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The severe and challenging insurance rate environment continues into 2018, despite the impact to insurers' balance sheets and profit and loss statements from the 2017 catastrophes.

This was laid bare in Lloyd's of London results for 2017. Even taking out Major Claims the 2017 combined ratio was 98.4%. Reserves releases from back years are dwindling (2.9% of Net Earned Premium in 2017 versus 8.0% of NEP in 2013).

The convenient bogey man is Alternative Capital. The narrative that Alternative Capital is causing an excess supply of insurance capital while simultaneously being satisfied with a lower Return on Capital is comforting to insurers, in the face of an insurance rate environment that insurers seem unable to reform or resist.

IS THIS TRUE?

No. In fact, insurers need to take a good look at themselves. A recent Aon Benfield report (Reinsurance Market Outlook, Capacity Builds Ahead of Mid-Year Renewals, April 2018) highlighted an uncomfortable truth.

From 2007 to 2017 Alternative Capital grew from $22b to $89b [+$67b].

From 2007 to 2017 Traditional Capital grew from $388b to $516b [+$128b].

That is, Traditional Capital has contributed almost twice as much growth in capital over the last decade in dollar terms as Alternative Capital.

THE QUESTION HAS TO BE ASKED: WHY?

Why are insurers increasing Traditional Capital if the environment is so terrible (according to their own narrative)? Could it be that insurers are the architects of their own dire situation?

Consider some of the methods by which Traditional Capital has expanded: quota share reinsurance treaties, sidecars, Lloyd's special purpose agreements (SPA), consortia, managing general agents (MGA), broker lineslips, with all these often paired with considerably larger gross line capacity.

All these methods of growth are actually causing the insurance market (i.e. insurance rates, and therefore premium income) to contract. Excess supply from traditional sources inevitably pushes rates down and keeps them down. Observe the initial enthusiasm post-H.I.M. (Harvey, Irma, Maria): many insurers immediately announced growth plans and expanded capacity. The hoped-for rate increases never arrived: I can't say I was surprised. A sober, restrained approach post-H.I.M. would have produced a much-better outcome for insurers.

Now let's examine the narrative that Alternative Capital is satisfied with a lower Return on Capital. Is that true? Yes, but not for lack of trying. Alternative Capital typically has to highly collateralise the exposure it underwrites. An extreme example would be Catastrophe Bonds, where 100% collateralisation is a core feature of that subset of Alternative Capital. Alternative Capital is satisfied with a lower Return on Capital because the 'C' of RoC is higher, not because the 'R' of RoC is lower. That is, the insurance rate Alternative Capital achieves by underwriting a given risk in a competitive environment will be the same as that achieved by Traditional Capital, it's just that Alternative Capital is at a competitive disadvantage and therefore is forced to accept a lower RoC. It is often true that Alternative Capital sees insurance as a diversification play, but this fact doesn't stop these sophisticated deployers of capital doing their level-best to maximise their RoC. They're dispassionate about insurance: they're just deploying their capital to an area of the economy where they can get the best risk-adjusted RoC they can (as of today).

By-the-by, this is why Alternative Capital is not as sticky or permanent to the insurance industry as some have speculated. If some other area of the economy provides a better RoC tomorrow you can be sure Alternative Capital will start to flow away from the insurance industry. The current global economic paradigm is unusual, and sooner or later it will normalise (or change in some other way).

So this narrative ("Alternative Capital is satisfied with a lower Return on Capital") is moot: Alternative Capital is no different to any other Traditional Capital competitor jostling for position in a relatively over-supplied marketplace.

Another often-overlooked point also bears highlighting. What RoC are insurers targeting in 2018? Are insurers clinging to their Glory Days? Is it possible that risk (of all types) is not as well-remunerated as historically? I believe that is a real possibility. Insurers may desire a given RoC, but that does not mean that desire is supportable in the current global economic paradigm. There's a lot of capital sloshing around the globe right now, looking for an adequate risk-adjusted RoC. For example, as of 1 May 2018 the ICE BofAML Euro High Yield Index Effective Yield (BAMLHE00EHYIEY) was 2.99%. As many readers will be aware: 'high yield' is often called 'junk'. How can insurance justify a 15%-20% RoC when junk bonds earn under 3%?

It's time to dial-back expectations. It's not that Alternative Capital is satisfied with a lower Return on Capital: it's that Traditional Capital has a wholly unrealistic view of an appropriate Return on Capital in 2018 in the current global economic paradigm.

One other thing has changed over the last decade (or perhaps slightly longer). There has been a rapid consolidation of insurance brokers, such that the major insurance brokers now control a very significant proportion of the total market. It is no coincidence, in my mind, that acquisition costs have increased markedly over this period. Insurance brokers are using their pivotal position in the insurance value chain to extract over-sized returns.

Situations like this don't last forever. Capitalism and capital will inevitably find a way to work around insurance brokers. It may take time, but it will happen. Time for a new bogey man?

Richard Hartigan FIA

If you have any thoughts which differ with the article above I would be very interested in having a conversation with you- Feel free to get in touch!

Samantha Yee
Manager Actuarial and Risk
020 7332 5881
Samantha.yee@lmarecruitment.com

Samantha Chan
Consultant Actuarial and Risk
020 7246 2641
Samantha.chan@lmarecruitment.com