Global (re)insurance: capitalisation strong but low interest rates continue to weigh

Willis Re
Strategic & Financial Analytics
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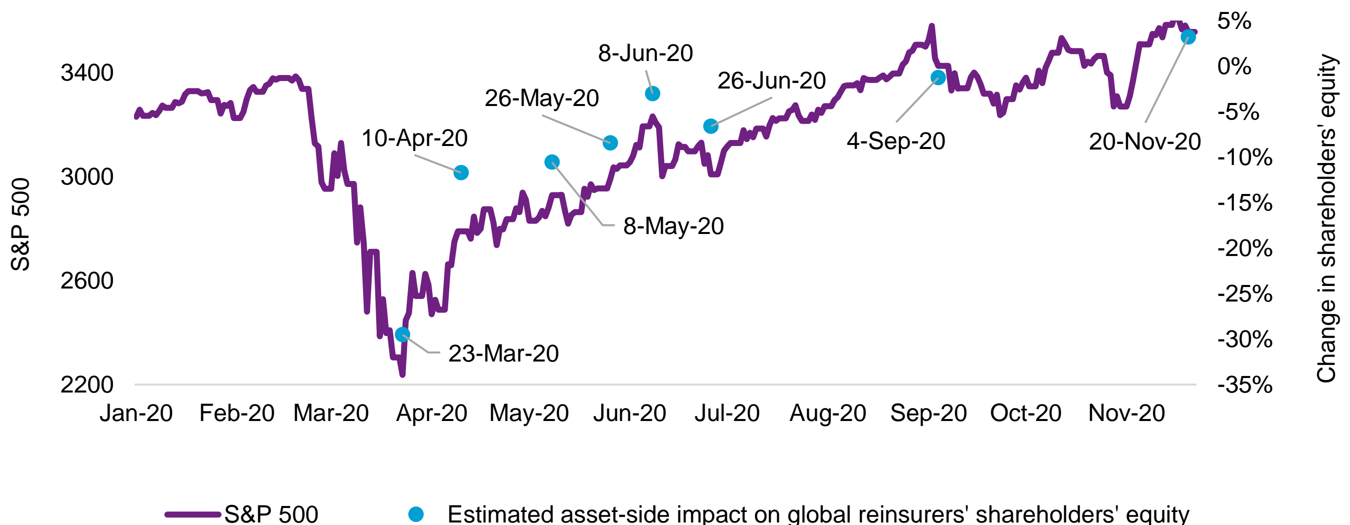
Summary

- We estimate that asset-side support to global reinsurers' shareholders' equity is now +3% YTD.
- Solvency capital, however, is constrained by falling interest rates.
- Capital raising has continued in Q4. We estimate that COVID-19 related capital raising by global (re)insurers totals $19b and a further $3b is being contemplated and/or is in progress.
- Pending legal rulings are one factor in the continued uncertainty around ultimate COVID-19 related losses. Booked losses in the first nine months of 2020 totalled $20b, which remains considerably below the c.$68b mid-point of top-down industry loss estimates.
- While falling interest rates provide an immediate constraint on solvency, their impact on earnings will be longer term. Overall, we see the decline in already low interest rates as a key long-term challenge for (re)insurers.
- Third quarter written premium bounced back from second quarter declines, as COVID-19 lock-downs re-opened, but we can expect another dip if second wave induces renewed lock-downs. Positive rate momentum continues to provide a strong offset to low and volatile exposure growth.

Growth in asset values continues

Substantial fiscal stimulus has driven a strong recovery in asset values following the sharp decline in Q1. As an example, the S&P 500 is now +9% YTD.[1] We estimate that asset-side support to global reinsurers' shareholders' equity is now +3% YTD. The extreme volatility this year serves as a reminder, though, of (re)insurers' sensitivity to investment markets.

