

# HARD TIMES.

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# Key takeaways

A coalescence of events – a global pandemic, adverse catastrophe loss development, lower investment yields and increasing concerns about climate change – represents a sweeping shock to risk transfer markets.

## Confluence of hard market drivers

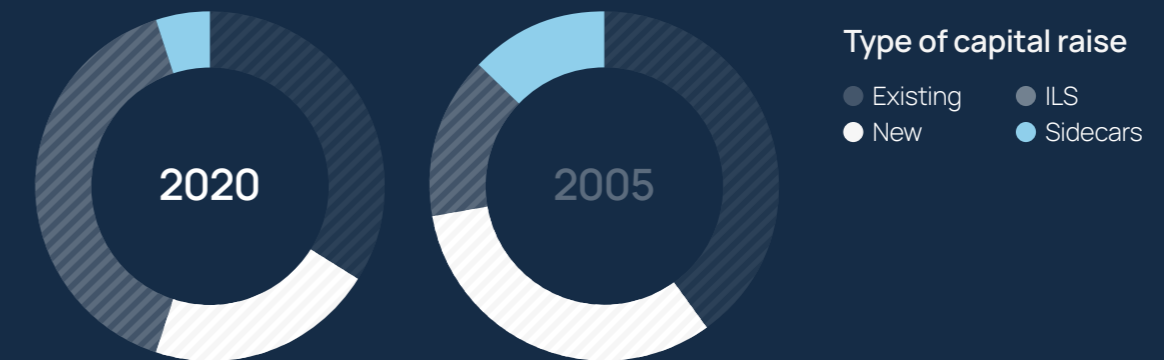
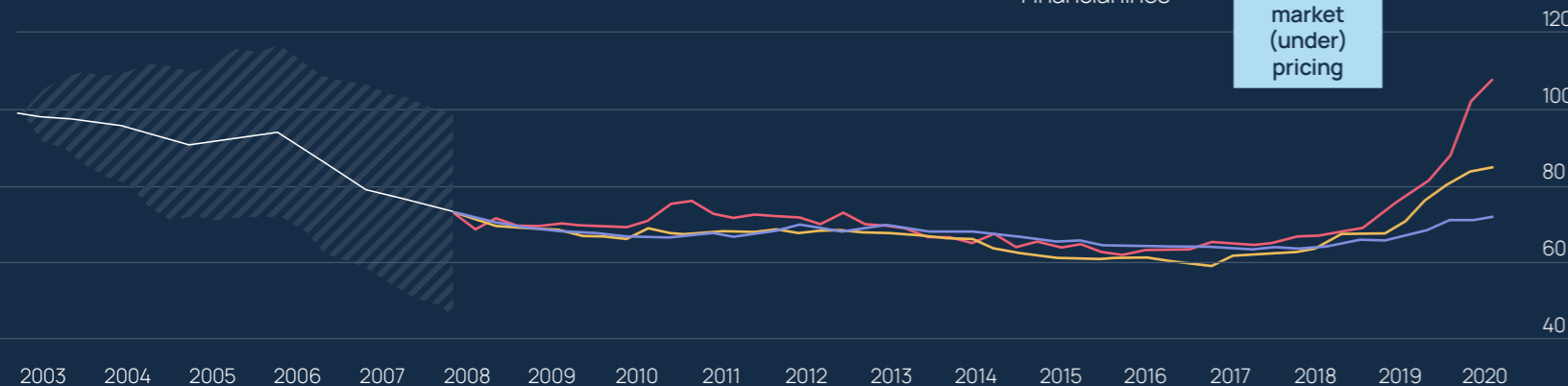


**\$416bn** DEDICATED REINSURANCE CAPITAL

**\$19bn** OF NEW CAPITAL ENTERED THE MARKET IN 2020

## Global commercial insurance pricing

- All lines-of-business
- Median line-of-business
- Property
- Casualty
- Financial lines



## 1 January 2021 reinsurance renewals

**+6%**

Global property-catastrophe:

The biggest year-over-year increase at 1.1 in over a decade

**+13%**

Retrocession:

