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Global Reinsurers' Returns Will Barely Cover Capital Costs In 2018 And 2019

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Key Takeaways

- The cost of capital has consistently fallen in recent years, but appears to have reached a floor at end-2016, rising through 2017 due to rising interest rates and the volatility caused by heavy catastrophe losses.
- Operating conditions for global reinsurance remain difficult despite modest 2018 renewal rate increases. We think reinsurers' profitability is likely to barely exceed their cost of capital in 2018 and 2019.
- The tide of cheaper alternative capital continues to compete with traditional players, who typically have a higher cost of capital.
- Despite these challenges to industry fundamentals, market valuations for listed reinsurers remain at decade-long highs.
- Our stable outlook on the global property/casualty reinsurance sector, which is supported by robust capital adequacy and strong enterprise risk management capabilities, would likely change to negative if the industry's profitability sustainably fell below its cost of capital. However, we don't consider the one-off impact from the 2017 U.S. hurricane losses to be reflective of the longer-term trend for catastrophe losses.

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In 2017, the reinsurance sector generated returns on capital of only 1.2%. At 6.3% below its cost of capital, this represents the worst level in more than 13 years. The impact of the 2017 U.S. hurricane season was a significant factor, but even during the benign first half of 2017, returns were only 1 percentage point higher than the cost of capital. S&P Global Ratings expects the sector's return on capital to increase to around 6%-8% by year-end 2018. Despite modest price rises following the 2017 catastrophes, this remains close to reinsurers' cost of capital, which we anticipate will increase modestly through the rest of 2018 and in 2019, remaining within the 7%-8% range.

Despite the optimism reinsurers showed when heading into the 1/1 2018 renewal season, overall reinsurance renewal rates have only modestly increased and the momentum is weakening, as witnessed through the latest renewals. While reinsurers welcome rate increases, their profitability continues to be hampered by persistent competitive pressures within the property/casualty (P/C) underwriting cycle and low investment returns, which will initially lag the increase in benchmark rates as reinsurers' investment portfolios have an average duration of around 3.4 years.

We are also seeing signs that prior-year reserve releases could decline, which will add to the earnings pressure. Some reinsurers have already demonstrated this during 2016 and 2017, following the U.K.'s Ogden discount rate reform, and, in some cases, individual reserve strengthening has even taken place in selected lines like U.S. casualty and Australian disability.

Our return on capital forecast is on a consolidated group basis (i.e., including any life reinsurance and/or primary business), and it incorporates benefit from recent reinsurance rate increases, normalized catastrophe loss expectations, and continued benefit from favorable reserve releases, albeit at lower levels. Our assumption also normalizes for the earnings volatility created by new U.S. generally accepted accounting principles (GAAP) accounting guidance on the recognition and measurement of equity investments, effective Jan 1, 2018, which adversely affected income statements during first-quarter 2018 for some U.S. GAAP reporting reinsurers.

These trends indicate that reinsurers are likely to barely cover their cost of capital in 2018 and 2019. This is entirely different from the situation witnessed in the aftermath of the 2005 and 2011 catastrophe losses, where excess returns were generated off the back of significant rate increases following the heavy catastrophe losses.

Returns Are Unlikely To Materially Exceed The Cost Of Capital

Despite dwindling returns since 2005, reinsurers have retained sufficient profitability to satisfy investors because their cost of capital has fallen along with their profitability levels. The returns investors required in 2005 were significantly higher than those they require today. Today's investors are operating in an environment in which yields have remained at historical lows for an entire decade.

The cost of capital among our rated peer group of global reinsurers peaked in 2005 at 10.0% (source: Bloomberg). Risk-free rates were then significantly higher than currently, which contributed to the high cost of capital in 2005. The pricing of property catastrophe risk also soared following the 2005 hurricane season in North America, causing the opportunity cost of reinsurance risk to spike.

Global property catastrophe pricing has softened since 2008 (except for temporary regional rate increases in Japan, Thailand, and New Zealand, where the major catastrophes of 2011 caused record losses). This lowered the returns that investors expected. However, except for 2011 and 2017, there have been relatively few major catastrophes since 2005, which has helped reinsurers realize returns that have exceeded their cost of capital. (For further details, see "Are Global Reinsurers Ready For Another Year Of Active Natural Catastrophes?" published on July 25, 2018)

For 2018, we assume modest price increases of 0%-5% across the board, with property catastrophe reinsurance pricing still an estimated 30% below 2013 levels (Source: JLT Re).