(Re)insurers benefit from rising asset side support



Source: Capital IQ and Willis Re

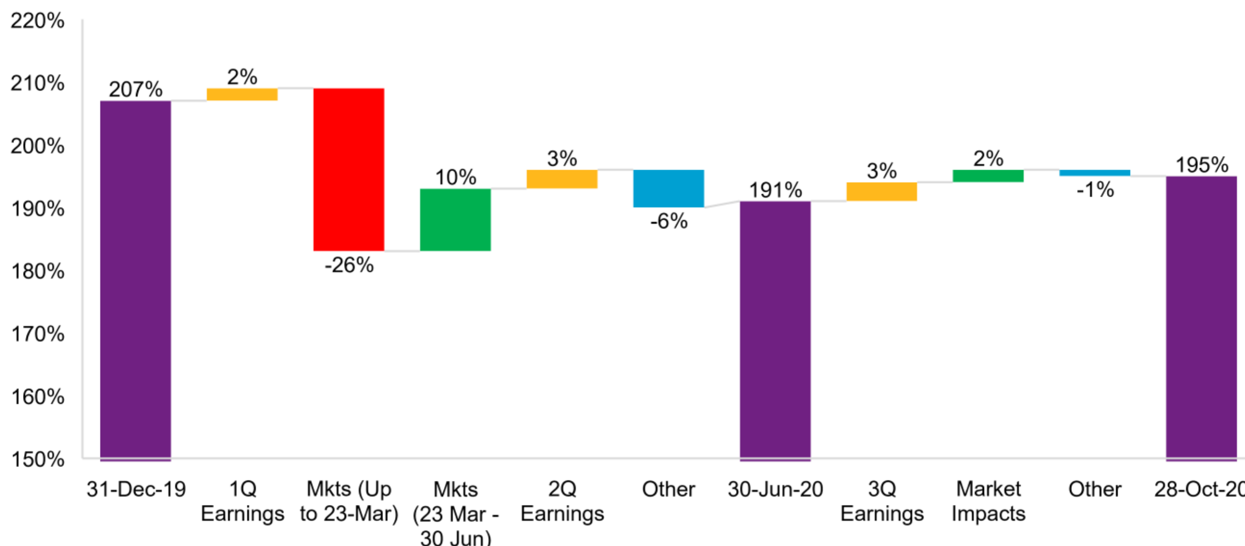
European sector solvency levels strong but declining interest rates continue to weigh

It is worth noting that even at the March low point the average solvency ratio for the European sector remained a healthy 180%. Although below the year-end 2019 position, European solvency has since recovered to an estimated 195% due to a combination of rising investment markets and retained profits. The latter benefited from improved pricing, lower claims frequency for certain P&C

[1] As of 20 November 2020.

lines of business, and some reduction in dividends due to a combination of company prudence and regulatory intervention. While sector solvency has been resilient, some companies have suffered significant capital impacts due to above average exposure to COVID-19 affected lines of business. More broadly, the sector's recovery has been more L than V, with the rebound constrained by the further decline in already low interest rates.