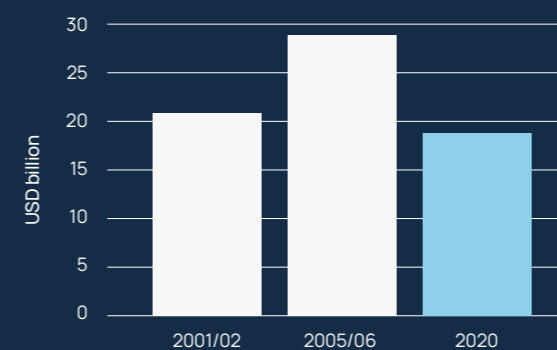
Cumulative increase of more than 50% over last four years

**+6%**

London Market casualty:

Accelerating rate increase due to loss inflation and lower interest rates

## New capital raised following shock events




THE SECTOR MUST NOW APPLY ITS CAPITAL (FINANCIAL AND INTELLECTUAL) TO CREATE PRODUCTS FOR NEW AND INCREASINGLY INTANGIBLE RISKS AND SEIZE THE OPPORTUNITY TO SECURE LONG-TERM RELEVANCE.

# Hard times

The coalescence of events currently unfolding represents a sweeping shock to risk transfer markets.

A global pandemic, increasing social and political unrest, adverse catastrophe loss development, lower investment yields, and increasing concerns about climate change and more frequent 'mega-cats' are driving heightened risk aversion worldwide.

The result is not only significantly higher pricing, but also more restrictive terms and conditions.



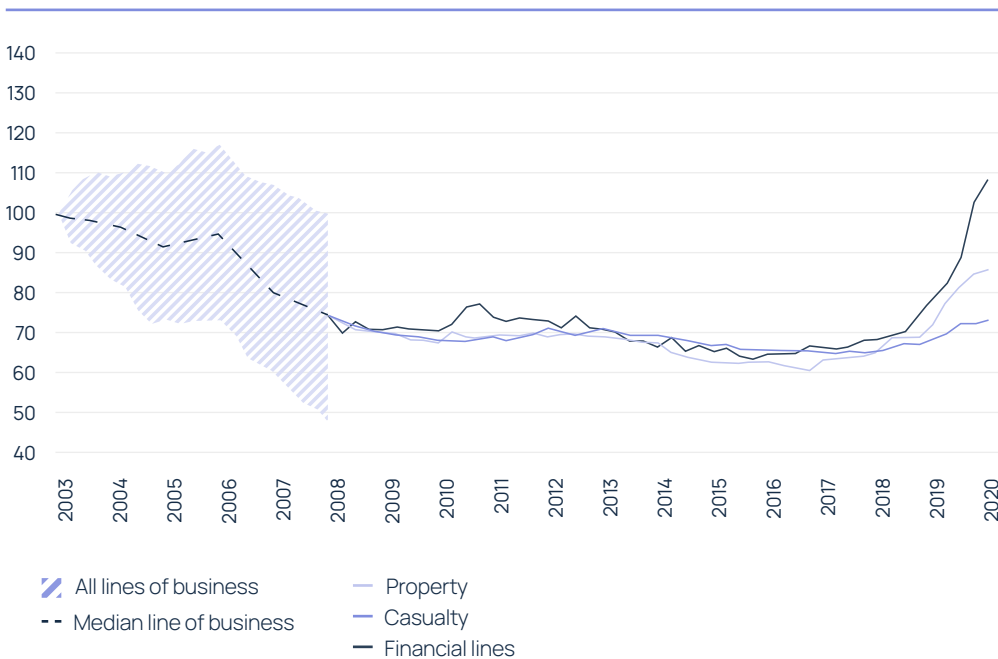
IN A DEVIATION FROM PREVIOUS HARD MARKETS, TIGHTER CAPACITY HAS BEEN (IN ALL BUT THE MOST DISTRESSED AREAS) A RESULT OF CHECKED APPETITE RATHER THAN CAPITAL DESTRUCTION. SENTIMENT HAS BEEN TRANSFORMED BY FEAR OF '(UN)KNOWN UNKNOWNNS' IN A HIGHLY UNCERTAIN AND VOLATILE ENVIRONMENT.

## Commercial insurance market

Insurance prices today are accelerating in most commercial lines, and rising from a lower base than in the last hard market (see Figure 1). Classes of business with the highest rate increases include property, excess / umbrella liability and financial lines. Pricing for commercial insurance globally rose by 16% on average in 2020, weighted by premium.

