Global (re)insurance: capital levels have recovered but ROEs pressured by low investment yields

Willis Re
Strategic & Financial Analytics
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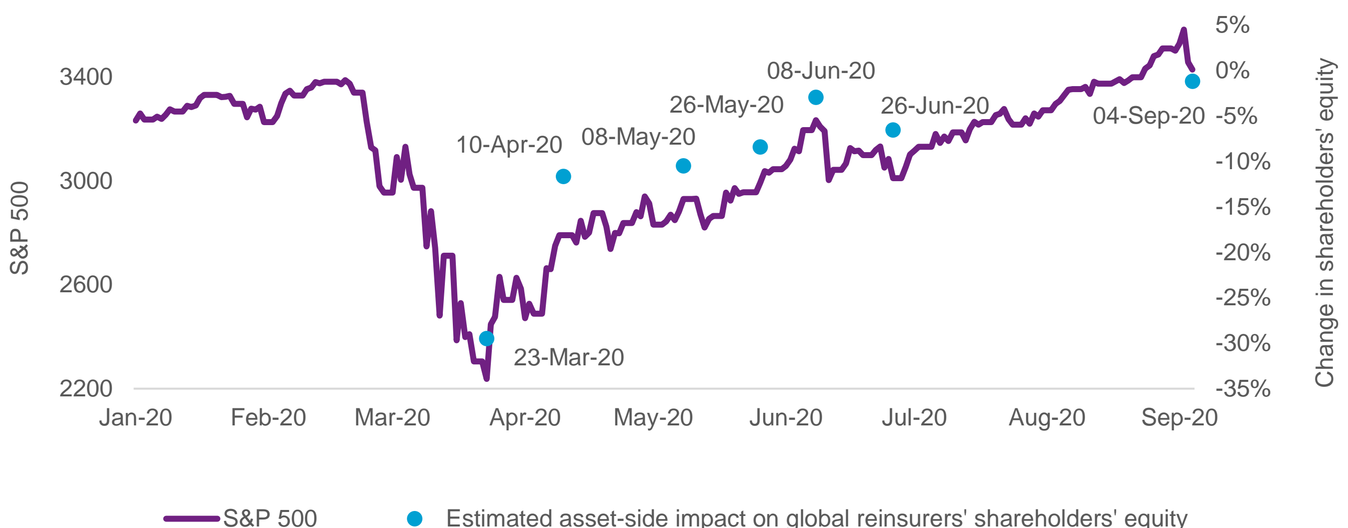
Summary

- The recovery in investment markets has completely neutralized the asset-side hit to global reinsurer capital positions we had estimated earlier this year.
- Capital positions for (re)insurers globally are in good shape, although solvency ratios for the Europeans have seen more of an L pattern than a V year to date.
- Capital raising continues; we calculate COVID-related capital raising of $14b to date by insurers and reinsurers globally, with a further $6b being contemplated and/or in progress.
- There remains uncertainty, however, on COVID-19 losses, with a wide gap between bottom-up loss announcements of $16b and top-down industry loss estimates of $30-100b.
- While balance sheets are in good shape for most (re)insurers, ROEs are under pressure due to lower investment yields.
- COVID-19 has meaningfully dampened premium income in Q2, but rate increases plus an expected rebound in 2021 GDP may contain this decline.

Asset side continues to recover

Since our last flyer, published on 2 July, investment markets have continued to march higher. The S&P 500, for example, is now +6% YTD.[1] We roughly estimate that the asset-side impact on reinsurers' capital positions has now completely recovered, having been -30% at the March low point.

