Reinsurance Market Outlook

June and July 2019
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Executive Summary: Traditional Markets Fair Well Through Q2 2019

Global reinsurance capital recovered through Q1 2019, ending up 3 percent to USD605 billion from year end 2018 at USD585 billion. Most notable is the increase from the traditional markets where reinsurers have seen low catastrophe loss activity coupled with a stock market rebound. Capital emanating from traditional reinsurers rose 5 percent to USD512 billion. Alternative markets showed a decrease of 4 percent over the same period ending at USD93 billion, driven in large part by loss payments and investor redemptions.

With the predominant renewals in Florida and Australia at June and July 1, both territories experienced loss activity that affected lower layers of programs 2018 and resulted in some increases in portions of programs. Nevertheless, supply remained adequate for placements tempering any potential further increases.

Alternative markets showed a slight decrease of USD4 billion to USD93 billion largely attributed to loss payments and redemption requests.

The first half of 2019 has seen the lowest catastrophe activity on record since 2006 with only USD18 billion of insured losses sustained by the public and private market. Through the middle of the year, all major regions are currently well below 10-year average (USD36 billion) and median (USD28 billion) activity and only four events have caused more than USD1 billion in losses to date. Three of these events emanated from severe convection storm activity in the US and the fourth was Windstorm Eberhard that hit central and western Europe in March.

The three main hurricane season prognosticators (National Oceanic and Atmospheric Administration (NOAA), Colorado State University (CSU) and Tropical Storm Risk (TSR)) have all forecast near normal hurricane activity for the 2019 season.
Global Reinsurer Capital

Traditional sector drives first quarter rebound

Aon estimates that global reinsurer capital rose by 3 percent to USD605 billion over the three months to March 31, 2019. This calculation is a broad measure of the capital available for insurers to trade risk with.

Traditional equity capital rose by 5 percent to USD512 billion, driven principally by strong earnings. Another factor was the launch of Stephen Catlin’s new venture, Convex Group Ltd, backed by committed funds of USD1.8 billion from a consortium of private equity investors. Assets under management in the alternative capital sector fell by 4 percent to USD93 billion, driven by the payment of losses and investor redemptions.

Exhibit 1: Change in Global Reinsurer Capital

Sources: Company financial statements / Aon Business Intelligence / Aon Securities Inc.

Traditional capital

Reinsurer operating performance was strong in the first half of 2019. Insured natural catastrophe losses were below long-term averages, the most significant ‘event’ being adverse development of reserves held for losses occurring late in 2018 (notably Typhoon Jebi). In addition, it was an unusually favorable period for investing:

- Stock markets rebounded strongly from the lows seen in December
- Ordinary yields benefitted from the recent rise in interest rates in the US and UK markets
- Bond yields went into reverse in all major markets, resulting in unrealized gains on fixed-income securities

The period was also notable for a significant weakening of the outlook for economic growth, driven by trade disputes and rising geo-political tensions. Fears of recession have prompted moves towards renewed monetary easing and downward pressure on central bank rates, dashing hopes that the recent improvement in ordinary investment yields will be maintained.
Aon’s Reinsurance Aggregate posted a net combined ratio of 95.8 percent for the three months to March 31, 2019, as shown in Exhibit 2. The ordinary investment yield ticked up again to 3.0 percent, with unrealized gains providing significant additional support to overall returns. As a result, the annualized return on average common shareholders’ equity jumped to 16.1 percent.

Company valuations are currently at the highest level seen since the financial crisis, partly reflecting modest improvement in the underwriting environment and continued speculation around future M&A activity. In addition, strong solvency ratios and solid dividends are appreciated defensive characteristics in a deteriorating macroeconomic environment.

Exhibit 2: Reinsurance Sector Performance*

Source: Company financial statements / Aon Business Intelligence
*Based on Aon’s Reinsurance Aggregate
Alternative capital

Headline assets under management are estimated to have contracted by around USD4 billion in the first quarter of 2019, driven by the payment of losses and redemption requests from investors. The total of USD93 billion at March 31, 2019 is shown gross of around USD15 billion of collateral still trapped on contracts impacted by losses from recent natural catastrophe events, several of which continue to develop adversely.

Inflows of new capital have continued, but at a slower rate, reflecting investor concerns around climate change, model credibility, loss reporting, and collateral management. New commitments have tended to favor larger ILS fund managers with strong long-term track records of successful capital deployment. In short, alternative capital has become more discerning and is generally seeking higher returns.

