued to analysts that changes to its programme would not have made much of a difference to the outcome in its loss experience this year.

The carrier previously had aggregate reinsurance cover in place. However, the firm's CFO noted that this cover did not attach in 2022 and said it "cost us a lot to have that policy" even before the 2023 rate hikes.

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ANALYSIS

Israel-Hamas conflict another wake-up for specialty reinsurance

The contingency market is monitoring the war between Israel and Hamas for potential loss activity, as well as keeping track on whether it has wider global implications for events, sources said.

Many contingency-type insurance covers have been placed in the terrorism market since the pandemic, and the Israel/Hamas conflict is just the latest incident caused by rising geopolitical volatility that has led to a split in the specialty reinsurance and insurance markets on pricing and coverage.

Sources said there was not a substantial exposure to Israel in the London market, although some cancelled events in the wake of the conflict are expected to result in claims, including a Bruno Mars concert in Tel Aviv which was cancelled on 7 October.

War, terrorism and civil commotion are excluded as standard from contingency policies, but can be bought back for additional premium, which is commonly advised by brokers.

Since the pandemic, which inflicted huge losses in the contingency market and prompted a rise in rates, this coverage is typically sought in the terrorism market, where pricing is cheaper and broader coverage available.

This also means there is uncertainty over how any Israeli losses may be treated or allocated between terrorism or political violence (PV) insurers, and how reinsurers will allow insurers to aggregate their losses from each source.

Reinsurance uncertainty has already been a factor for specialty insurers over the past year. Rising reinsurance costs have weighed heavily on small-scale specialty writers, especially at Lloyd's, yet in some lines of business, underlying rates have not caught up.

Composite deals had been common in the specialty market – bundling in lines including marine, energy, aviation and PV – but in many (but not all) instances, these structures were drastically reshaped in 2023 after the Ukraine war.

Brokers are optimistic that, in the current more orderly market, they will be able to achieve clearer and more aligned coverage for cedants at 1 January 2024.

However, any re-bundling of contracts restructured last year is unlikely.

The bifurcation between primary and reinsurance markets is highly marked in the aviation segment, which faces significant losses from the Ukraine war, despite signs of settlements that should notably reduce insured losses.

Meanwhile, the Israel/Hamas war could have a knock-on impact for negotiations around coverage for social riots and civil commotion (SRCC), which was heavily limited as part of property treaties in 2023 renewals.

> "There is uncertainty over how any Israeli losses may be treated or allocated between terrorism or political violence insurers, and how reinsurers will allow insurers to aggregate their losses"

The July French riots also underscored fears around rising costs from these exposures, as the event was expected to cost insurers more than three times the level of claims from the 2005 riots, according to France Assureurs.

During the Baden-Baden reinsurance conference, one theme was that reinsurers were pushing to implement higher retentions on SRCC portions of cat treaties and impose lower sub-limits and tighter event definitions in a bid to put parameters around the exposure.

This comes after many policies have already had hours clauses cut from as long as 168-200 hours to typically 72 hours, while more geographic limitations were brought in to ensure that coverage typically will only relate to a specific city.

Outside property treaty covers, specific specialty reinsurance covers have also been heavily restructured to limit PV and terror exposure.

However, like the mismatch in change between primary and reinsurance aviation markets, the underlying PV and terrorism markets have not enforced such sweeping changes to policies.

While PV rates are up, geographic radii of coverage is often still more extensive than carriers are reinsured for.

Lloyd's has put this mismatch under the microscope in some of its market messages this year, highlighting PV facilities as one area where they want syndicates to "look in detail at the terms and conditions and the amount of aggregations that can emerge from facilities, and make sure they're well matched against their outward protections".

Israel claims

Sources said there was greater concern about wider implications if the conflict spreads across the Middle East or has knock-on impacts globally.

There is more substantial event-cancellation exposure across the region – such as conferences and sporting events – in countries such as Saudi Arabia and the United Arab Emirates.

Meanwhile, sources raised potential scenarios where the conflict spills into global incidents, such as terror attacks in countries seen as allies of Israel.

The potential for the conflict to have wider impacts was highlighted by the cancellation of next month's MTV Europe Music Awards in Paris, owing to the "volatility of world events".

Voluntary cancellations are unlikely to result in losses, with claims only paying out in the event of specific attacks or threats.

Nonetheless, claims disputes testing the extent of exclusionary language can come into play in more nuanced situations.