Investment markets have recovered, and so have reinsurer capital positions



Source: Capital IQ and Willis Re

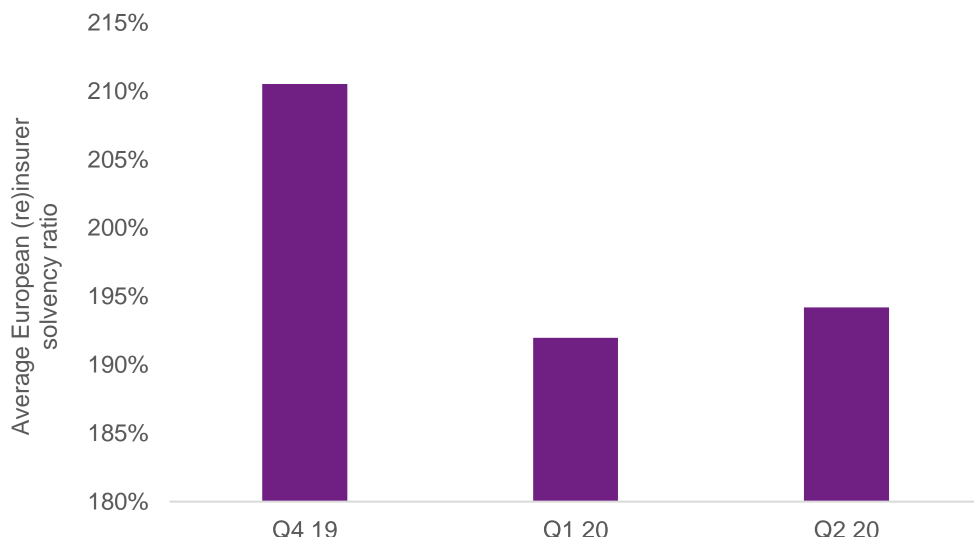
Capital positions generally in good shape, although solvency ratios for the Europeans have been more of an L than a V

An important take-away from (re)insurers' Q2 reporting, globally, was that capital positions are generally sound. In our recently published Reinsurance Market Report, for example, global reinsurers' capital declined by only 3% in H1 2020. And this position should have improved so far in Q3 given the continued recovery in investment markets.

[1] As of 4 September 2020.

For U.S. companies we calculate that regulatory Risk Based Capital scores have regained their prior year-end levels as equity markets have recovered and U.S. statutory accounting is less sensitive to interest rate movements. Solvency ratios for the Europeans, however, while staying at a strong level, have shown more of a L pattern than a V year to date. The broad group of quoted European (re)insurers that we track started the year with an average Solvency 2 ratio of 211%. This fell to 192% as of the end of Q1, and then only moved up to 194% as of the end of Q2. Low interest rates are the main culprits. While equities were rebounding in Q2, interest rates were falling – both risk-free rates and credit spreads.

