Bermuda Re/Insurance Quarterly Insights: Despite Record 2017 Catastrophe Losses, Reinsurance Price Increases May Vanish In 2019

June 5, 2018

Bruised by severe natural catastrophe losses, most of the Bermudian re/insurers' 2017 underwriting performance slipped into the red and affected their consolidated return metrics. Last year brought many challenges: soft reinsurance pricing, heightened competitive environment, record influx of alternative capital, and, most importantly, the unprecedented historic catastrophes that racked up more than $138 billion in natural catastrophe insured losses globally.

These losses were the highest ever recorded in a single year between 1970 and 2017, according to a Swiss Re Sigma report. Hurricanes Harvey ($30 billion), Irma ($30 billion), and Maria ($32 billion) totaled about $92 billion, or 0.5% of 2017 U.S. GDP. Global wildfires were also the highest ever recorded in a single year, reaching $14 billion, of which $13 billion emanated from northern and southern California.

For Bermudian re/insurers, natural catastrophe losses totaled about $8.9 billion, net pretax including reinstatement premiums, representing about 6.5% of the global figures, which wiped out the 2017 earnings for a number of players and became a capital event for some companies. As a result, during fourth-quarter 2017 and first-quarter 2018, S&P Global Ratings took some negative rating actions on a few issuers (see "Notable Rating Actions").

PRIMARY CREDIT ANALYSTS

Taoufik Gharib
New York
(1) 212-438-7253
taoufik.gharib
@spglobal.com

Hardeep S Manku
Toronto
(1) 416-507-2547
hardeep.manku
@spglobal.com

Saurabh B Khasnis
Centennial
(1) 303-721-4554
saurabh.khasnis
@spglobal.com

SECONDARY CONTACTS

David J Masters
London
(44) 20-7176-7047
david.masters
@spglobal.com

Johannes Bender
Frankfurt
(49) 69-33-999-196
johannes.bender
@spglobal.com

Ali Karakuyu
London
(44) 20-7176-7301
ali.karakuyu
@spglobal.com

Overview

- Record 2017 catastrophe losses wiped out Bermudian re/insurers' earnings and became a capital event for some re/insurers.
- We view the 2017 natural catastrophe losses as closer to a one-in-30-year event on an aggregate basis.
- Alternative capital has been tested, reloaded without major hitches, and continues to exert its growing influence on the reinsurance sector as the competitive dynamics remain intact.
- We are maintaining our stable outlook on the global reinsurance sector mostly because of re/insurers' strong enterprise risk management (ERM), and still-robust capital adequacy.
- Given the supply-demand imbalance and the resulting pressures on reinsurance pricing, the recent momentum on rate increases could be short lived and dissipate heading into 2019.

Following 2017's record catastrophe year, global reinsurance pricing was up slightly to about 5%, in aggregate, during the year-to-date renewals. Specific increases varied by line of business and region, and whether reinsurance contracts had experienced any losses. However, according to a JLT Re report, JLT Re's Risk-Adjusted Florida Property-Catastrophe Rate-on-Line Index rose by only 1.2% this year from 2017, failing to meet early market expectations. It seems that the Florida June renewals were highly competitive, reflecting abundant capacity and only moderate rate increases. Therefore, the reinsurance price increase momentum that the industry was hoping for at the beginning of 2018 is losing steam and may fizzle out heading into 2019.

The mergers and acquisitions (M&A) activity that remained somewhat subdued in 2017 has revived in 2018 and we are likely to see continued interest in the market as players look to offset some of the secular trends, as organic growth has been hard to achieve. Notable deals were American International Group Inc.'s $5.6 billion acquisition of Validus Holdings Ltd. announced in January and AXA Insurance Group's $15.3 billion acquisition of XL Group Ltd. announced in March. A few others may be in the making, based on market chatter. As a result, re/insurers will likely continue to pursue transformative M&A deals and tactical bolt-on acquisitions to defend their competitive position while hoping to enhance their value proposition. Indeed, various stakeholders continue to believe that "big is beautiful," but, in our view, it's not necessarily better given the unimpressive industry M&A track record. (See "You Must Be This Tall To Ride: Global Property Casualty Re/Insurers Seek Scale Through M&A To Remain Relevant," published Aug. 1, 2017, on RatingsDirect).