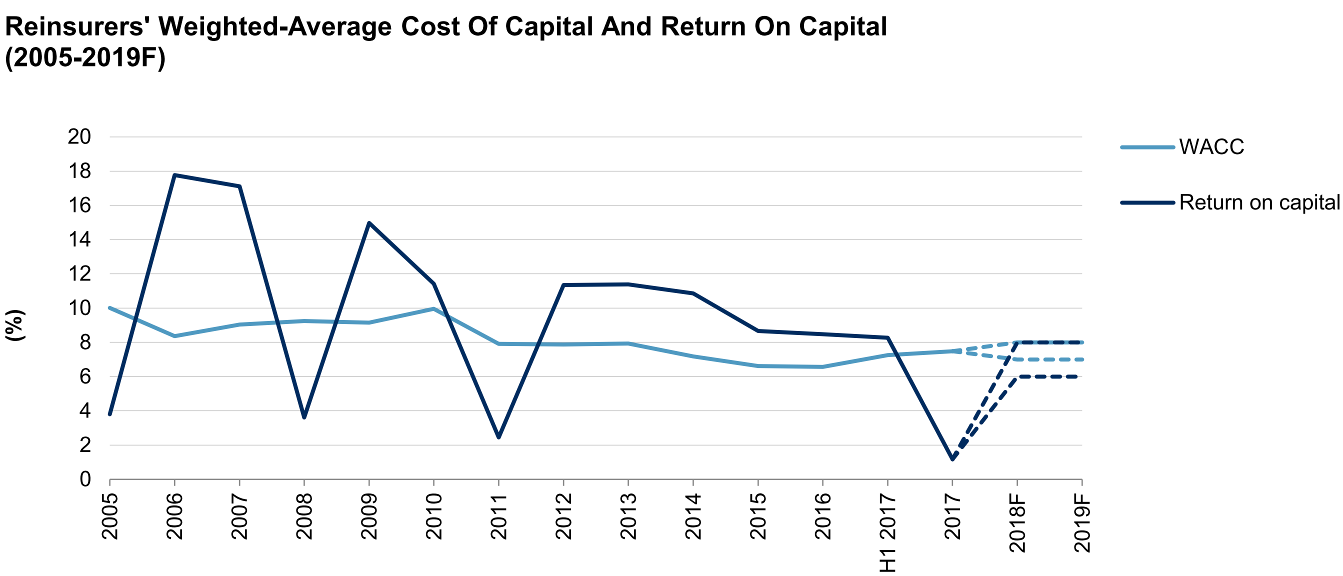
As of Dec. 31, 2017, the cost of capital for our peer group had declined by around 250 basis points since 2005, to about 7.5%, including an increase of around 90 basis points during 2017. This overall decline since 2005 is due to a combination of:

- A reduction in the cost of equity, caused by the reduction in risk-free rates, combined with the declining return from competing asset classes such as bank equity investments.
- A reduction in the cost of debt, again caused by lower risk-free rates, combined with overall improvements in the sector's capitalization, and thus creditworthiness. We estimate capital redundancy at the 'A' level of $31.5 billion at the end of 2017 for our peer group.

- A modest increase in the proportion of debt funding on reinsurers' balance sheets today versus (more expensive) equity funding. At the end of 2006, approximately 13.5% of our rated reinsurers' capital stack comprised debt, rising to 18.0% by Dec. 31, 2017.
- An increase in supply of capital into the reinsurance market as hedge fund investors, pension funds, sovereign wealth funds, and high-net-worth investors look to diversify their portfolios by adding catastrophe risk.

During 2017, our cohort of global reinsurers delivered an average return on capital of 1.2% compared with a cost of capital of 7.5% as at end-December 2017 (chart 1). This negative "spread" of 6.3% represents the worst level in more than 13 years, including 2005 and 2011, which were both affected by heavy natural catastrophe losses. At end-2015, the spread stood at 2.1%, and in 2016 it was 1.9%, dropping to 1.0% in first-half 2017.