European solvency ratios have seen more of an L pattern than a V

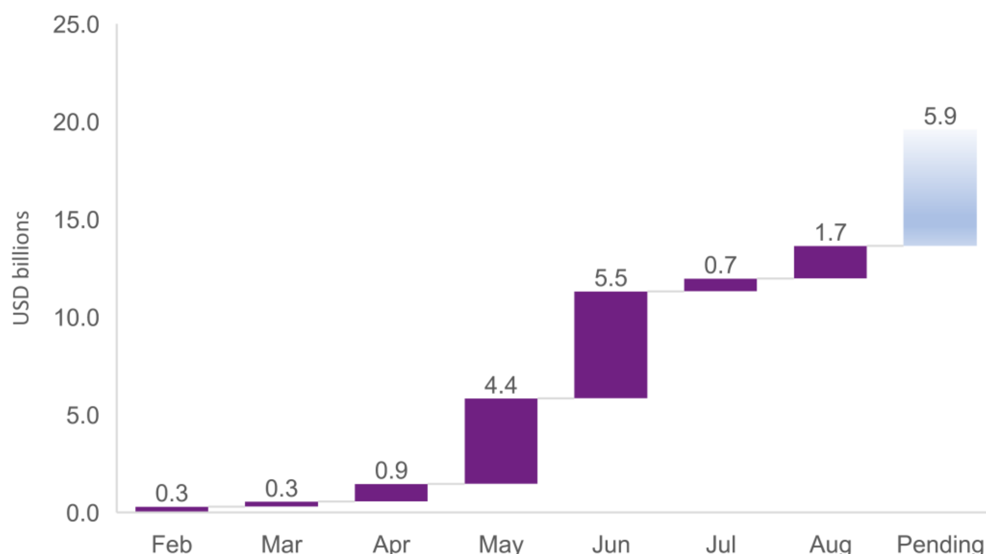


Source: Company reports and Willis Re

Capital raising continues

Capital raising in Q3 has continued with several declared or pending raises announced. To date, capital raises have been focused on existing carriers. However, several large new ventures are expected to enter by the end of the year in order to begin writing business at 1/1 or sooner. Initially, insurers were looking to shore up balance sheets in the face of uncertain asset markets and COVID-19 losses. However, recent raises and anticipated new formations are looking to increase participation in a P&C market that is experiencing accelerating rate increases across several insurance and reinsurance lines. Raising capital quickly is critical as the length of a hard market is typically only 2-3 years.

COVID-related capital raising by insurers and reinsurers globally has reached $14b, with a further $6b being contemplated and/or in progress



Source: Company reports, insurance trade press, Willis Re

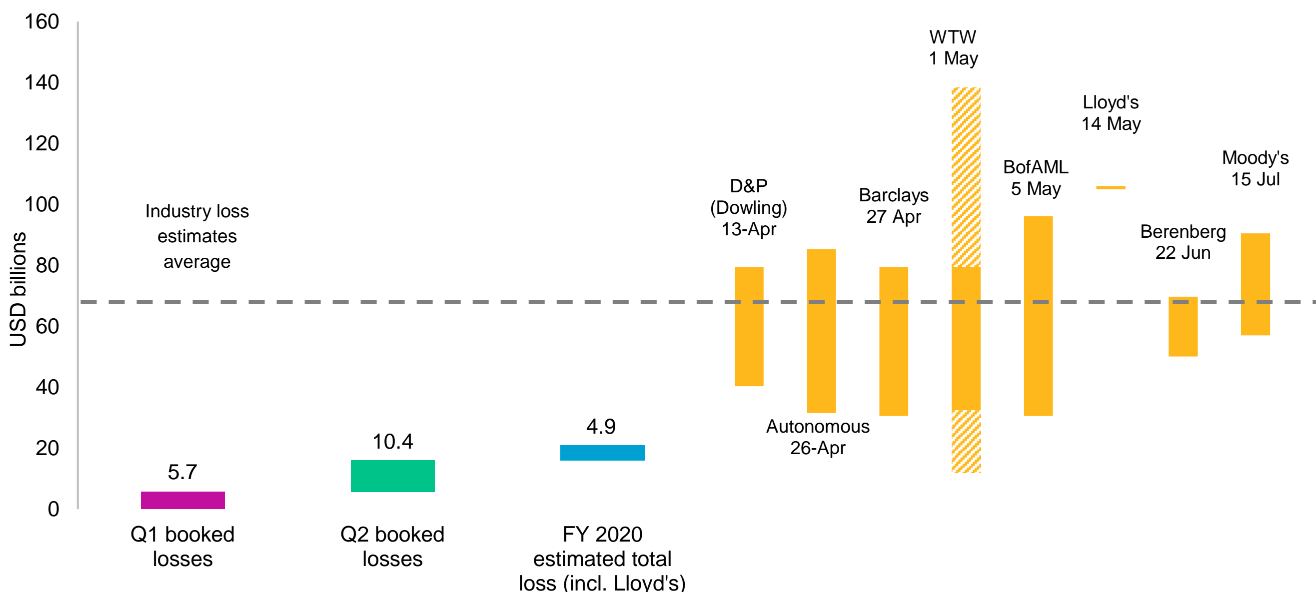
Still uncertainty, however, on COVID-19 losses

To date, the global (re)insurers that we track have booked $16b of Covid losses, with $10b of that being recognised in Q2 earnings. While Q2 accelerated loss recognition, we are still a long way from commentators' top-down loss estimates for the global non-life industry. These are in a rough range of $30-100b. Moreover, booked losses still consist primarily of IBNR, at least for those companies who have commented on their IBNR percentage. This highlights how young COVID-19 still is as a claim event, and we expect that loss emergence will continue to be a long drawn out process, lasting years not quarters.

