

Seven themes to shape 2023 in London (re)insurance

Insurance Insider Team



Overview

"Permacrisis" was the word of 2022 for many general news outlets, and while in popular culture this might represent an array of political, social and economic turmoil, it was also reflective of the (re)insurance market's experience.

From the Ukraine war exposing unprecedented areas of specialty risk aggregation, to investment markdowns wiping billions in equity off balance sheets, to Florida's failing insurance markets, (re)insurers might reasonably feel they never got a break in 2022 (quite literally, in the case of those working through Twixmas on their renewals).

Many of these shockwaves will continue to set the direction for 2023. Capital costs are higher and capital availability more constrained. Aggregations are being closely managed, and this means painful realities in some cases: line of business exits or job cuts.

But permacrisis conditions also tend to allow risk-takers to extract higher returns from their participation in the markets, and the hardening market in January sets the scene for a more lucrative 2023 – on paper, at least. The rollercoaster ride may not yet be over, but for the stronger players, there should be more ups than downs this year.

Here we walk through seven themes of the market that will be drivers of change in the year ahead.

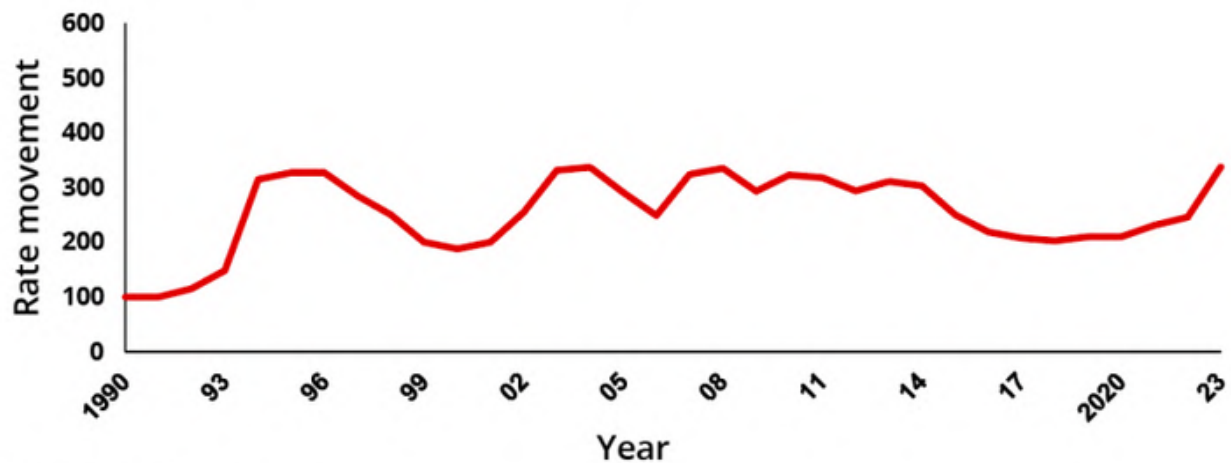
- Reinsurance turn – back in the driver's seat
- ILS constraints persist – for how long?
- Macro will again help make the weather
- Specialty pricing – one more year for the Golden Age?
- Lloyd's and the capital squeeze
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Reinsurance turn

In recent years, the market has found all sorts of new terms – such as the “U-shaped” or “W-shaped” pricing cycle – to describe the uncanny stasis in the reinsurance sector amidst a drive upwards on rate led by primary insurers.

But 1 January 2023 marks the determined return of the pricing cycle in reinsurance, particularly in property cat and specialty. This will have multiple spill-over effects in the underlying primary market, particularly as it is not just higher prices that insurers are facing to remove volatility from their books.

US cat rates surge at 1.1.23



Source: Gallagher Re

Structural change has also led to much higher retentions in cat and specialty risks, and this could prompt a fresh round of changes to primary risk-taking strategies, as well as questions over the durability of capital-light regional carriers or MGA providers who fail to deliver strong results.