SPONSORED

Q&A: Kelly Superczynski and Pat Matthews

What is the backdrop for insurers' need for capital management?

Many insurers and reinsurers are experiencing reductions in capital adequacy. Capital has been declining over the past 18 months due to factors such as unrealised losses resulting from interest rate increases, equities market volatility, and increased catastrophe losses from the recent frequency of events coupled with higher reinsurance retentions.

Persistent inflation is also continuing to impact capital. Companies need to buy more cat limit for the same set of exposures as structural repairs are more expensive. Loss ratios continue to tick up, and some companies are even reporting adverse loss development, as auto and building repairs cost more than planned – both labour and materials.

Further, the past year has been a pretty challenging renewal period for a lot of insurers, with reinsurers raising rates and insurers being forced to raise retentions – a lot of firms had to increase retentions on their property cat programmes.

What this means is that, in 2023, you continue to have this frequency of small catastrophe events, where a fair amount of exposure might have been ceded to reinsurers in the past, but now those losses are being retained by insurance carriers. It all combines to put further constraints on insurers' balance sheets and capital.

What about rating agencies? What impact do they have?

S&P, which for many insurance and reinsurance companies is currently the primary capital constraint, is changing its model. The implementation of that new model is expected before the end of the year, and notably, the new model has softened those capital requirements for many companies.

For some insurance and reinsurance companies, AM Best is likely to be the capital constraint going forward, and there will be a transition curve to ensuring companies understand how their business risks, and how their strategic decisions, impact AM Best's capital adequacy calculation. For US P&C companies, we have seen a lot of pressure on capital adequacy and ratings.

While results have been challenging, there are some tailwinds with respect to underwriting and rate actions that most companies are taking to return to profitability – as long as they have adequate capital to lean into this market. As such, effectively managing capital through this part of the cycle is crucial.

How important is it for capital advisors to provide clients with a holistic outlook?

Holistic means understanding all available forms of capital, and it's essential that our clients are aware of the options available to them. Companies need diversified sources of capital, and there are a number of forms of capital available to insurers and reinsurers: traditional reinsurance, structured reinsurance such as legacy reserve sales or capital relief quota share, debt, and equity to name the obvious ones.

But clients should also examine alternative risk-transfer solutions such as catastrophe bonds or parametric covers and structuring solutions such as captives and internal reinsurance vehicles to support capital optimisation.

We help clients review a wide range of capital opportunities so they can be nimble, flexible, and make better business decisions.

What impact do legacy dynamics have on capital provision?

Legacy is becoming a bit of a misnomer because the transactions now often include both discontinued lines and, for a number of companies, active lines of business as well.

In this particular area of the market, there is actually material capital coming to support these transactions, which makes for an interesting dynamic when you compare it to the rest of the reinsurance sector where capital is entering at a trickle.

Reserve transfers entail insurance organisations handing reinsurers their assets and insurance liabilities, and the asset managers aligned with the reinsurers have the opportunity to invest a bit more aggressively than an insurance company because they are regulated in a slightly different way, which is how the reinsurers make most their profit on these transactions.

How are clients responding to your advice, and are you seeing any trends in your service provision?

There's an increasing interest in private debt deals in the United States. We're also seeing the structured reinsurance market step up to support some of the property catastrophe retention increases we saw earlier this year, meaning that structured reinsurance, which is a small piece of the reinsurance market, will offer multi-year, multi-event type solutions, as well as capital relief quota shares and other structured quota share solutions. So, we're seeing a part of the market gaining momentum to support some of the more challenged areas.

Kelly Superczynski
Head of Capital Advisory, Aon's Reinsurance Solutions

Pat Matthews
US Head of Capital Advisory

ANALYSIS

D&O rate adequacy in focus as pressure from claims severity rises

Concerns are mounting that US public D&O is drifting towards rate inadequacy, as rates continue to fall and evidence starts to show that claims severity is rising in the class, according to sources speaking to *Inside P&C*.

Rate declines have continued in recent renewals, but the pace of those decreases has slowed, particularly for established public companies, sources said, noting the market is not at mid-2000s soft market levels just yet. Some of that deceleration in rate declines is in part because some accounts are now at their second round of renewals in this softening phase.