Enhancements in model clarity and refinements in contract language are expected to result in the resumption of growth on a more sustainable basis, once recent losses have been fully digested. Many long-term investors have made good returns over time and the strategy of investing in insurance risk for diversification purposes in a low interest rate environment remains valid, as confirmed by the January 2019 announcement that leading fixed-income investment manager PIMCO was entering the ILS business.

Exhibit 3: Alternative Capital Deployment

Source: Aon Securities Inc.
Focusing on the most transparent area of the alternative market, issuance of Rule 144A property catastrophe bonds in the first half of 2019 was well down on the volumes seen in the two prior years, at around USD2.6 billion. However, total limit outstanding remains at a near record high of USD30 billion. Taking life, mortgage, and private deals into account, the total is around 25 percent higher.

**Exhibit 4: Rule 144A Property Catastrophe Bond Issuance**

![Graph showing Rule 144A Property Catastrophe Bond Issuance from 2007 to 2019](image-url)

Source: Aon Securities Inc.
Reinsurance Demand

Total demand for renewals at June / July were flat to down slightly in private market reinsurance demand. Dynamics of peak Florida reinsurance placements shifted following two years of loss activity, and in some cases increased loss development for Hurricane Irma, resulting in several insurers electing higher participation percentages for their Florida Hurricane Catastrophe Fund limit. In addition, a few non-core reinsurance layers were eliminated from overall placements to maintain spend closer to prior years.

The Florida private market benefited from legislative changes enacted this spring including an increase in the LAE coverage provided by the FHCF from 5 to 10 percent. This resulted in positive impacts on placements for 2019 and is expected to be fully realized in future placements. In addition, assignment of benefits legislation was signed into law in May to curtail historical abuse of the coverage.

In Australia, while weather activity including Sydney Hall (AU$1.5 billion; Dec 18) and Townsville Flood (AU$1.5 billion; Feb 19) affected mainly first layers of Nationwide programs, occurrence programs were completed with some renewing reinsurers looking for increased participations on certain layers and new reinsurers continuing to develop relationships in the region.

A revision of the view of earthquake frequency in Australia was released by Geoscience Australia during the year which resulted in large reductions in modelled losses for most earthquake-exposed portfolios. Despite this, vertical limits purchased remain unchanged.
Florida Hurricane Catastrophe Fund

Despite estimated ceded losses for Hurricane Irma USD3.75 billion and Hurricane Michael of USD1.45 billion, the FHCF remains in a strong financial position. The 2018 YE fund balance was estimated at USD12.4 billion, or more than 70 percent of the total potential claims paying capacity needed (USD17 billion). Although the prior few years were fully funded with cash balances, pre-event bonds, and reinsurance, 2019 does show a slight gap in total claims paying capacity from those sources. That said, assuming the FHCF purchases reinsurance like prior years, Raymond James estimates that market conditions suggest that an estimated USD8.6 billion would be available to the FHCF for the current year and would be more enough to cover any claims paying shortfall from other sources.

Exhibit 5: Total claims paying capacity

Source: Florida Hurricane Catastrophe Fund’s website

Rating Agency View of Cat Risk

Rating agencies are continuing to put more emphasis on catastrophe tail risk since 2017 and 2018 were the costliest back-to-back catastrophe loss years in recent history and some companies exhausted their reinsurance coverage. The rating agencies will continue to incorporate tail risk management into their ERM discussions with companies around stress testing, accumulations and ensure risk tolerances are set and being met. A.M. Best computes an unpublished BCAR score at the 500-year return period that is used as part of ERM assessments. Wildfire has been a peril that has received renewed attention recently due to four of the five worst fires ever occurring in 2017 and 2018. The significance of these losses has resulted in greater scrutiny around model performance and ERM practices in general at the company level. The rating agencies are now taking a closer look at and asking companies more questions around how they plan to manage the exposure given recent experience.
TRIPRA Extension Impact

The U.S. federal terrorism backstop, (known as TRIPRA) is set to expire on December 31, 2020. The upcoming deadline has become a topic of growing concern for the insurance industry. Insurers are facing the possibility that TRIPRA may not be extended beyond 2020, or might be modified from its current format. A.M. Best recently released commentary regarding the impact that changes to TRIPRA could have on certain companies and their expectations for managing the uncertainty going forward. To meet rating agencies expectations, insurers with terrorism exposure who are reliant on TRIPRA will need to begin contemplating risk mitigation practices in the event of changes or expiration in the current legislation.