For the reinsurance sector itself, some of these changes will create self-propelling momentum in other areas. For example, the terror/political violence class of business should see growth as a result of exclusions and a heightened appreciation of risk in today's unsettled world. Cyber too continues to be an underserved niche where developing models may boost expansion.

In the casualty sector, the industry is watching the ongoing progress in clearing Covid backlogs of court cases to see how it impacts their counterparties. Clyde & Co lawyers have forecast that a new EU directive on collective actions this year could produce more lawsuits impacting PI or cyber lines, such as in data breach cases.

Ultimately, the key question is how long this market peak can last. Reinsurance brokers have already begun attempting to drive the narrative that more stability will come as 2023 progresses. In their 1 January renewals reports, they forecast additional capital would flow into the sector to assist with this. But the timing and destination of inflows remains highly unclear.

Even setting aside the specific dysfunction of the Florida market at 1 June, there are other factors that will propel the market to continue at its reset levels.

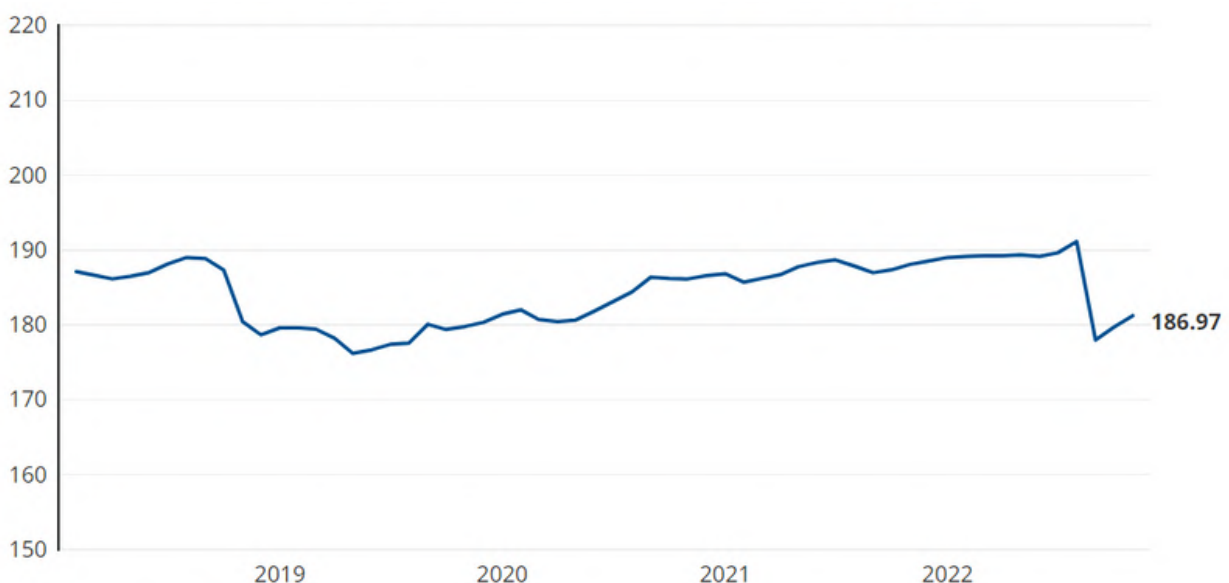
Notably, the past year's inflation has stirred up latent demand for more reinsurance cover that could not be met at this 1 January renewal, remaining an issue to be solved.

ILS constraints persist – for how long?

Just as reinsurers have kept tight control over their catastrophe risk appetite in the past year, so too are ILS investors in highly watchful mode after Hurricane Ian dented returns from the sector in 2022.

It is not clear how far or how fast rising prospective returns will help to revive inflows into the sector, despite the good news of significant rate hikes in the 1 January renewals. The industry also needs to overcome the hurdle of poor prior-year performance that has dragged down five-year average track records. Even with the Irma losses of 2017 ageing out of this dataset, the ILS Advisers index shows a 3% drop since 2018.

