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Reinsurance Outlook Maintained at Negative - Redundant Reserves, Benign Catastrophes Mask Reality

Ongoing market challenges keep reinsurance ratings outlook negative.

A.M. Best is holding its outlook for the reinsurance sector at negative, citing the significant ongoing market challenges that will hinder the potential for positive rating actions over time and may eventually translate into negative rating pressures.

As compression continues bearing down on investment yields and underwriting margins, this strain on profitability will ultimately place a drag on risk-adjusted returns and financial strength. At this point, our view remains longer-term than our typical 12-18 months. The market headwinds at this point present significant longer-term challenges that industry players need to work through. The companies that are not proactive will not lead their own destiny. It is likely that several franchises that exist today will be sporting the logo of another brand by the time this soft market has run its full course.

Declining rates, broader terms and conditions, unsustainable flow of net favorable loss reserve development, low investment yields, and continued pressure from convergence capital are all negative factors that will adversely impact risk-adjusted returns over the longer-term. Interest rates remain extraordinarily low, despite the recent action taken by the U.S. Federal Reserve. These weak operating fundamentals are being exacerbated by continued weakening demand from primary insurers as they retain more business to leverage their own excess capacity. While a broader cyber (re)insurance solution in the market as well as pending regulatory changes in the European Union and China may, over time, provide some new business opportunities for reinsurers, it is too early to gauge any potential benefits.

Reinsurers are responding to these challenges by employing greater capital market capacity to help optimize results and reduce net probable maximum loss (PML) for peak zones as a percentage of capital. A.M. Best believes that convergence capital accounts for roughly 20% of the dedicated global reinsurance market capacity. This percentage has been steadily growing year-over–year, which is why cycle management has been a key strategy for those organizations possessing the capability to oscillate between primary and reinsurance platforms. There has also been meaningful effort to embrace new opportunities and geographies, produce fee income, and a subtle migration into asset classes that will produce some increased investment yield. Further market consolidation is also a likely response to the current market environment as balance sheet scale becomes even a more important attribute to retain and win new clients. M&A activity remains an important strategic option to gain greater scale and diversification as companies navigate the market cycle. However, M&A does have potential hazards and can have either a positive or negative rating consequence depending on the quality of the partners, earnings accretion, and execution risk.

Broadly speaking, rated balance sheets are currently well-capitalized and capable of withstanding various stress scenarios. However, over time, this strength may be eroded for some carriers as earnings come under increased pressure, favorable reserve development wanes, earnings grow more volatile, and the ability to earn back losses following events is prolonged by the instantaneous inflow of alternative capacity. All of these issues reflect increased concern that underwriting discipline has diminished as companies look to protect market share at the expense of profitability.

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Given where rate adequacy is, it will continue to take optimal conditions, including benign or near benign catastrophe years, a continued flow of net favorable loss reserve development, and stable financial markets to produce even low double-digit returns. Such return measures would have been considered average or perhaps mediocre just a few short years ago. The reality of the current situation is that a major catastrophe will occur at some point and the mask of redundant reserves will eventually be removed to reveal the true ramifications of current market conditions. If history is a guide, it may be uglier than some believe!

In our view, companies with diverse business portfolios, advanced distribution capabilities, and broad geographic scope are better-positioned to withstand the pressures in this type of operating environment and have greater ability to target profitable opportunities as they arise. It also places increased emphasis on dynamic capital management in order for companies to manage the underwriting cycle and remain relevant to equity investors and the capital markets, two important characteristics of strong financial flexibility.

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