Persistent global volatility amid trend toward increased reinsurance capitalisation

Guy Carpenter's Jay Dhru and Richard Hewitt examine how macroeconomic trends are impacting reinsurance capital

Global headline inflation levels are falling, but remain above central bank targets and pre-pandemic levels. With inflationary drivers persisting, in particular catastrophe losses, geopolitical uncertainty, supply chain issues and tight labour markets, the outlook for US inflation, for example, is trending towards staying marginally above targets – by ~2 percent – over the longer term.

Inflation directly impacts (re)insurance pricing, reserving, costs, current-year underwriting margins and asset values, increasing earnings volatility and reducing capital. It is critical for companies to integrate macroeconomic and financial market forecasting and scenarios into decision making, and to adjust pricing for inflation based on robust data and modelling.

In times of unexpected inflation, reserves also require adjustment, with consideration of the economic and social inflation assumptions.

Managing slowing economic growth

The International Monetary Fund predicts global economic growth of 3 percent per annum for 2023 and 2024, below the 2000 to 2019 annual average of 3.8 percent.

Signs of stabilisation in the economy indicate that recession is now less likely, but as long as inflation remains above target, monetary tightening is likely to continue to increase the cost of borrowing and weigh on economic growth.

A slowing economy may limit insurer growth potential as premium volume growth reduces and social inflation effects may spur adverse claims trends.

Managing ongoing financial market stress

Equity markets have generally rebounded in the last year. In contrast, although bond yields are showing signs of stabilising, they remain in challenging territory. Volatility in the US Treasury bond market (based on the MOVE index) remains elevated and above pre-pandemic levels.

The financial markets are still adjusting to falling, but stubbornly above-target inflation, slower economic growth outlooks and materially higher borrowing costs. There is still a heightened risk of financial market stress and volatility.

Shifting bond yields significantly impact (re)insurers' balance sheets and solvency, necessitating the repricing of financial risks. Insurers can mitigate the impact by reassessing and rebalancing their investment portfolios to reflect changes in their asset-liability risk and return profiles, as well as liquidity buffers.

Notably, a movement to more liquid assets may help insurers to fund losses that may manifest due to higher retentions, and for increasing investment in investment-grade bonds, which also reduces volatility.

Disciplined mid-year renewal, but capacity is rebounding

At mid-year 2023, Guy Carpenter and AM Best estimated that $4bn of new reinsurance capital was raised, largely from existing players. Incumbent reinsurers appear well-capitalised, and capital deployment remains disciplined.

We also observed higher insurer retentions, an increase in the use of captives and continued restrictive terms and conditions. Insurers may mitigate the impact of the challenging risk-transfer market with risk-adjusted pricing and by rebalancing the underwriting portfolio away from tail risks and underperforming accounts.

Reinsurance capital exists to support clients. In addition to the new capital raised, the future estimated returns on equity for reinsurers tracked in the Guy Carpenter Reinsurance Composite are expected to be materially above the cost of equity.

We estimate that up to $50bn could be added to the composite's total equity by year-end 2025 if these returns materialise. Add to this the positive development of ILS, which saw a record $9.3bn of issued risk capital in the 144A catastrophe bond market in the first half 2023, and the implication overall is for a sizeable amount of risk capital for deployment to support insurers' growth and volatility management.

How Guy Carpenter can help

Guy Carpenter's insights, along with our broking, strategic advisory and analytics services, all rely on a foundation of dedicated experts, cutting-edge tools and data insights that lead clients to smarter solutions.

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