We maintain a stable outlook on the global reinsurance sector and on the majority of the re/insurers we rate. Despite the 2017 catastrophe losses, Bermudian re/insurers' capital adequacy remains robust, though lower than at year-end 2016. In addition, their strong ERM programs have helped most of them contain these losses within their risk-tolerance limits. Rising interest rates in the U.S. and Europe should somewhat improve investment returns. Headline inflation remains under control in most developed economies and favorable reserve developments have helped underwriting results, though at a declining pace.

We believe alternative capital passed its stress test last year and continues to come of age, reaching $89 billion as of year-end 2017. As its influence in the reinsurance sector grows, especially in property catastrophe and more recently, life reinsurance, the sector's competitive dynamics remain intact. As a result, the recent momentum on reinsurance pricing rate increases could be short lived. However, we believe that the focus on underwriting discipline and strengthening of balance sheets needs to remain de rigueur.

The Hit To Capital Was Not Severe In Most Cases

Even though the 2017 natural catastrophe losses were significant, the hit to capital was not severe enough to cause industrywide panic or major declines in risk-adjusted capitalization. Where there was deterioration in capitalization, we viewed it as manageable, with most of the affected companies in a position to replenish their lost capital with a year or two of normalized earnings. As a result, we did not take broad sectorwide negative rating actions; rather, those were limited to a few outliers.

In 2017, underwriting profitability slipped into the red with reported net losses to shareholders' equity of $511.8 million in 2017, down from $5.3 billion of net income in 2016 (see table 1). This was principally due to the historic level of catastrophe losses and lower favorable reserve development, partially offset by improved expense ratio and an increase in the net investment income.

Table 1

Bermudian Re/Insurance Industry Statistics

	--Quarter ended March 31--			--Year ended Dec. 31--		
(Mil. $)	2018	2017	2016	2017	2016	2015
Gross premiums written (GPW)	20,724.2	17,543.4	16,635.7	61,120.5	54,796.1	49,183.2
Change in GPW (%)	18.1	5.5	20.1	11.5	11.4	8.3
Net premiums written (NPW)	14,584.7	12,649.1	12,603.0	45,706.2	42,220.4	39,089.0
Change in NPW (%)	15.3	0.4	15.8	8.3	8.0	4.9
Net premiums earned (NPE)	10,753.3	9,804.8	9,420.0	44,798.8	41,243.0	39,134.0
Change in NPE (%)	9.7	4.1	15.0	8.6	5.4	7.8
Loss ratio (%)	58.6	59.0	54.4	76.0	57.7	53.9
Acquisition expense ratio (%)	20.6	20.3	20.5	20.3	20.7	20.3
General and administrative expense ratio (%)	11.9	12.2	13.1	11.5	12.7	13.2
Corporate expense ratio (%)	1.9	2.4	2.8	2.0	2.6	3.5
Combined ratio (%)	93.0	93.9	90.7	109.9	93.6	90.8
(Favorable)/unfavorable reserve development (mil. $)	(150.4)	(248.8)	(498.8)	(1,914.7)	(2,785.8)	(2,968.6)
Reserve development effect on combined ratio (%)	(1.4)	(2.5)	(5.3)	(4.3)	(6.8)	(7.6)
Net natural property catastrophe losses (mil. $)	238.7	233.5	110.6	8,924.1	2,119.3	777.5
Net natural catastrophe losses effect on combined ratio (%)	2.2	2.4	1.2	19.9	5.1	2.0
Reported net income (loss) to shareholders (mil. $)	722.8	1,171.3	1,235.9	(511.8)	5,281.9	5,721.2

Table 1

Bermudian Re/Insurance Industry Statistics (cont.)

	--Quarter ended March 31--			--Year ended Dec. 31--		
(Mil. $)	**2018**	**2017**	**2016**	**2017**	**2016**	**2015**
Shareholders' equity (mil. $)	59,758.3	62,580.0	60,239.1	62,812.3	64,058.8	61,366.8
Return on average reported shareholders' equity (%)	4.7	7.6	8.4	(0.8)	8.4	9.7
Share buybacks (mil. $)	23.6	424.3	842.6	1,227.0	2,714.5	2,282.3
Net investment income (mil. $)	936.4	855.9	672.0	3,688.9	3,267.2	3,065.5

Yearly data includes: Arch, Argo, Aspen, AXIS, Everest, Hiscox, Lancashire, Maiden, PartnerRe, RenRe, Sompo International (ex-Endurance), Validus, and XL. Quarterly data excludes Hiscox.