Chart 1



F--Forecasts. Source: S&P Global Ratings, Bloomberg

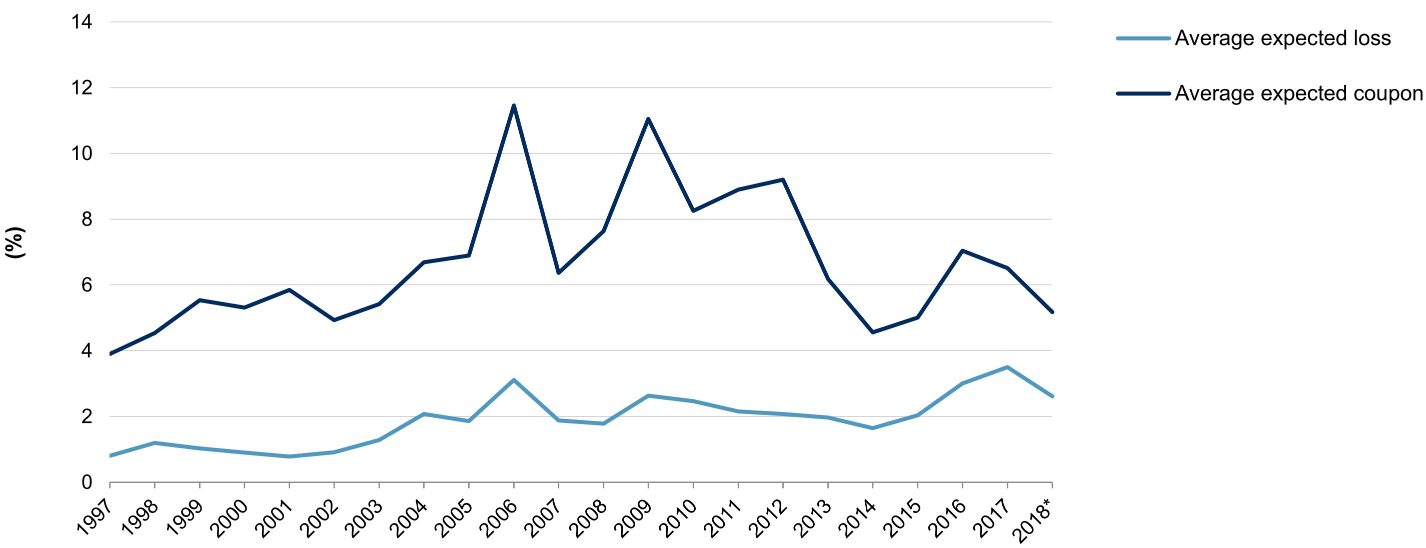
Alternative Capital Remains A Threat To Profitability

The increase in alternative capital has been one of the biggest emerging risks to reinsurers' business models and profitability over the past decade. Competing capital from pensions, endowments, and other large institutional investors has entered the space in search of yield and the diversification benefits of adding a theoretically noncorrelated asset class to their portfolios. These investors also have a competitive advantage over traditional reinsurers in that their cost of capital (long-term return) targets tend to be lower than reinsurers' weighted-average cost of capital (WACC), allowing them to profitably assume risks at prices that would be uneconomical for the traditional players.

Market participants appear to demand less for investing in alternative capital versus the publicly listed securities of a reinsurer, as demonstrated by catastrophe bond/insurance-linked securities issuances in 2017, which were launched at an average coupon of 6.51% (with an expected loss of 3.50%). The diversification benefits of adding pure natural catastrophe risk to a portfolio may help to explain this.

Chart 2

Average Expected Loss And Coupon For Catastrophe Bonds And Insurance-Linked Securities



*As of July 18. Source: S&P Global Ratings, Artemis' deal directory.

Market Valuations Are Near Historical Highs

All valuations are flawed because they reflect expectations about a future that is inherently uncertain. However, the market's valuation of reinsurers gives valuable information about how investors view the industry's prospects. Premiums (or discounts) to book value typically reflect investors' view of a reinsurer's future ability to generate returns above (or below) its cost of capital. An investor that expects a reinsurer to sustainably earn above its cost of capital should be willing to pay a premium to book value, reflecting the value created, and vice versa.