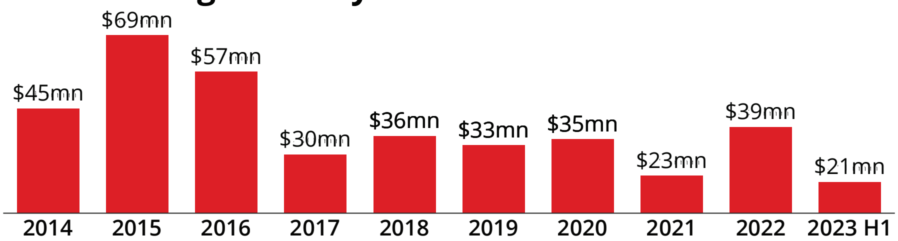
Some are seeing lead markets pushing back on further declines, in line with commentary from executives during recent earnings conference calls, but overall capacity is still plentiful.

Few in the US market agreed with Lloyd's chief of markets recent comments on "moronic" behavior in the class, and suggested the US domestic market was not in the same position as Lloyd's.

However, recent rate declines have been historic in speed, or at least the fastest declines seen in multiple decades. Some long-time participants even suggested pricing mechanisms are "broken" and need to be revamped using better data.

Sources agreed that the whipsaw in D&O pricing is not sustainable. "There is a lot of focus on discipline and cash flow underwriting versus profitable underwriting," Tim Fletcher, CEO of Aon's financial services group in the US, told Inside P&C.

Average settlement value (in 2022 $mn) of class action suits settling in each year since 2014



Excludes settlements over $1bn, merger objections, crypto unregistered securities and settlements for $0 to the class; historic figures adjusted for inflation
Source: NERA Economic Consulting

Rates

For established accounts, rate declines can be in the 5%-15% range for primary and low excess layers, while for public companies that entered during the hard market of 2020 and 2021, rates can be as much as 50%-60% lower, sources said. Some sources reported trouble securing even modest decreases on carrier pushback, but this was not the norm.

"I do think that it'd be hard for those [significant rate declines] to continue just as it's hard to sustain an acceleration of hardening for multiple cycles. It's sometimes harder to sustain the decreases in big chunks. But that being said, it is still competitive," Andy Doherty, USI's national executive and professional risk solutions practice leader, told this publication.

Competition remains greatest higher up towers, but primary layers are also getting squeezed as carriers aim to retain accounts and ensure future opportunities. Participation on primary often ensures carriers will "get a second look" higher up the tower, said one broker.

There are sharp pricing declines for companies that are more than two or three years into being public. Those companies, especially if they were operating in riskier areas like cryptocurrency or cannabis during a time when D&O capacity was already tight, saw the highest rate increases at the time, but are now benefiting from significant discounts.

Some pointed out that established public companies did not see the significant increases of the more recently public ones, and that aggregate rate reports have possibly exaggerated the general D&O decline.

Buying strategies of insureds are a significant differentiator in recent renewal discussions, with those that are valuing long-term relationships with established carriers and broader coverage seeing perhaps only single-digit declines, while for more aggressive insureds seeking "commodity" coverage double digits are more common.

"Established underwriters are pushing back. They're really feeling the squeeze, saying 'this is not a reasonable ask,'" said one broker.

Carriers are "flexible when pushed" on terms and conditions, with entity investigation coverage now easier and cheaper to obtain.

"That used to be a hot-button issue," said one source. "It has been the main recent example of broadening coverage, though carrier sources described coverage as "about as broad as it's going to get."

"There is more of a willingness to open up the contract, or at least offer expanded coverage on more competitive terms. Entity investigations traditionally cost more premium and in a harder market, maybe something that a carrier wouldn't feel obliged to even consider, or need to offer," Doherty said.

Concerns about past accident years

There is a sense among sources that rates are still largely adequate, despite the declines. However, an evolving loss picture threatens that stance.

The class is not immune from wider social inflation trends, and there is concern around loss severity development, as defense costs climb and verdicts become larger. The accident years of 2017-2019 are showing particularly concerning loss development, sources said.

Large recent settlements such as Fox News-Dominion are being watched carefully but have not yet trickled through the system into large claims.

The average size of settlements fell in H1 2023 after a significant rise in 2022, though the sample size was small, and US securities class action cases are projected to rise year on year in 2023.

Compared to other lines of business, D&O lacks data about loss cost development, making it hard to ascertain rate adequacy, some sources said.

"Generally speaking, it's the cost of defense from a lawyer perspective, and then the settlement amounts are certainly something insurers are focused on and we're seeing, you know, elevation of those amounts when it comes to defense costs. Plaintiffs are aggressive," Fletcher said.