ILS returns since 2018: ILS Advisers index lags 3%



Source: Eureka hedge ILS Advisers

Moreover, the dynamics are not purely driven by ILS conditions. Last year's market meltdowns had knock-on ramifications for the ILS market and reinsurer equity. Investors found their alternative allocations overweight relative to poor-performing stocks and bonds, constraining their willingness to double down in the cat space.

Meanwhile, the subsequent increase in risk-free rates boosts underlying ILS yields, but also resets the bar for taking additional risk, as other distressed opportunities have been a more immediate priority.

Indeed, prior structural reforms have helped parts of the industry stand up better to lean than might have otherwise been expected, with the retro market unlocking late in the renewal and Gallagher Re citing lower trapped capital as a help in freeing up trading.

But until the distraction factor of dealing with major macro shifts is put to rest, the ILS market may still struggle to attract investor attention.

Some are expecting to see a return of more opportunistic players in the space – multi-strat funds or private equity, as were more prolific in 2005-2006 – while institutional investors deal with other parts of their portfolios. This could mean smaller-ticket inflows in the meantime, with one senior ILS manager predicting that capital will flow incrementally into the space rather than coming in one fell swoop.

DE Shaw, with an existing presence in the space and in-house underwriters, is among those cited as being willing to pledge more capital for expensive fill-in reinsurance capacity, alongside the likes of the opportunistic Berkshire Hathaway, although take-up is as yet unclear.

Beyond the cat market, it is likely that ongoing expansion into non-cat ILS, including segments such as cyber, will continue to be a focus for the sector in 2023, as managers look to build on appetite for diversifying within ILS. As this comes from a very low base, it will represent incremental change rather than market-changing trends.

Macro factors will again help make the weather

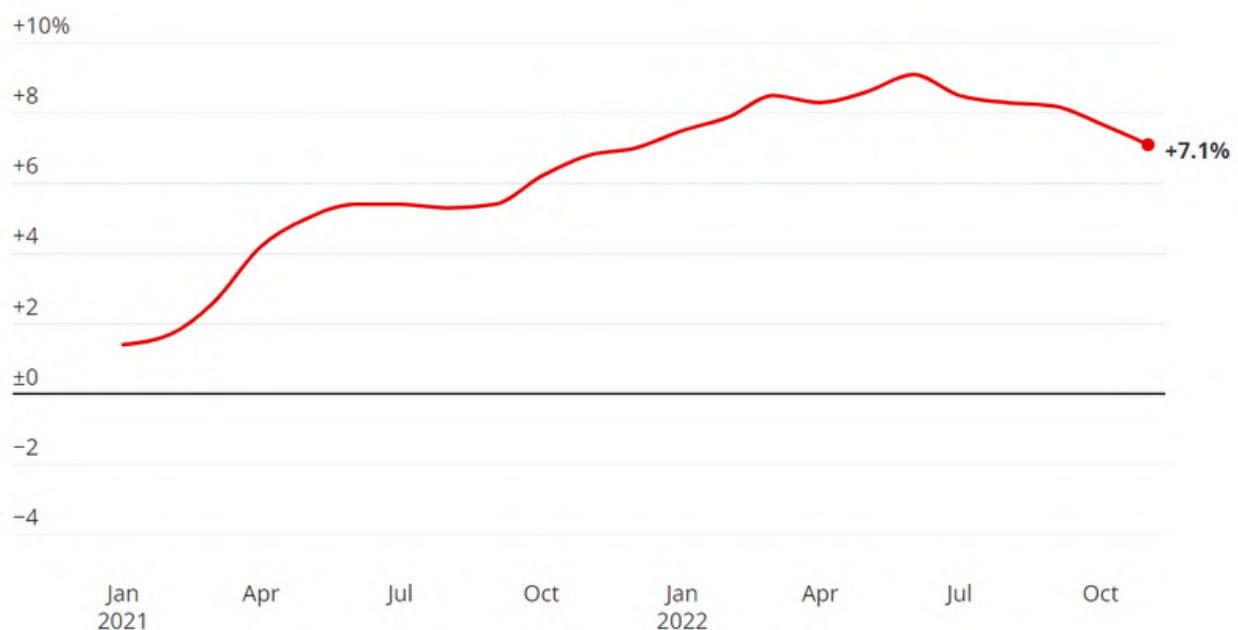
Macro factors were centre stage in 2022, with late pandemic inflation turbo-charged by the Russia-Ukraine conflict causing a historic rise in interest rates from the Fed. The 4.25-point interest rate tightening in the US crushed bond portfolios and brought an end to the Long Bull market in equities, with tech companies suffering most.