It may therefore seem surprising that the market values the industry at a premium to book value today (on average at 1.24x at year-end 2017), and at near historical highs, given the challenges mentioned above and the fact that the industry failed to cover its cost of capital in 2017. We believe the market optimism implied by these valuations has four main causes:

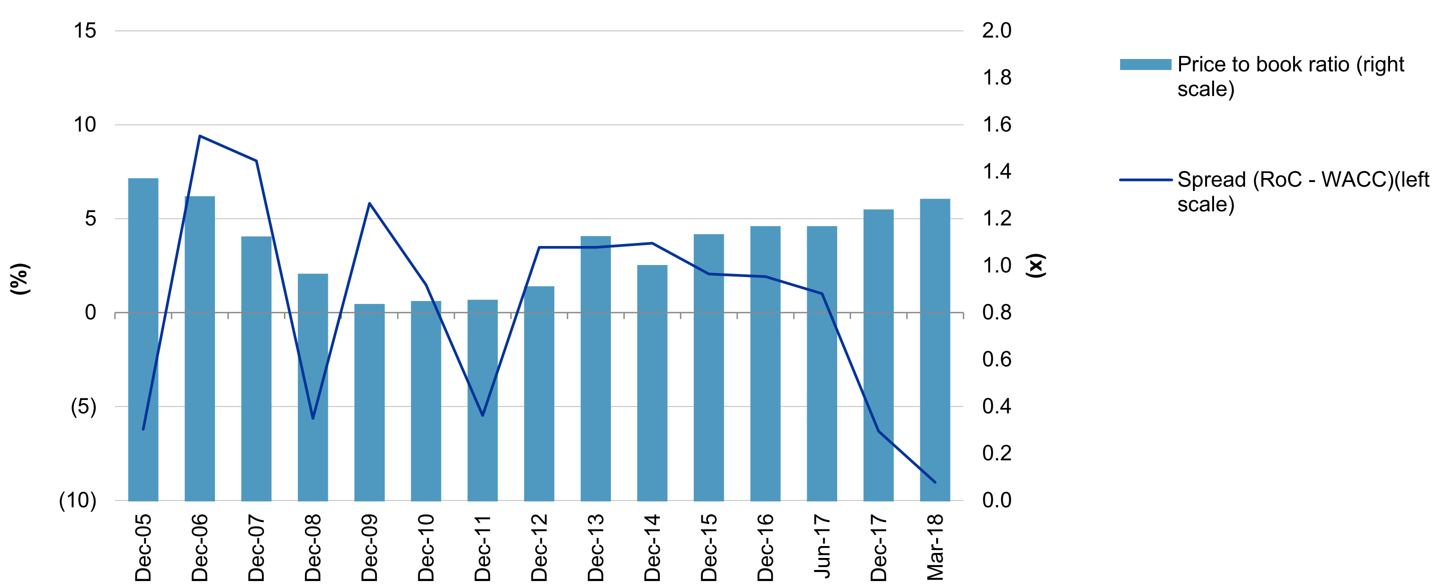
- Following the 2017 catastrophe losses, reinsurers have managed to push through some rate increases, which should improve profitability in the near term. If these rate increases fail to deliver improved profitability, reinsurers may seek to return more capital to investors.
- Because they are positively correlated with the broader stock market average, reinsurers' stocks have traded up, in tandem with the many consecutive years of increases in the S&P 500

index.

- Market consensus has continued to build now that the era of low interest rates may be coming to an end--we suspect investors may be factoring in the prospect of higher interest rates and higher investment income for reinsurers, whose asset duration remains slightly short on average.
- Most importantly, we suspect that an embedded takeover premium exists for many groups, following the recent wave of consolidation in the industry, particularly among smaller players (see "Bulking Up: The Global Reinsurance Sector Marches Toward Consolidation," published on August 23, 2018, for further details). Recent M&A examples include AXA's acquisition of XL Group and the January 2018 announcement that AIG was acquiring Validus Holdings at an implied multiple of 1.53x book value.

Chart 3

Reinsurers' Price-To-Book Ratio And Spread



RoC--Return on capital. Source: S&P Global Ratings, Bloomberg.

Capital Adequacy Strength Is A Buffer Against Earnings Pressure

Our forecast regarding the interplay between profitability and cost of capital may appear negative for the sector, but we do not expect swathes of negative rating actions. On July 18, 2018, the outlook on 16 of our 20 non-life reinsurance groups was stable. Of the remaining four groups, the outlook on three (Aspen, Axis, and Lloyd's of London) was negative and the outlook on Allied World was positive. We base our ratings on the capital adequacy strength and the overall strong enterprise risk management within the sector, which buffers the industry against the continued pressure on earnings.