US Primary Rate Changes

Several major lines of business saw more market hardening in Q1 2019. Commercial Auto, Commercial Property, General Liability and Umbrella all saw larger increases in rates during Q1 2019 according to CIAB. These lines saw increases of 9.2 percent, 6.1 percent, 2.1 percent and 3.5 percent. Across all 16 lines of business the CIAB follows, Workers Compensation was the only one that experienced decrease in rates of 3.5 percent.

Exhibit 6: US primary rate changes

Source: CIAB
Property Catastrophe Events Update

Convective Storms and Flooding Lead First and Second Quarter Catastrophe Losses

Preliminary insured catastrophe losses were below average during the first half of 2019. Most of the losses during Q1/Q2 were incurred in the US, Europe, and Australia. The combination of payouts by public and private insurance entities is currently estimated at USD18 billion making this the lowest six-month insured loss tally since 2006, though expected to change as more data is compiled. The USD18 billion total is 50 percent below the recent 10-year average of USD36 billion and 36 percent lower on a median basis of USD28 billion. Using a median analysis helps provide a more accurate depiction of losses and eliminates any potential skew of outlier years.

*Please note that the 2019 data will continue to evolve in the coming weeks and months. Upward revisions will likely occur. Not included in this preliminary total are any initial claims data for insured crop losses in the US where impacts from ongoing flooding is expected to produce a high volume of agricultural claims.*

Exhibit 7: First and second quarter insured losses by year by type

The first half of the year was highlighted by four individual catastrophe events that caused more than USD1.0 billion in insurable losses. Preliminary data showed that three of the four events occurred in the US. All three resulted from severe convective storms (losses driven by tornadoes, hail or straight-line winds) and subsequent heavy rainfall that prompted major riverine flooding. The combined cost of the three billion-dollar US insured events is currently estimated at USD4.15 billion; the costliest of which was a late-May outbreak that prompted USD2 billion in payouts. The other event that cost insurers at least USD1.0 billion was Windstorm Eberhard, which swept through Western and Central Europe in March.

Nearly two-thirds of first-half insured losses (65 percent) were sustained in the US; or approximately USD11.7 billion. Most of the losses were attributed to the severe convective storm (SCS) peril as several major hailstorm events and an elevated number of tornadoes – including 28 rated EF3 or EF4 – were...
recorded in central and eastern parts of the country. At least seven events in the US caused at least USD500 million in insured losses; all of which were SCS, winter storm, or flood-related. There were four additional non-US events that passed the half-billion-dollar (USD) threshold. These included Windstorm Eberhard (Europe), Storm Jörn (Europe), Cyclone Fani (India), and severe flooding in Townsville (Australia).

Beyond the US, the highest percentage of insured losses occurred in EMEA (21 percent), APAC (10 percent), and the rest of the Americas (4 percent).

**Exhibit 8: 2019 YTD Insured Losses Compared to Recent Annual Averages by Region**

As previously noted, the largest portion of the USD18 billion in global insured losses was attributed to the severe convective storm peril. The more than USD10 billion in losses accounted for 57 percent of the overall Q1/Q2 total. The two other perils that accounted for more than 10 percent of the first-half total included winter weather (20 percent) and flooding (10 percent). The only additional peril above five percent was European Windstorm (9 percent).

If current trends from the first half of the year continue, 2019 is on pace to be below normal for the entire year. As always, it is imperative to remind that it only takes one – or a series – of catastrophic natural disaster events to entirely change the trajectory of a year for the insurance industry. The peak months for catastrophe losses are often found between July and October – which nearly coincides with the most active months for Atlantic hurricanes. 2017 and 2018 were also marked by relatively quiet natural peril losses but ended with costly tropical cyclone and wildfire events in the last six months.

This preliminary data comes via Aon’s Catastrophe Insight group, which is part of Impact Forecasting. To view the most up-to-date catastrophe loss data, please visit: [http://catastropheinsight.aon.com](http://catastropheinsight.aon.com)
Protection Gap

Large gap persists despite back-to-back high loss years

2017 and 2018 resulted in the two costliest back-to-back years on record for the insurance industry. Public and private insurers paid out USD248 billion in gross claims following several high-cost tropical cyclone and wildfire events in the U.S. and Japan. While the insurance cost was quite high, it represented only a relatively small portion (35 percent) of the overall economic cost: USD710 billion. This further highlights the wide protection gap that exists on a global scale.