All these macro factors heavily impacted the insurance sector, and macro will again help make the weather in 2023, although perhaps less dramatically. But the shape of the impact is likely to differ.

Macroeconomic forecasting is notoriously difficult, but the likeliest outcome is that inflation cools down, particularly in the US. As it does, the focus may shift toward low growth or recession and its consequences, like unemployment and business failures.

How is Consumer Price Inflation trending?

12-month % change in CPI for All Urban Consumers (CPI-U), Not Seasonally Adjusted



Source: [US Bureau of Labor Statistics](#)

In that scenario, there is likely to be only limited additional monetary tightening in the US and the UK, although central banks won't want to go into reverse without being certain that inflation has been tamed.

Lower inflation may ease some of the fears around loss-cost inflation bleeding into long-tail lines, as well as take some of the pressure off in short-tail lines, where claims costs were inflated last year. Although there are certain recession-exposed lines where claims could worsen, like EPLI, professional indemnity and D&O.

Higher interest rates have been feeding through for some time now, and significantly higher re-investment yields should be a meaningful driver of earnings in 2023. With most of the climb now done on interest rates, book values also won't get crushed by markdowns, as they were in 2022.

Delivering top-line growth is going to be harder for insurers amidst lower inflation and a weaker economy. Along with higher earnings from bond portfolios, there is a risk that this could encourage competition for market share, particularly outside cat-exposed property.

Brokers can ride out an inflationary environment, but will find a weaker economy more challenging. It will bear down on top-line growth after a remarkable period of expansion.

The more highly levered private brokers will face a second squeeze from the increased cost of debt, which is likely to weigh on valuations and slow dealmaking. To date, the sector has held up well due to its defensive qualities, but gravity is likely to weigh on it over time.

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Specialty pricing – one more year for the Golden Age?

The industry has witnessed a “Golden Age” in specialty insurance pricing, characterised by surging rates, strong E&S submission flow and robust profitability.