European solvency ratios recover but remain constrained by low interest rates

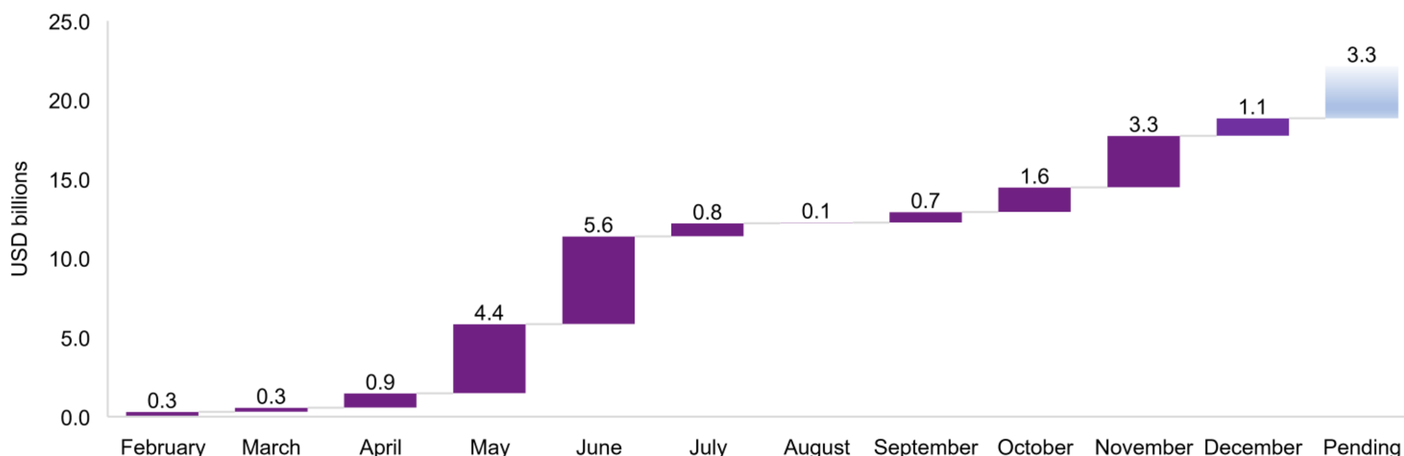


Source: Autonomous Research

Improved pricing spurs further capital raising

Capital-raising has picked up again as we approach year-end, with an estimated $6b raised thus far in Q4. This takes our YTD tally to $19b, with a further $3b being contemplated and/or in progress. Recent capital raises have been largely motivated by the strengthening pricing environment, particularly for reinsurance and commercial insurance lines of business. Required balance sheet bolstering due to COVID-19 loss exposure also continued during the quarter. Looking ahead we may see further required capital raises as pending legal rulings on COVID-19 related claims are reached. Capital raising is likely to remain a high-profile topic but, for context, global reinsurers returned to shareholders three times more than they raised in the first half of 2020 as we noted in our half-year 2020 Reinsurance Market Report.

COVID-19 related capital raising by global (re)insurers totals $19b YTD; a further $3b is being contemplated and/or is in progress



Source: Company reports, insurance trade press, Willis Re

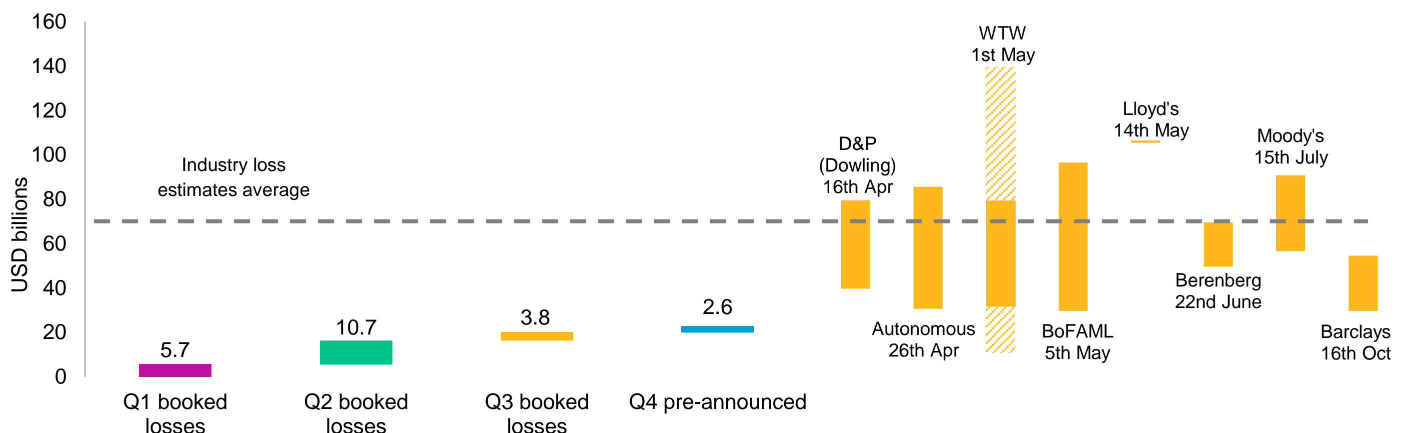
COVID-19 losses continue to emerge slowly

In the first nine months of 2020 the global (re)insurers which we track booked $20b of COVID-19 related losses. This remains considerably below the c.$68b mid-point of top-down loss estimates for the global non-life industry. More is coming with Q4 results with, for example, Munich Re announcing on 1 December that it will book an additional c.€1.1b.