**Figure 1: Global commercial insurance pricing – 2003 to 2020**

(Source: HX Nova Portal)



In a deviation from previous hard markets, tighter capacity has been (in all but the most distressed areas) a result of checked appetite rather than capital destruction. Despite sizeable price increases, a number of major capacity providers have scaled back or withdrawn from underperforming lines of business. Market sentiment has been transformed by fear of '(un)known unknowns' in a highly uncertain and volatile environment.

Industry balance sheets remain strong. Despite the asset-side shock that occurred immediately post-COVID lockdown and full-year underwriting losses of USD 100 billion or more, capitalisation has proved remarkably resilient. Assets have recovered since March on the back of a strong financial market rebound. Additionally, incumbents and new players raised close to USD 20 billion of capital in 2020 to replenish buffers and take advantage of market opportunities, with more to come this year.

This is therefore *not* a universally dislocated market: differentiated risk profile and risk management strategies and advice can still unlock access to capacity, even if the landscape has undeniably become more difficult. Whilst acknowledging the imperative of underwriting profitability at a time of historically low yields, insurers should weigh the implications of extreme price swings on trading relationships, particularly when some businesses are fighting for survival. These market conditions will not last forever and memories will endure long after the cycle has shifted.

Detailed analysis into key market drivers is provided in the pages ahead; carrier resolve to remedy under-pricing during the soft market and to respond to fast-changing risk characteristics are having a major impact on sector dynamics. With probable additional COVID-19 loss development, financial market volatility, elevated costs of equity and one of the most expensive insured loss years ever, current market conditions look set to extend into 2021.

## HEADWINDS

- Legacy of soft market pricing
- COVID-19: major (re)insured loss
- Elevated cat losses (and climate change concerns)
- Loss inflation / adverse development
  - Reserve inadequacy
  - Global recession
- Financial market volatility
  - Risk premia
- Higher reinsurance costs

## OFFSETS

- Strong capitalisation
- Recession resilient
- Frequency benefits (mostly motor, but other lines too)
- Pricing acceleration mitigating top lines pressures
  - Pockets of rising demand for (re)insurance products
- New solutions / growth opportunities

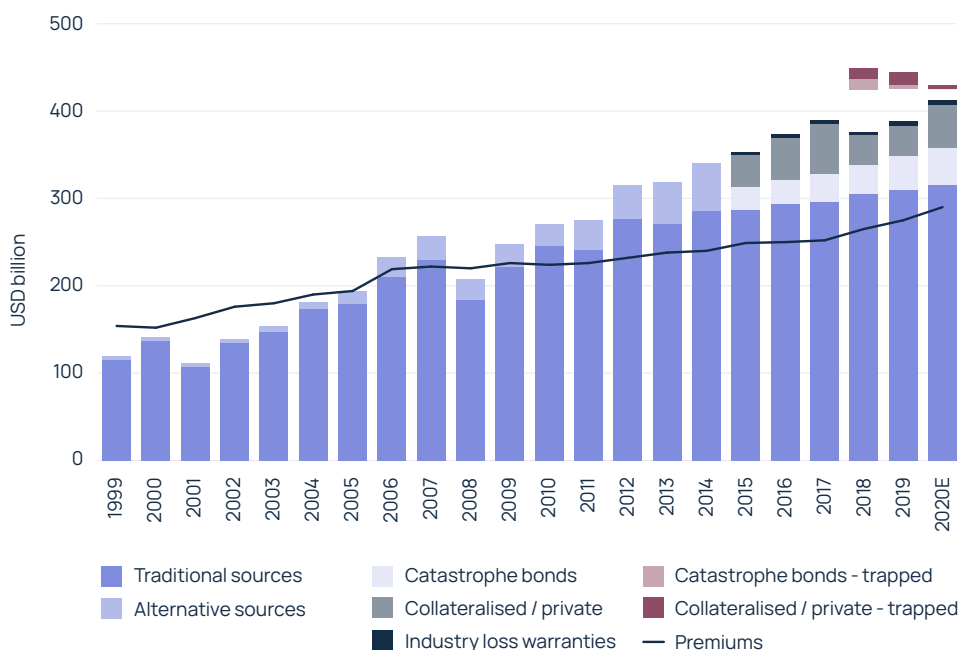
## Reinsurance market

Confronted with this backdrop, reinsurers were mostly circumspect and discerning at 1 January 2021 reinsurance renewals. The best performing classes and regions saw pricing outcomes fall towards the more modest end of (positive) ranges. But those experiencing successive years of losses, poor performance and / or changing risk profiles faced, almost without exception, more significant pricing corrections.