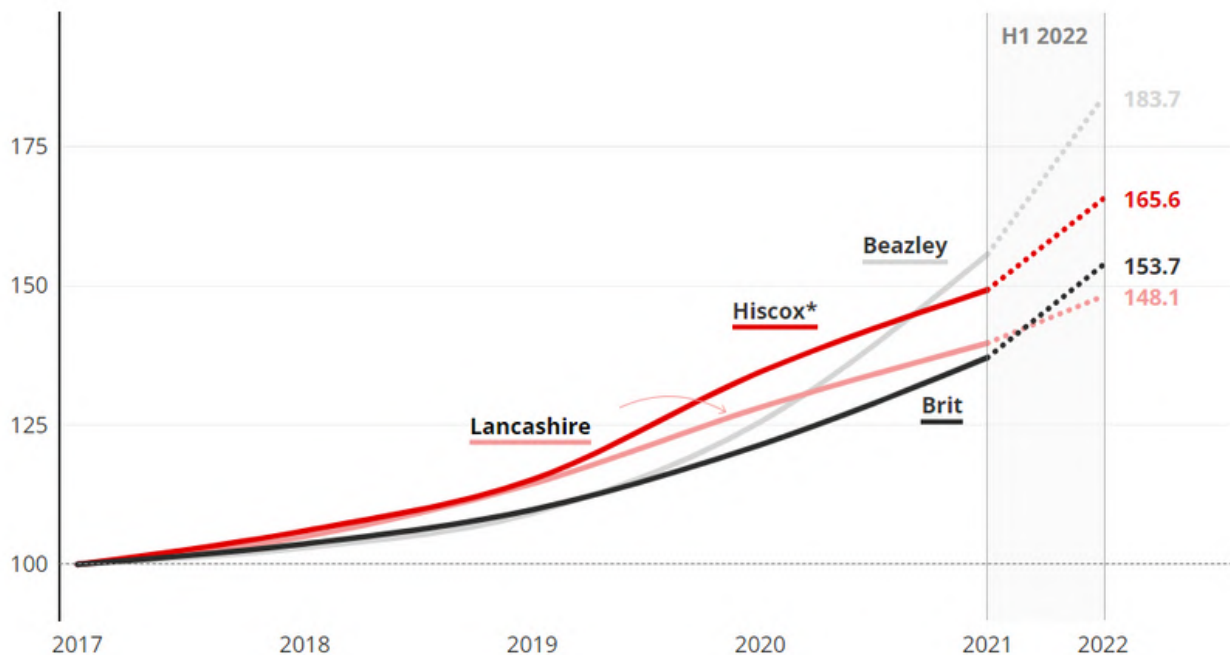
But after the best part of five years of consistent rate increase, there is now a question of how much further this pricing momentum can go.

The drift downward of rate rises has been longer and slower than many expected, and before Monte Carlo, there was talk of perhaps another year of single-digit rate increases.

However, with Hurricane Ian and the cat reinsurance chaos that followed, there is now very real discussion around whether the dislocation in the reinsurance market will spill over into the underlying insurance space.

Beazley's rates have risen the most since 2017

Cumulative risk-adjusted rate change on renewal business reported by Beazley, Hiscox*, Brit and Lancashire since the 2017 financial year



Rebased: 2017 = 100

* Figures for Hiscox are an average for the London Market and Re & ILS segments, weighted by GWP; at H1 2022, Hiscox estimated cumulative changes since 2017 of +72% and +52% respectively for those segments

Source: Company financial reports

E&S sources suggested that commercial property rates were already starting to re-accelerate pre-lan in the US. This trend may well filter through into the London property market, driven by both loss experience and the prospect of higher reinsurance spend, particularly in cat-exposed areas where capacity is already constrained.

Carriers writing specialty lines which historically have been propped up by plentiful reinsurance in the form of composite treaties are also reassessing the economics of running a much smaller book, or running more of it net. Exits are expected in some classes (PV is the most cited example), and the supply-demand imbalance could be further exacerbated if several carriers go down the same route.

Brokers are already attempting to dampen expectations of another year of increased spend for their clients, and it is possible that some longer tail lines will see increased pricing competition as capacity flows away from cat exposures. The D&O market has already shown how quickly a market can initiate a race to the bottom on pricing.

However, both economic and social inflation continues to prevail, and even if economic inflation is waning, these are both still pressing reasons to push rate. Meanwhile, there is still a gap between the tally of disclosed Ukraine losses and the circa \$10bn-\$20bn initially anticipated by the industry.

Amidst high stakes and ongoing uncertainty, it feels increasingly likely that the bulk of reserving action on Ukraine will be delayed for months, if not years.

Lloyd's and the capital squeeze

The Lloyd's market is facing an uncertain first few months in 2023. Its constituents are typically heavily reliant on reinsurance and/or retro protection, and so the extremely delayed 1 January renewal will both frustrate and complicate the market.

In the past, the actions of the Performance Management Directorate have determined the fate of certain Lloyd's syndicates, and whether they will be able to trade forward. This year, the biggest determinant of that fate for some will be the availability of capital.