A number of (re)insurers have included a significant IBNR component in their booked losses due to considerable uncertainty around ultimate COVID-19 losses. This uncertainty is due in part to pending legal rulings, particularly in relation to business interruption (BI) covers, which will decide if and how COVID-19 related claims should be covered. One notable recent ruling was that taken by the Supreme Court of New South Wales on 18 November which determined that COVID-19 related BI claims should not be excluded under certain policy wordings. This prompted IAG to advise that it will recognise an AUD 865m after-tax provision and launch a capital raise of up to AUD 750m. The likelihood of significant COVID-19 losses arising from future underwriting years has been reduced by the introduction of exclusionary policy wording by (re)insurers.

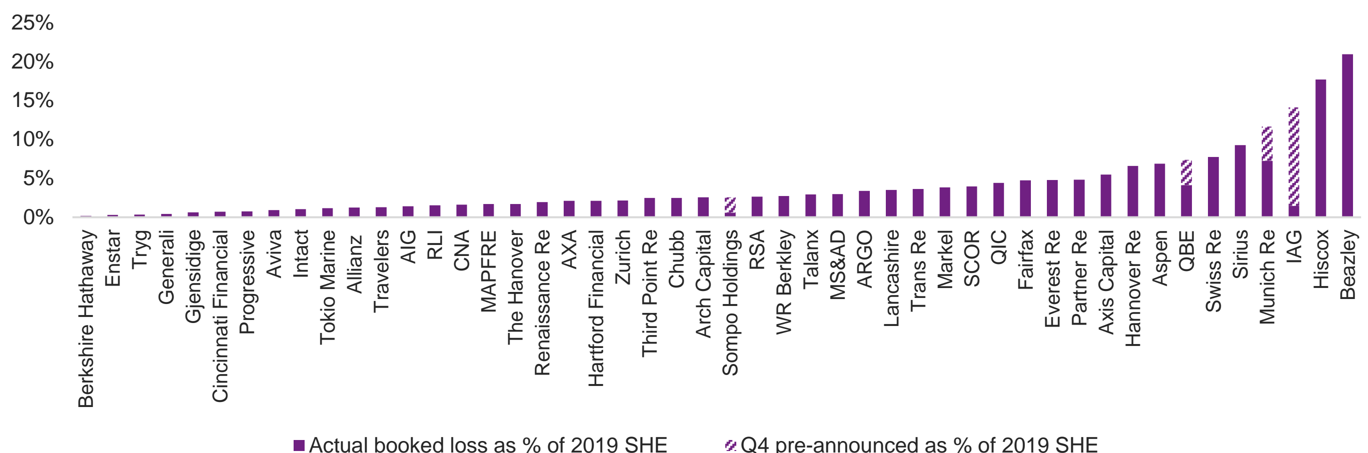
When we look at losses booked by individual companies, we again see the slow pace of COVID-19 loss emergence; c.80% of the (re)insurers which we track booked losses of less than 5% of 2019 shareholders' equity in the first nine months of 2020.

Booked losses remain well below 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.