"Deterioration in prior accident years is something that all of the incumbents are monitoring. And as we get into Q4, and maybe Q1, perhaps you see more disciplined action when it comes to holding the line a bit firmer."

Capacity

There is still ample capacity in the US market, with sources estimating access to 20-30 markets in public D&O. There are the established carriers, start-ups and also, increasingly, MGAs and program businesses started by former carrier executives.

"Some of the established players certainly are talking a game of stabilisation and a lack of sustainability with respect to the current environment. With that said, there's still a lot of capacity out there," Fletcher said.

Overall, competition is still fierce, and any gap in placements is quickly filled, sources said. In fact, less-established carriers are in some cases struggling to find opportunities as lead markets strongly defend their primary and lower excess positions on major accounts.

More recent start-ups that have built their business plan on growing their D&O book have less leverage to pass on risks, but ultimately might only succeed in pushing pricing down without getting on an account. "It's a different set of pressures when you strike out on your own," said one source.

"They [carriers] want to be responsible and will price deals commensurate with the risk. However, unlike long-term D&O insurers, newer capacity providers, who don't have an established book of business and are tasked with growing a book, may have more aggressive pricing," CAC Specialty EVP Brad McDonald told *Inside P&C.*

Overall, there is no "material" pullback of capacity yet, but sources expect a "shake-out" after the January 1 reinsurance renewals, as carriers and MGAs will have to grapple with possibly much higher reinsurance rates.

One market that has exited completely is Howden MGA Dual's US arm, which left D&O in July. Howden declined to comment.

"Maybe M&A takes capacity out of the system but we're not hearing rumblings of anybody closing up shop or redeploying to property [for example]," Fletcher said.

Some also wonder about the impact of higher interest rates on carrier appetite.

"For a long time, carriers were not earning much money [on their investments]. Is that changing their philosophy? Get premium in and earn some interest," Doherty said.

> "Some of the established players certainly are talking a game of stabilisation and a lack of sustainability with respect to the current environment.. that said, there's still a lot of capacity out there"
> **Tim Fletcher, CEO of Aon's financial services group in the US**

Fresh IPO demand

There are "green shoots" for the US public D&O market from recent IPOs such as ARM and Birkenstock, which should create more demand for abundant D&O capacity.

However, sources pointed out that the momentum might not be sustained given the uncertain economic and political environment.

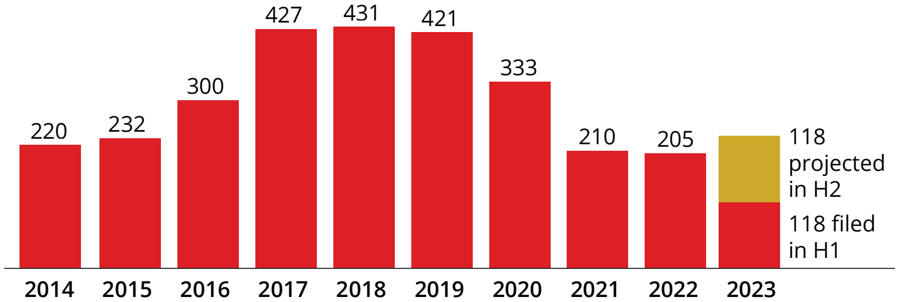
High interest rates impacting cost of capital and the conflict in the Middle East are creating further uncertainty, which may persuade firms to delay IPOs.

"There are a lot of mixed signals with respect to the economy, inflation, and what the Fed is going to do. Between the performance [of recent IPOs] and that uncertainty, and now the high geopolitical risk there's still a lot of tempering of optimism. A few of the deals that we've worked on sound like they might get pushed to 2024," Fletcher said.

It's unlikely the market will see the plethora of public companies as in the SPAC boom of 2020-21, when hundreds of entities were formed each year, each needing D&O coverage. There have been virtually no transactions this year.

Meanwhile, not all IPO business is well priced, sources said.

Federal securities class-action cases filed in the USA



Source: NERA Economic Consulting

AON

Optimize and Diversify Capital Strategies

As a more stable market brings optimism, Aon's focus this renewal season is creating capacity to enable insurers to diversify with new sources of capital.

To help our clients make better decisions, we are building stronger reinsurer partnerships, accessing diversified capital sources and driving differentiation so clients feel seen and understood by trading partners.

Discover more on our Reinsurance Renewal Season Platform.