For Bermudian re/insurers, the reported 2017 catastrophe losses from Hurricanes Harvey, Irma and, Maria, Mexico earthquakes, and California wildfires totaled $8.9 billion, contributing 19.9 percentage points to the combined ratio--a huge surge from $2.1 billion or 5.1 percentage points on the combined ratio in 2016. These losses were just a reminder that a few benign years of weather-related losses don't represent a long-term trend. As a result, Bermudian re/insurers reported a combined ratio, in aggregate, of 109.9% in 2017, up by 16.3 percentage points from 93.6% in 2016. In addition, favorable reserve developments contributed only 4.3 points to the combined ratio in 2017 compared with 6.8 points in 2016.

The impact of the natural catastrophe losses on underwriting results was more pronounced for some companies, particularly RenRe, Aspen Insurance, and Lancashire Holdings Ltd., which were the negative outliers in their peer group. RenRe reported a combined ratio of 139.0% in 2017, with catastrophe losses contributing 57.6 points to its combined ratio while Aspen and Lancashire reported combined ratios of 125.6% and 124.8% with sizable catastrophe losses too (see table 2). On the other hand, Arch Capital Group Ltd. was a positive outlier, reporting the lowest combined ratio of 90.2% among its peers in 2017, where the impact of catastrophe losses in its property books was diluted by the large contribution of its mortgage insurance business to its overall premium base.

Table 2

Bermudian Re/Insurers -- Combined Ratio Comparison

	--Quarter ended March 31--		--Year ended Dec. 31--		2017 catastrophe losses	
(%)	**2018**	**2017**	**2017**	**2016**	**% of combined ratio**	**% of shareholders' equity**
RenaissanceRe Holdings Ltd.	72.1	89.9	139.0	75.2	57.6	22.5
Aspen Insurance Holdings Ltd.	95.6	96.5	125.6	98.4	24.4	19.2
Lancashire Holdings Ltd.	66.6	85.6	124.8	78.6	42.5	16.4
Validus Holdings Ltd.*	90.9	83.2	122.6	84.2	42.5	28.2
AXIS Capital Holdings Ltd.	90.8	102.1	113.1	95.9	20.1	15.6
Maiden Holdings Ltd.	101.9	101.0	111.7	103.6	N.A.	N.A.
XL Group plc	98.0	98.2	111.2	99.2	19.5	20.5
Argo Group International Holdings Ltd.	95.8	99.1	107.2	96.2	8.0	6.9

Table 2

Bermudian Re/Insurers -- Combined Ratio Comparison (cont.)

	--Quarter ended March 31--		--Year ended Dec. 31--		2017 catastrophe losses	
(%)	2018	2017	2017	2016	% of combined ratio	% of shareholders' equity
Everest Re Group Ltd.	93.9	86.7	103.9	87.6	25.3	18.0
PartnerRe Ltd.	99.4	101.5	103.0	97.2	15.4	8.4
Hiscox Ltd.	N.A.	N.A.	99.3	91.5	8.9	9.5
Arch Capital Group Ltd.	80.1	80.1	90.2	89.0	8.9	4.2
Industry aggregates§	93.0	93.9	109.9	93.6	19.9	14.2

Company ranked by 2017 combined ratios (highest to lowest). *Validus' combined ratio includes AlphaCat. N.A.--Not available. §Includes Sompo International Holdings Ltd.

Lower operating expenses and an increase in net investment income partially offset the year's underwriting losses. In a soft pricing environment, the Bermudian re/insurers continued to focus on creating efficiencies in their expense structure, which along with a cut to incentive compensation in 2017, led to a 2.1 percentage point improvement in the expense ratio to 33.9% in 2017 down from 35.9% in 2016. In addition, the improving financial markets and rising interest rate in the U.S. generated year-over-year improvement of 12.9% in net investment income. In 2017, Arch reported 37.8% growth in its net investment income and was a positive outlier among peers. This growth was mostly attributable to a higher invested asset base following the company's acquisition of United Guaranty Corp. (UGC).