At the 'A' level, we estimate that capital redundancies at the end of 2017 stood at about $31.5 billion. Even if the return on capital were to drop to 1 percentage point below the cost of capital for a full 12 months, we estimate that surplus capital would deteriorate by only about $2.3 billion. Although this trend would not have a material sectorwide impact in isolation in the near term, certain reinsurers might see a more pronounced effect. In particular, where a reinsurer has a capital adequacy assessment close to a border between different outcomes, the impact would be greater, as it would if repeated over successive years.

Similarly, should a reinsurer's return on capital drop below its cost of capital for a prolonged period, it will have implications for our view of its competitive position and financial flexibility. Holistically, if we see that investors no longer view value in a sector--for example, because of falling returns on equity--and this causes market growth prospects to suffer, we could revise our industry and country risk assessment for reinsurers.

Since our ratings are forward-looking, we consider prospective views of pricing, the market, and reinsurer-specific circumstances. On the asset side, we incorporate both unrealized losses on fixed-income securities (should interest rates rise) and the reinsurer's asset duration. At the end of 2017, reinsurers' average asset duration was approximately 3.4 years, implying that around 30% of assets will roll off the balance sheet each year and be reinvested at possibly higher rates. Our ratings are designed to look through the cycle. Therefore, if we expect a reinsurer's earnings to pick up as it reinvests assets at higher rates, a short-term profitability decline wouldn't necessarily lead to a negative rating action. However, weaker profitability because of structural underperformance would be a different story.

Investors Are Likely To Stick With Reinsurance

As we have consistently said, our base-case assumption is that most reinsurance equity investors will reluctantly accept lower returns on their reinsurance holdings, rather than exit the sector. Given prevailing low (albeit rising) interest rates, investors remain hungry, even desperate, for yield. Therefore, as returns on reinsurance securities have declined, investors will likely reassess their reinsurance investments, relative to potential returns available in other sectors. Should investors withdraw their capital, one consequence would be that reinsurance rates could increase as the excess capital in the reinsurance sector reduces.

Reinsurance returns underperformed many other assets classes in 2017, given the catastrophe losses that year. However, on a more normalized basis, the 6%-8% forecast return on capital in 2018-2019 still compares relatively favorably with other industries. Investors have limited options elsewhere that offer more favorable or even comparable returns. For example, in 2017, the average return on capital for major banks was 3.2% (source: KBW Bank Index). Even the global industrials sector, which is on average lower rated than reinsurance, only generated a return on capital of 6.1% in 2017 (source: Dow Jones Global Industrials Total Stock Market Index). Returns on five-year risk-free assets (as measured by U.S. Treasuries) stood at a meagre 2.21% at year-end 2017, increasing to 2.77% by July 18, 2018.

Calculating The Cost Of Capital

Investors have many options for investing their capital; the cost of capital represents an investor's opportunity cost of investing in one security versus another. A company's weighted-average cost of capital (WACC) represents the return demanded by all of its capital providers (debt and equity). For management, WACC represents the benchmark by which investors can judge if they are creating or destroying value.

In our analysis, we continue to use Bloomberg's cost of capital figures for our universe of 20 global reinsurers. Our primary comparison point here remains return on capital versus WACC.

Reinsurers' Luck Finally Ran Out In 2017

Reinsurers' earnings have been heavily supported in the past by benign catastrophe experience and significant prior-year reserve releases. We noted last year that these trends were, at least in part, due to luck and that eventually that luck would run out. The luck previously enjoyed by reinsurers clearly ran out in the 2017 U.S. hurricane season.

Even incorporating the benefits of modest rate increases in 2018, reinsurers' profitability is likely to barely exceed their cost of capital in 2018 and 2019, assuming a normalized catastrophe year, continued prior-year reserve releases, and normalizing for the U.S. GAAP accounting changes. However, reinsurance still offers expected returns that exceed those of most competing asset classes, limiting the likelihood of a mass investor exodus from the sector in the short-to-medium term.

While welcome, the modest rate increases so far seen in 2018 will do little to restore the sector's profitability significantly above its cost of capital. However, we continue to believe that the reinsurance sector can stand the strain on its capital base in the near term, with issuer-specific rating actions more likely than sectorwide downgrades.

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