More than a quarter of premiums have been ceded outwards to reinsurers in each of the last five years

Aggregate Lloyd's market GWP (in £bn) and outward ceded premiums as a proportion of GWP in each of the last 10 financial years

	GWP (£bn)	Cession ratio
FY 2012	25.5	23.8%
FY 2013	25.6	21.0%
FY 2014	25.3	20.8%
FY 2015	26.7	21.2%
FY 2016	29.9	22.8%
FY 2017	33.6	26.0%
FY 2018	35.5	27.7%
FY 2019	35.9	28.5%
FY 2020	35.5	27.2%
FY 2021	39.2	27.5%

Source: Lloyd's

The market was already faced with putting up more capital in 2023 to account for growth. However, the increased need for capital is going to collide with a macro environment in which capital in all its forms (including reinsurance) is increasingly expensive and risk-averse. This has raised the prospect of a return to alternative funding deals, and raises questions about navigating through 1 January renewals.

Although the market as a whole is in a far more robust state in terms of profitability, attracting new capital will still be an ask.

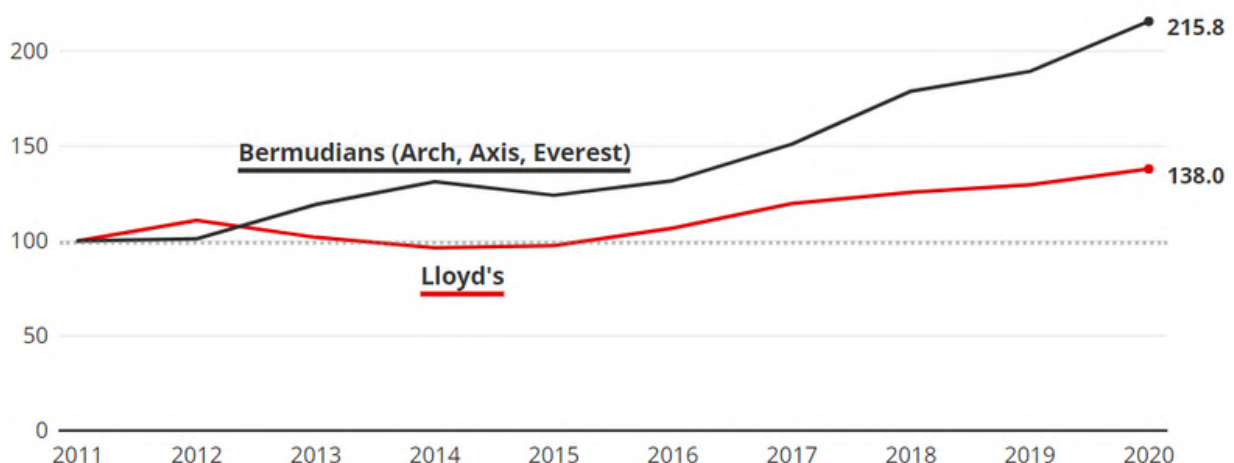
Failing to source enough capital will mean business plans may have to be trimmed, or classes exited. It is not inconceivable that in a worst-case scenario the Lloyd's market will see syndicate closures.

Conversely, this market does provide an opportunity for Lloyd's (and the wider London market) to grow its market share in treaty, where it is underweight. CEO John Neal said the market could be "50% larger" than at present in treaty business at our London Market Conference in November. Currently 15% of all premium at Lloyd's is treaty business.

As we have written before, London's historical pre-eminence as a centre for reinsurance business has faded considerably as a result of Lloyd's diminished ability to lead, issues with its regulation and the convention around brokerage, declining client relevance, and the rise of Bermuda.

Bermuda's reinsurance growth dwarfs that of Lloyd's

Change in reinsurance premiums since 2011 (rebased: 2011 = 100)



Lloyd's: annual gross written premiums reported for 'reinsurance' line of business

Bermudians: aggregate annual gross premiums reported by companies' 'reinsurance' segments

Source: Lloyd's annual reports and company reports

If London is to capitalise on the current market opportunity, it must swiftly address structural challenges and strengthen the value proposition for four groups: capital providers looking for access to risk, multi-platform players with optionality around where they write business, brokers, and cedants.