One driver of the uncertainty is litigation. In the U.S., for example, several states have pending legislation that aim to overturn in whole or in part the virus exclusion in Business Interruption policies. To date, these proposed bills have stalled or have been remitted to a legislative sub-committee for further review. The District of Columbia has passed a law providing policyholders an extension to file a claim under their current policies while the public health emergency exists. However, the D.C. law is significantly narrower in scope than an earlier bill that was withdrawn which would have expanded the definition of a covered peril to include virus related losses. Also, U.S. insurers have recently prevailed in several prominent litigation cases which have upheld B.I. virus exclusions or not found Covid-19 to be "physical damage". However, numerous litigation cases continue to be in progress which pose significant risks to the industry. On a favorable note, the U.S. Senate has taken up proposed federal "Safe Harbour" legislation that would shield businesses from COVID-19 related civil lawsuits. This would be significant protection for writers of Commercial and Professional liability policies.

Significant variation remains in how COVID losses are impacting individual insurers, with losses amounting to up to 11% of book value.

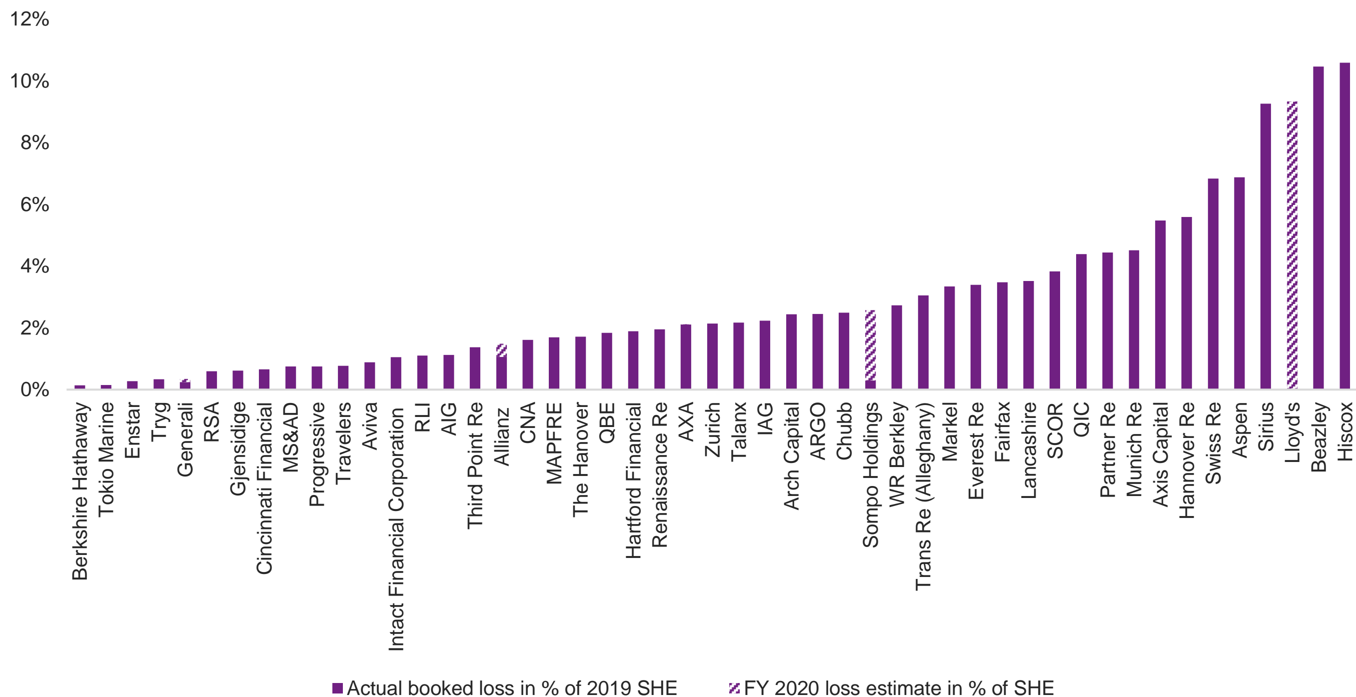
While loss recognition accelerated in Q2, we are still a long way from commentators' top-down industry loss estimates[2]



Source: Company disclosures, Dowling & Partners, Barclays Research, Autonomous Research, BofA Global Research, Lloyd's, Berenberg, Moody's, Willis Towers Watson

[2] WTW's USD 32-80bn estimate corresponds to its Moderate to Severe scenarios. WTW has also published Optimistic and Limited Success scenarios. These are represented by the hashed portions of the WTW bar and widen the range to USD 11-140bn.