This gap, however, has begun to slowly close when analyzing insurance industry and overall economic losses dating to 1990. As new insurance schemes and pools become available in developing or emerging markets – such as Asia, Latin America, and Africa – this is allowing more homeowners and some commercial interests access to policies that cover impacts from natural disasters. While the protection gap remains concerningly high in these areas, with often less than 10 percent of disaster losses covered by insurance on an annual basis, slight improvement is expected as insurance expansion continues into these markets.

The U.S. remains the dominant driver of insured losses. From 1990 to 2018, there has been USD1.6 trillion in public and private industry payouts from global natural disasters. The U.S. accounts for USD933 billion – or 59 percent – of those payouts alone. Every other major region of the globe accounts for less than 20 percent: EMEA (18 percent), Asia-Pacific (16 percent), and the rest of the Americas (7 percent).

Exhibit 9: Percentage of Economic Losses Covered by Insurance

Since 1990, the annual rate of growth in the percent of catastrophe losses covered by insurance is +1.2 percent. While this percentage does not seem significant, it does translate to many millions (USD) – or perhaps as much as USD1 billion in an active year – of additional payouts utilized by policyholders to aid in helping people recover following a disaster.
Perhaps the bigger focus on protection gap should be on individual perils and not just regions. Even in developed countries with the most mature insurance markets in place, there are several perils and sub-perils of events that remain highly uninsured.

The most significant on a global scale is earthquake. Since 1990, just 12 percent of economic damage has been insured. Most of the costliest earthquakes during this time occurred in Japan, China, Italy, Algeria, Nepal, Indonesia, and Iran, where earthquake coverage remains in the low single-digits of home and business owners. This same issue is also true in California. A 2018 report by the California Earthquake Authority\(^1\) noted that nearly 90 percent of residents or commercial structures did not have earthquake coverage – highlighting the significant vulnerability if another major earthquake strikes.

**Exhibit 10: Percentage of Economic Losses Covered by Insurance by Peril (1990-2018)**

Tropical cyclone and flooding are also major drivers of global economic losses, but a large portion of physical damage is often left uninsured. This is particularly true in the U.S., where water-related losses are not covered under standard homeowner or commercial policies. Flood insurance take-up remains quite low, with most active policies located along coastal locations and areas immediately along major rivers. This leaves many properties exposed to high intensity rainfall events that may cause flooding beyond typical 100-year flood zones.

For other tropical cyclone-prone regions, such as parts of Asia, Africa, and Latin America, insurance take-up remains very low. With the prospect of impactful storms reaching land, it will become even more imperative for insurance scheme implementation into some of these vulnerable areas. This will also be true for agricultural interests given major damage often inflicted to seasonal crops by these storms.

The bottom line: Insurance penetration is improving around the world, albeit at a slow pace. As take-up rates improve in emerging and developing markets, this should work to further lessen the existing protection gap. However, protection challenges persist around the world and in the industry’s most mature markets. Maintaining forward momentum to expand insurance will help strengthen the industry’s portfolio and provide more protection for the public.

2019 Atlantic Hurricane Season Forecast

The three main hurricane season prognosticators (National Oceanic and Atmospheric Administration (NOAA), Colorado State University (CSU) and Tropical Storm Risk (TSR)) have all forecast near-normal hurricane activity for the Atlantic Hurricane Season. Each agency, however, does cite some uncertainty surrounding the intensity and longevity of the current weak El Niño conditions that exist in the Central and Eastern Pacific Ocean. If El Niño conditions slightly strengthen more than currently forecast during the peak development months of August, September, and October, this could lead to less favorable atmospheric and oceanic conditions in the main development region of the Atlantic Ocean.

However, beyond the state of ENSO, sea surface temperatures across the tropical Atlantic Ocean remain at near-normal levels – which means enough warmth available for cyclogenesis to occur. Suppressing mid and upper-level winds, known as wind shear, are close to normal values throughout the Atlantic and Caribbean Sea as well. Given these conditions, a near-normal season is anticipated.

As always, it is imperative to remind that it only takes one landfalling storm to entirely alter the perception of a season from a financial loss perspective. This can occur regardless of how meteorologically active or inactive a year may be.

Exhibit 11: Hurricane Forecasts for 2019 Season

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Sources: Tropical Storm Risk (TSR), Colorado State University (CSU), NOAA
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