COVID-19 related booked losses vary widely amongst (re)insurers



Source: Willis Re

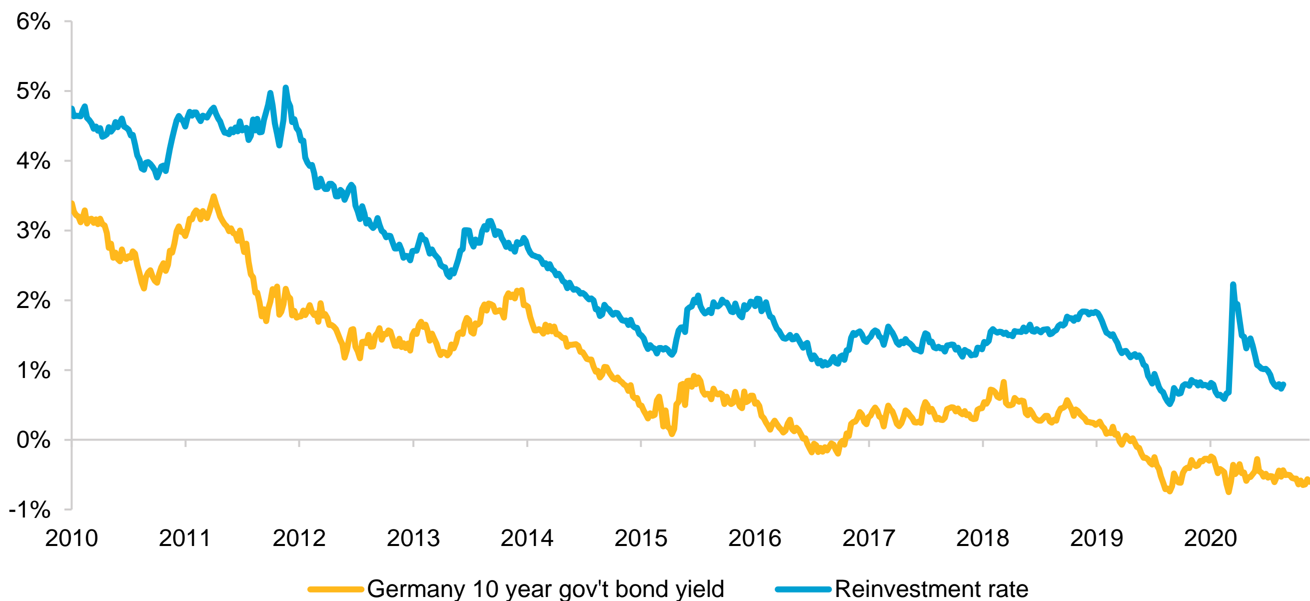
[2] WTW's USD 32-80bn estimate corresponds to its Moderate to Severe scenarios. WTW has also published Optimistic and Limited Success scenarios. These are represented by the hashed portions of the WTW bar and widen the range to USD 11-140bn.

Falling interest rates have immediate impact on solvency; earnings drag will be longer term

The yield on German 10-year government bonds has edged further downwards since our 10 September update in which we noted that the reinvestment rate for typical European insurers is now below 1%, according to Autonomous Research. Given ongoing macro-economic uncertainty, a meaningful uptick in reinvestment rates seems unlikely in the near-term.

Falling interest rates reduce European sector solvency as the resulting increase in asset values is outweighed by a more significant rise in liabilities which are valued at risk-free interest rates under Solvency 2. Those risk-free rates are updated on a monthly basis so there is negligible lag in terms of solvency impact. The same isn't true for the earnings impact; falling re-investment rates take some time to be fully reflected in (re)insurers' reported investment yields. The drag on earnings is further exacerbated as there is also a lag before reported investment yields recover after reinvestment rates improve. Overall, we see the decline in already low interest rates as a key long-term challenge for (re)insurers.