Impact on individual insurers ranges widely

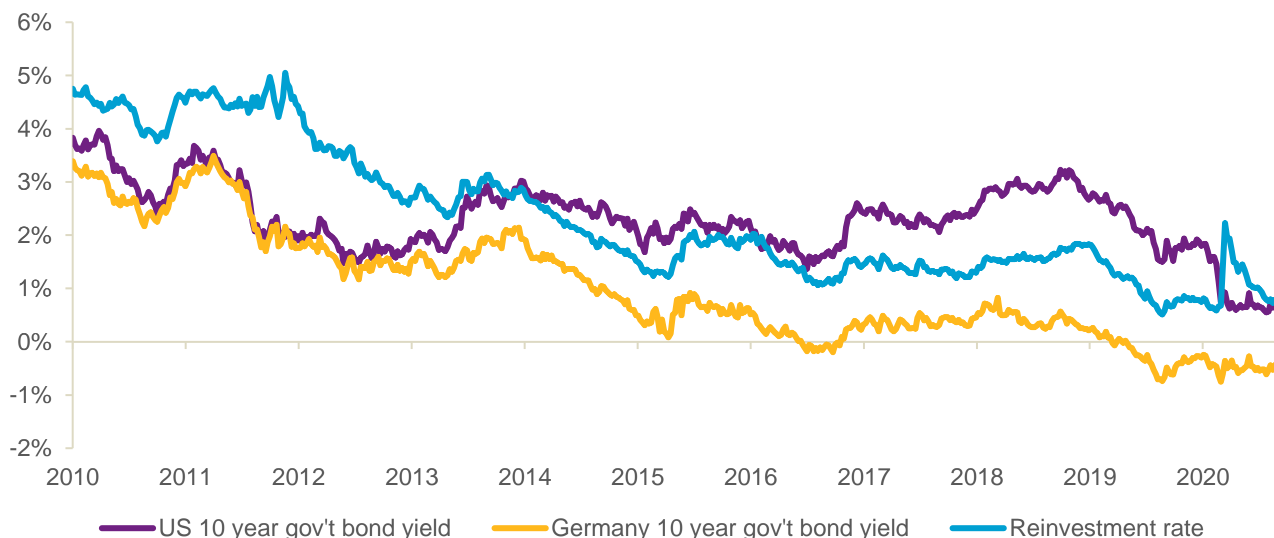


Source: Willis Re

ROEs are under pressure due to lower investment yields

While balance sheets are in good shape for most (re)insurers, ROEs are under pressure due to falling investment yields. Government bond yields have contracted sharply this year, with the US 10-year, for example, falling from 1.9% at year-start to 0.7% currently. Credit spreads, having temporarily widened at the start of the COVID crisis, have also narrowed again. This means that the typical reinvestment rate for an insurer now stands at a very low level. Autonomous Research estimates that, for the typical European insurer, the reinvestment rate stands at only 0.8% today. This is down from 3-4% over 2010-14. If markets stay at their current levels and insurers keep a constant investment mix, the overall investment yield will gradually converge down to this reinvestment rate.