First-quarter 2018 underwriting performance was slightly better than in the prior-year quarter as both loss and expense ratios marginally improved. The favorable reserve developments were lower than those in the prior-year quarter, because of adverse reserve developments related to the California wildfires. Most of the benefit from price increases following the year-to-date renewals will flow through the rest of the year, which should help the annual underwriting results. Net investment income improved as well, supported by increasing interest rates. However, net income was lower due to a change in GAAP accounting requiring the change in market value of equities to be reported through the income statement rather than other comprehensive income.

Top Line Growth Boosted By Acquisitions And Rate Increases

Throughout 2017, the soft pricing environment prevailed and the global reinsurance market remained competitive. Despite these challenges, Bermudian re/insurers' top line grew year-over-year, helped in part by additional business from back-up covers and reinstatement premiums in the aftermath of the hurricanes and wildfires. Also contributing to the top line growth were premiums assumed through recent acquisitions. As a result, gross premiums written (GPW) increased by 11.5% in 2017 from 2016. A large part of the growth came from Arch's acquisition of UGC (GPW jumped 21.3% or $1.07 billion) and Argo Group International Holdings Ltd.'s acquisition of Ariel Re (GPW rose 24.6% or $532.4 million). This was partially offset by overall rate declines during 2017 renewals and portfolio management actions related to the soft cycle. For example, Lancashire's GPW continued to shrink in 2017 while the company was managing the soft underwriting cycle. In first-quarter 2018, GPW increased by 18.1% relative to the same period in 2017. The premiums growth was spurred by rate increases in a response to the 2017 catastrophe losses, a few acquisitions, and to a lesser extent, by organic growth.

Reinsurance Pricing Hits An Inflection Point But The Momentum Is Fading

Momentum is starting to slip for reinsurance rate increases during the June renewals. While the rates on average are up by low-to-mid single digits in Florida (based on a June renewals update from JLT Re, with positive movement compared with prior-year renewals), the industry's expectation was for closer to high single-to-double-digit rate increases on average, taking cues from January and April renewals and given the severity of the catastrophe losses in 2017. The risk-adjusted rate increases varied across flat-to-high single digits based on loss/non-loss exposed layers and cedents' performance but were held back by ample reinsurance capacity, both traditional and alternative, which re-loaded without major hitches after 2017's catastrophe events.

After a number of years of rate declines, the January 2018 renewal period was an inflection point, as global reinsurance pricing was flat-to-up about 5%. Consistent with our expectations, specific increases varied by line of business, whether the policy had experienced any losses, and region. While in certain casualty lines the rates are still inadequate, the trend is positive. We expect flat-to-mid single-digit positive rate increases through the remainder of the year. Rate increases by cedents in their primary lines will help the pro rata reinsurance, as will the rate increases on renewals of portions of multi-year programs (especially in loss-affected lines). However, the sector's secular trends have remained intact and the competitive dynamics have not abated. As a result, we continue to see a build-up of pressure on rates, which doesn't make for a rosy pricing outlook going into 2019.

Valuations Dipped After 2017 Catastrophe Events, But Not For Long

Despite disappointing operating results in 2017, the Bermudian re/insurers' valuations have held up fairly well. Companies traded at an average of 1.23x price-to-book value ratio at year-end 2017, largely in line with the 1.25x at year-end 2016. The momentum continued in 2018 as valuations remained high at an average 1.36x price-to-book value ratio at the end of the first quarter. As of May 31, 2018, excluding XL and Validus because of the pending acquisitions, Hiscox Ltd., Lancashire, and Arch continue to lead the pack and traded at 2.46x, 1.53x, and 1.28x, respectively, of their book value while the laggard AXIS and Maiden Holdings Ltd. traded at 1.06x and 1.05x, respectively (see table 3).