Blueprint Two: The hard conversation begins

One way or another, in the first half of 2023, Lloyd's firms will fire the starting gun on new processes to enact the market's modernisation.

Q1 in particular will come loaded with milestones for market adoption of foundational components of the Lloyd's Blueprint Two programme – namely, the latest version of the core data record (CDR) and the MRC v3.

Lloyd's CEO John Neal told this publication in September last year that if the market operates under a framework of a CDR and new MRC, then “that's the way it has to be done”. In any case, under the Corporation's bylaws, all Lloyd's contracts must use the most recent MRC template, though the market will be given a six-month transition period.

As the market begins to embed new data processes and use new contract templates, it is likely there will be hard conversations around which party (broker or carrier) takes responsibility for obtaining which data at which stage, and ensures it's of a sufficient standard for straight-through digital processing.






The Data Council's consultation, pencilled in for February, should be the catalyst to resolve this, as it sets out the process, roles and responsibilities for brokers and carriers in assembling, submitting and amending the CDR for the digital gateway now being developed for the reforms.

The tricky dialogue on adoption will begin during this time – a factor Neal has acknowledged. Either way, the programme will have to begin with newly established responsibilities around data.

While more certainty will materialise on these core elements for open market business in the coming months, a new data strategy on delegated authority business for the programme is still in the works.

Last month, Lloyd's said it was working through the final stages of engaging with carriers, brokers, coverholders, and other stakeholders on the DA strategy.

Blueprint Two and PPL NextGen: Select milestones for 2023

- 
February
 LMG Data Council to launch consultation on proposed new processes and roles for London market firms around the CDR and new digital gateway
- 
February
 PPL to launch NextGen, with subsequent releases over the summer
- 
End of Q1
 Data Council to launch MRC v3 and accompanying guidance, with six-month transition for adoption
- 
End of Q1
 Data Council to launch CDR v3.2 alongside MRC v3
- 
End of Q3
 The use of MRC v3 will be required from end of September

Source: LMG Data Council

ESG: A Lloyd's transition, enhanced regulation and litigation threats looms

In 2023, as global P&C carriers face new accountability mechanisms over their progress to net-zero, the mechanics of transitioning underwriting portfolios will gain prominence.

Last year, this publication reported on the disparate measures deployed by London market firms to reduce the carbon intensity of their portfolios, which included blanket exclusions and the use of ESG ratings providers. This year, the market could see the start of a convergence on standardised methods for measuring decarbonisation in underwriting portfolios, and also on how ESG data is obtained from insureds.

One of the catalysts for this could be at Lloyd's, where ESG plans will be formally embedded into business planning, while the marketplace will see the implementation of a framework to measure progress toward a net-zero underwriting position at an aggregate level. Lloyd's will publish its latest ESG guidance to the market in early 2023, with a transition roadmap for managing agents.

Enhanced transparency will be among the themes for ESG in 2023.

In the UK, London market firms that meet the Treasury's threshold will have to start preparing the first iterations of net-zero transition plans before their full implementation next year, while in the US, the Securities and Exchange Commission is expected to finalise a new rule requiring firms to report more information on their emissions.

In 2023, ESG risks for insurers could crystallise in predictable ways, as the Prudential Regulation Authority and Financial Conduct Authority tighten scrutiny on the issue. But the risks could also manifest in unpredictable forms, as investor activism and an ESG backlash evolve and likely escalate in opposing directions.

This has already been observed in the US, with the Florida state Treasury's aim to pull a \$2bn mandate with BlackRock over the asset manager's ESG stance. Climate litigation is expected to accelerate in several jurisdictions, with US and German automotive firms facing lawsuits, while cement manufacturers, architects, engineers and other construction firms are expected to come under pressure.

In the US, oil companies are battling to keep cases in federal courts due to fears that state courts may be less sympathetic. According to the Grantham Research Institute, there were over 2,000 live climate litigation cases globally as of June 2022 – double the number in 2015.

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