Typical reinvestment yields have declined sharply

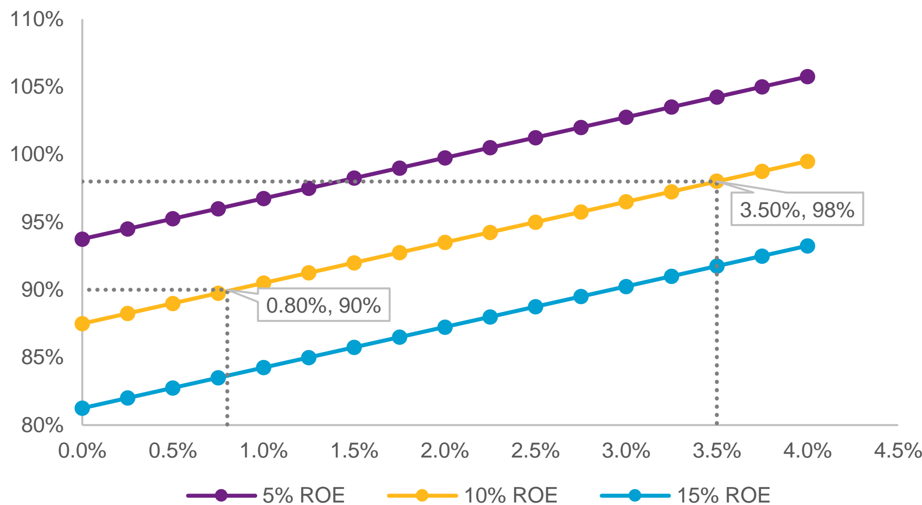


Source: Autonomous and Capital IQ

Insurers’ ROEs are highly sensitive to yield. For most, a one percentage point change in yield will have a bigger impact on ROE than a one percentage point change in combined ratio. The graph below illustrates. In this hypothetical example, an insurer earning a 3.5% yield and wishing to target a 10% ROE would need to achieve a 98% combined ratio. If the yield falls to 0.8%, to keep ROE at 10%, the insurer would need to achieve a 90% combined ratio.[3]

In our recent Reinsurance Market Report, we calculate that our Subset of global reinsurers earned a 2.7% underlying ROE in the first half of 2020, down from 4.2% a year ago, even though their underlying combined ratio improved from 100.5% to 98.6%. This was principally due to their underlying investment yield falling from 2.9% to 2.2%.

Lower investment yields require much lower combined ratios – a hypothetical example



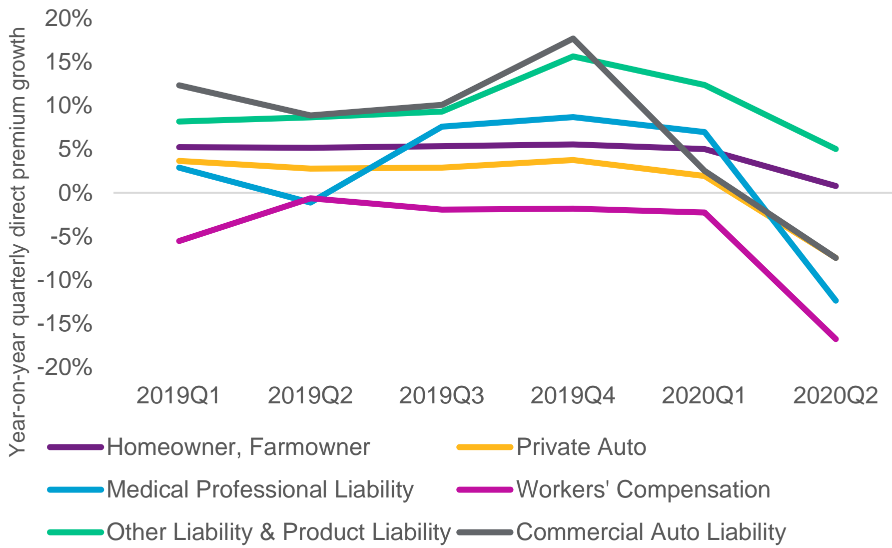
Source: Willis Re

COVID-19 has meaningfully dampened premium income in Q2, but this trend may be short-lived

Second quarter 2020 US P&C financial data shows COVID-19’s significant macro-economic impact on insurance premium volume. The impact has varied by line of business depending on the sensitivity of the line to the economic downturn. However, the level of prevailing rate increases is also a significant factor driving premium volumes. For lines which have exposure bases which are highly sensitive to lock-down or economic conditions, e.g. Personal Auto, Workers Compensation, or Medical Professional Liability, premium volume in the second quarter declined significantly. Other (Commercial) Liability, however, continues to experience significant rate increases which have offset in large part the downward pressure of the worsened macro-economic environment. This quarterly trend of premium growth/contraction has to date closely matched the trend in GDP. While a reduction in full year 2020 GDP continues to be forecasted, the US P&C market has, however, experienced periods of hard market pricing where premium growth significantly outpaced GDP growth. From 2021 many commentators, including the IMF cited in the graph below, expect GDP in the major economies to rebound.