Falling bond yields contribute to low reinvestment rates

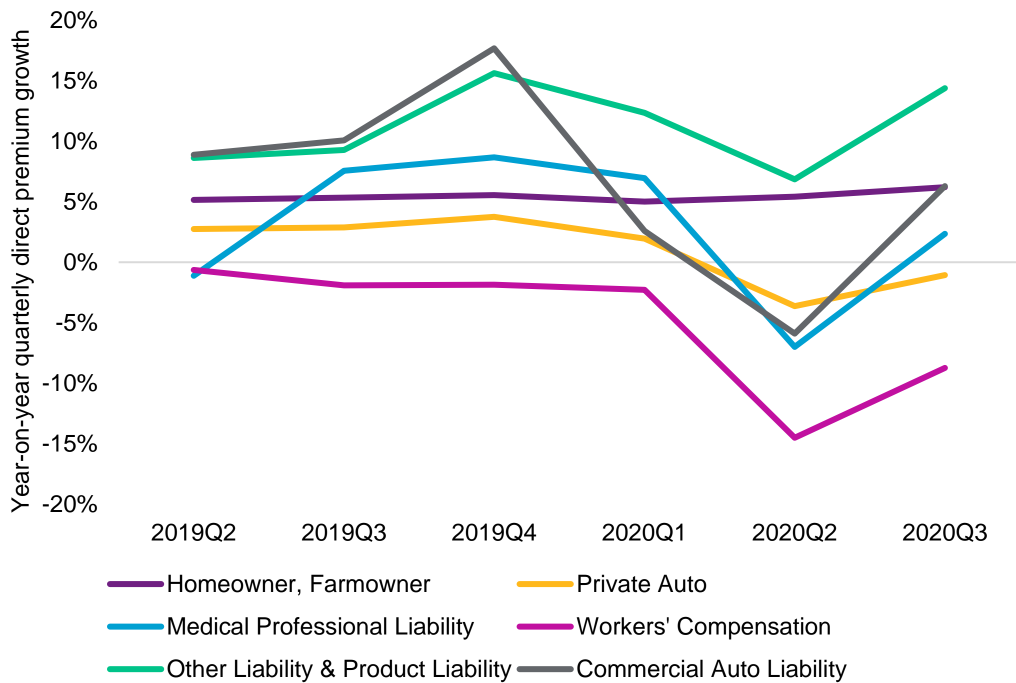


Source: Autonomous and Capital IQ

The end of lock-downs reverse earlier declines in premium volume but will it last ?

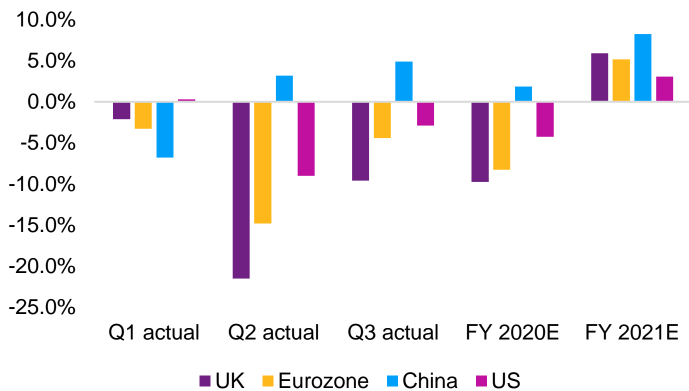
With lockdown periods ending throughout the summer, the effects of pricing changes can now be seen affecting premium volumes (in comparison to prior year same quarter), especially in Other (Commercial) Liability. Fourth quarter would show this more clearly across more lines if we could assume a full and continuing return to normalcy. However, second-wave lockdowns beginning in some locations now will suppress this, and if the anticipated spike causes more widespread lockdowns, then the uptick in Q3 will be only a blip in a continuing decline, especially in those lines that are highly sensitive to lock-down or economic conditions. e.g. Personal Auto, Workers Compensation, or Medical Professional Liability. 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.

Most LOBs in the US insurance market reversed Q2 declines

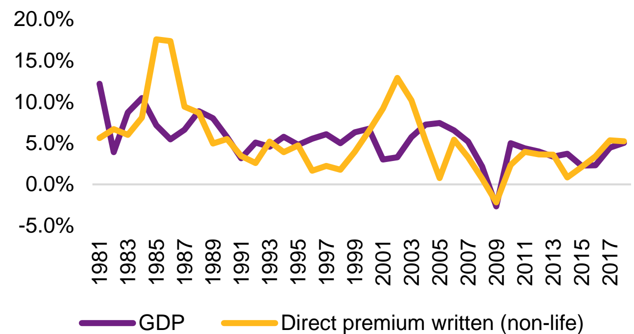


Source: NAIC data provided by S&P Market Intelligence, Willis Re

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 October 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 Advisory

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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