Table 3

Bermudian Re/Insurers -- Price-To-Book Value Ratio Comparison

		Price-To-Book Value Ratio (x)		
	Stock exchange ticker	At Dec. 31, 2017	At March 29, 2018	At May 31, 2018
Hiscox Ltd.*	LON: HSX	2.40	2.38	2.46
Validus Holdings Ltd.	NYSE: VR	1.06	1.53	1.54
Lancashire Holdings Ltd.	LON: LRE	1.66	1.48	1.53
XL Group plc	NYSE: XL	0.91	1.48	1.49
Arch Capital Group Ltd.	NASDAQ: ACGL	1.49	1.40	1.28
RenaissanceRe Holdings Ltd.	NYSE: RNR	1.26	1.38	1.22
Argo Group International Holdings Ltd.	NASDAQ: AGII	1.00	1.09	1.15

Table 3

Bermudian Re/Insurers -- Price-To-Book Value Ratio Comparison (cont.)

		Price-To-Book Value Ratio (x)		
	Stock exchange ticker	At Dec. 31, 2017	At March 29, 2018	At May 31, 2018
Everest Re Group Ltd.	NYSE: RE	1.08	1.26	1.11
Aspen Insurance Holdings Ltd.	NYSE: AHL	1.00	1.14	1.10
AXIS Capital Holdings Ltd.	NYSE: AXS	0.92	1.07	1.06
Maiden Holdings Ltd.	NASDAQ: MHLD	0.71	0.78	1.05
Bermudian industry average price-to-Book value ratio		1.23	1.36	1.36

*Hiscox book value per share at March 29, 2018, is not available; thus, we assumed the same figure as of year-end 2017. PartnerRe Ltd. and Sompo International Holdings Ltd. (ex-Endurance) are not included because they are private.

Bermudian re/insurers bought back $1.2 billion of their shares in 2017, or about 54.8% less than in 2016. Similarly, share buybacks dried-up with a drop of 94.4% in first-quarter 2018 relative to the same period in the prior year. The decline was mainly because most of the companies stopped their share repurchases due to the catastrophe losses that took place in the second half of 2017. In addition, given the relatively high valuations and an attempt to build up capital adequacy eroded due to catastrophe losses, we expect the share-repurchase activity will continue in 2018 but at a lower rate than in previous years.

M&A Is Back In Vogue

2018 started with a bang, with two big M&A announcements by AIG and AXA. With these acquisitions, both these global multiline insurers are reentering the reinsurance sector, which they had exited years ago because of its earnings and capital volatility. XL will provide both critical size and geographic diversification to AXA's mainly European property and casualty operations and with AXA looking to contribute and consolidate its Corporate Solutions business with XL, this latter will ultimately gain heft as well. After the closure of both deals, we expect Validus and XL to benefit from being part of larger organizations with bigger balance sheets and greater diversification, providing them with better ability to navigate negative secular trends facing the sector.

With Bermudian companies looking at M&A to gain scale and stay relevant in the market, they are dusting off their acquisition playbooks. Prospectively, we expect deals to continue creating fewer but larger re/insurers in the sector. Small-to-midsize companies with quality underwriting and specialty books of business will likely be the targets of choice. High valuations don't seem to be a deterrent anymore to potential acquirers. If well-executed, M&A has the potential to improve a re/insurer's business and financial risk profiles, and, ultimately, our opinion of its creditworthiness. However, given the significant added risks involved in executing and integrating separate books of business with potential overlaps, infrastructure, systems, and cultures, we tend to take a conservative view of deals in the early months or years until the transactions have been able to season and the value of the acquisition proved. We do not see M&A as a catalyst for changing the underlying challenging market trends as capital (both traditional and alternative) will remain plentiful and cedents will continue to consolidate their reinsurance panels. However, an increased scale and broader product offerings could provide a means to maintain relevancy for their clients and diversified books help in resiliency against market forces.

What Does The Future Hold?

After 2017's record year, it seemed that the reinsurance pricing cycle finally reached an inflection point during the January and April 2018 renewals. However, during the Florida June renewals, it appeared that the reinsurance price increase momentum is losing steam and could vanish heading into 2019. The reinsurance supply glut has been exacerbated by a continued influx of alternative capital as investors have continued to show a strong appetite for property catastrophe risk, which is becoming increasingly commoditized.