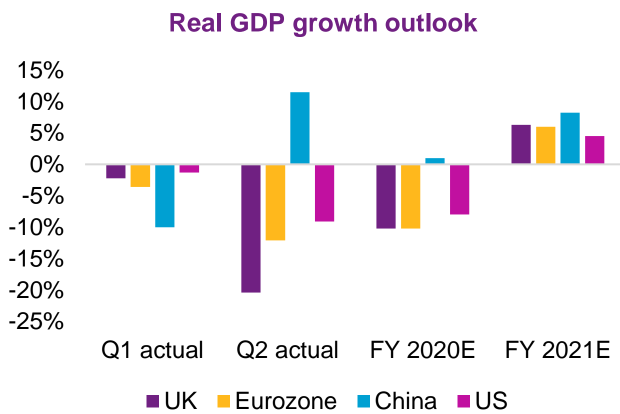
[3] In this simple hypothetical example, we assume that invested assets are 3x premium income and shareholders’ equity is 1x premium income.

Several LOBs in the US insurance market recorded a decline in premiums in Q2

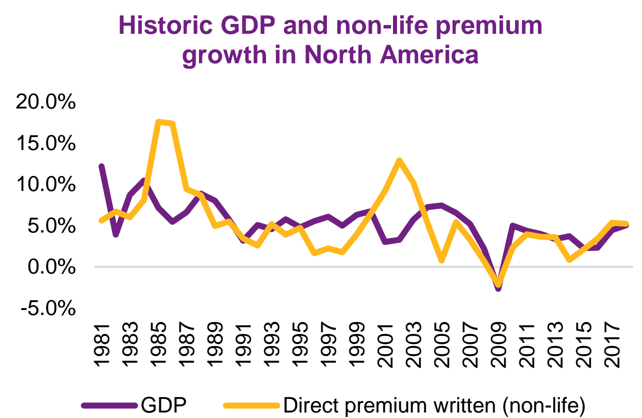


Source: NAIC data provided by S&P Market Intelligence, Willis Re

Gloomy GDP forecasts aren't necessarily predicting premium decline: 1980s and 2000s premium growth was driven by rates in North America



Source: OECD and IMF's June 2020 forecasts



Source: Sigma

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Contact us – Willis Re International Strategic and Financial Analytics

Brian Shea
T: +44 (0)20 3124 7552
E: brian.shea@willistowerswatson.com

Stephen Mullan
T: +44 (0)20 3124 8625
E: stephen.mullan@willistowerswatson.com

Benoit Lavedeau
T: +44 (0)20 3124 7717
E: benoit.lavedeau@willistowerswatson.com

Contact us – Willis Re North America Financial Analytics

Raj Bohra
Executive Vice President
Raj.Bohra@WillisTowersWatson.com
+1 212 915 8444

Ralph Cagnetta
Executive Vice President
Ralph.Cagnetta@WillisTowersWatson.com
+1 212 915 8412

Elizabeth Cordani
Assistant Vice President
Elisabeth.Cordani@WillisTowersWatson.com
+1 860 241 4490

Enrico Leo
Senior Vice President
Enrico.Leo@WillisTowersWatson.com
+1 212 915 8014

Adrian Nusaputra
Senior Vice President
Adrian.Nusaputra@WillisTowersWatson.com
+1 212 915 7856

Gus Park
Vice President
Gus.Park@WillisTowersWatson.com
+1 212 915 8438

Frank Reda
Executive Vice President
Frank.Reda@WillisTowersWatson.com
+1 212 309 3595

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