Furthermore, according to JLT Re's report, during the Florida June renewal process there was some evidence of insurance-linked securities players extending provisions into areas traditionally dominated by traditional re/insurers, such as reinstatements. This inevitably exerted more competitive pressures on the traditional re/insurers to defend their market share and, hence, limit price increases.

Although the 2017 catastrophe losses were largely within the Bermudian re/insurers' risk tolerance limits, we expect some of them to readjust their exposures and take the necessary underwriting actions. As a result, we may see these companies using more retrocessions, even via alternative capital, to effectively manage their exposures in peak zones. Overall strong ERM and risk controls as well as strategic risk management would be the key differentiators, as companies navigate these choppy waters (see table 4).

Table 4

Bermudian Re/Insurers -- Ratings, Outlooks, And ERM Scores

	Holding company ICR	Operating company FSR	Outlook	Enterprise risk management score
RenaissanceRe Holdings Ltd.	A-	A+	Stable	Very Strong
Everest Re Group Ltd.	A-	A+	Stable	Strong
PartnerRe Ltd.	A-	A+	Stable	Strong
Sompo International Holdings Ltd.	A-	A+	Stable	Strong
XLIT Ltd.	A-	A+	Stable	Strong
Arch Capital Group Ltd.	A-	A+	Negative	Strong
AXIS Capital Holdings Ltd.	A-	A+	Negative	Strong
Hiscox Ltd.	BBB+	A	Stable	Strong
Validus Holdings Ltd.*	BBB+	A	Stable	Strong
Aspen Insurance Holdings Ltd.	BBB+	A	Negative	Very Strong
Lancashire Holdings Ltd.	BBB	A-	Stable	Strong
Argo Group US Inc.§	BBB-	A-	Stable	Adequate with Strong Risk Controls

ICR--Issuer credit rating. FSR--Financial strength rating. *Validus' ICR outlook is negative. §Argo Group US Inc. is a wholly owned intermediate holding company of the Bermuda-based ultimate holding company, Argo Group International Holdings Ltd. We withdrew the ratings on Maiden Holdings Ltd. on Nov. 17, 2017.

Notable Rating Actions

- Everest Re Group Ltd. And Subs Ratings Affirmed On Strong Results; Outlook Stable, May 30, 2018
- XLIT Ltd. And Subsidiaries Ratings Affirmed On Announced Acquisition By AXA; Outlook Stable, March 6, 2018
- RenaissanceRe Holdings Ltd. And Subs Ratings Lowered By One Notch On Continued Competitive Pressures; Outlook Stable, Feb. 28, 2018
- Lancashire Holdings Ltd. And Subs. Outlook Revised To Stable From Positive; Ratings Affirmed, Feb. 28, 2018
- Everest Insurance Co. of Canada Rated 'A+' On Guarantee From Everest Reinsurance Co.; Outlook Stable, Feb. 26, 2018
- Aspen Insurance Outlook Revised To Negative On Deterioration Of Underwriting Performance; Ratings Affirmed, Jan. 26, 2018
- Validus Holdings Ratings Affirmed; Holding Company Outlook Revised To Negative On Announced Acquisition By AIG, Jan. 22, 2018
- Everest Insurance (Ireland) DAC Rated 'A+' On Guarantee From Everest Reinsurance (Bermuda) Ltd.; Outlook Stable, Dec. 11, 2017
- XLIT Ltd. And Subsidiaries Outlook Revised To Stable From Positive On Lower Capitalization; Ratings Affirmed, Oct. 12, 2017

Related Research

- Reinsurance Pricing Was Up At The January Renewals, But Will The Momentum Continue Or Fizzle Out?, Jan. 23, 2018
- Third-Quarter 2017 Catastrophe Losses Are Becoming A Capital Event For Global Reinsurers Oct. 13, 2017
- No Respite For Re/Insurers As Hurricane Irma Prepares To Give A Big Jolt, Sept. 8, 2017
- Clouds On The Horizon: Global P/C Reinsurers Search For Cover From Market Turbulence, Sept. 5, 2017
- Bermuda Re/Insurance Quarterly Insights: Holding The Line At All Costs, Aug. 31, 2017
- Harvey, The First Major Hurricane To Hit The U.S. In More Than A Decade, Is Testing Re/Insurers," Aug. 28, 2017