Strong capitalisation and competition informed this rational approach. Figure 2 shows dedicated reinsurance capital is estimated to have increased marginally to USD 416 billion in 2020, as growth amongst traditional sources and catastrophe bonds offset the remaining trapped capital in the collateralised market. Investors, especially those who experienced unfavourable development of losses beginning in 2017, were cautious as they reassessed risk. Kelvin Re and Humboldt Re, two Guernsey based reinsurers backed by insurance linked securities (ILS) funds, announced in December that they would stop writing business and be put into run-off. Investor caution had a meaningful impact on capacity availability in catastrophe-exposed markets, although there were early signs of some improvement, as new capital entered the sector, some of it for the first time.

**Figure 2: Dedicated reinsurance capital and global gross reinsurance premiums (all lines) - 1999 to 2020**

(Source: HX Nova Portal, Swiss Re)



COVID was, of course, a weighty factor at renewal. Whilst some of the more outlandish industry loss predictions had lost authority by year-end, there was lingering uncertainty about the quantum of COVID losses, as well as disputes over the classification and aggregation of these claims. Concerns about potential loss outliers notwithstanding, negotiations were generally conducted in an orderly fashion, with both parties motivated to look through the uncertainty and close transactions.

Attentions were focused on programmes' pricing, structures and underlying terms and conditions (e.g. communicable disease and silent cyber exclusions). Finding agreeable language for pandemic-related exclusions in property and liability contracts especially was front and centre of discussions this year.

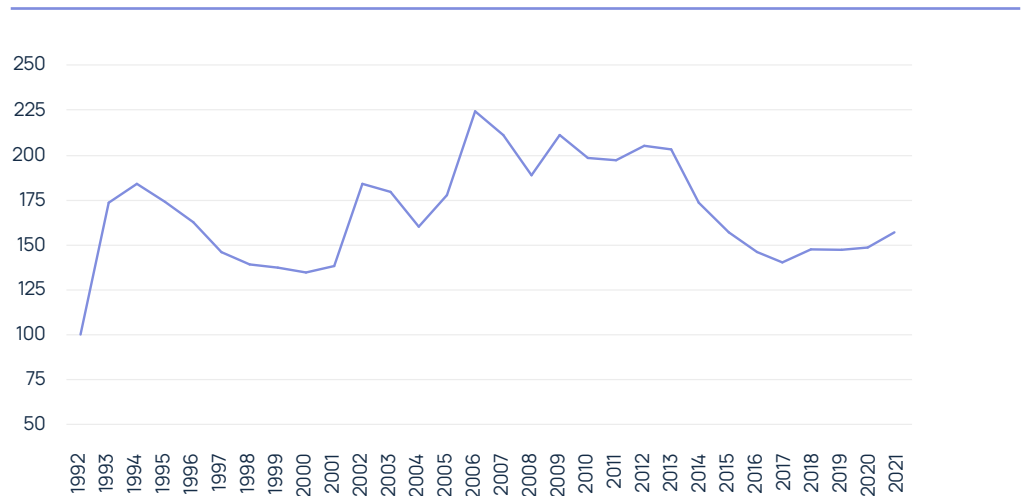
Cedent differentiation was another important feature at 1 January 2021. Those able to demonstrate favourable loss experience, resilient capitalisation and outperformance typically benefitted from capacity prioritisation and favourable pricing and terms relative to peers.

## Property-catastrophe reinsurance

Figure 3 shows that global risk-adjusted property-catastrophe reinsurance rates-on-line rose by an average of 6% at 1 January 2021<sup>1</sup>. This was higher than the roughly flat outcome of 2020, and the biggest year-over-year increase in over a decade. COVID loss experience, along with yet another hyperactive natural catastrophe year, were key inflating drivers.

**Figure 3: Howden Global Risk-Adjusted Property-Catastrophe Rate-on-Line Index – 1992 to 2021**

(Source: HX Nova Portal)

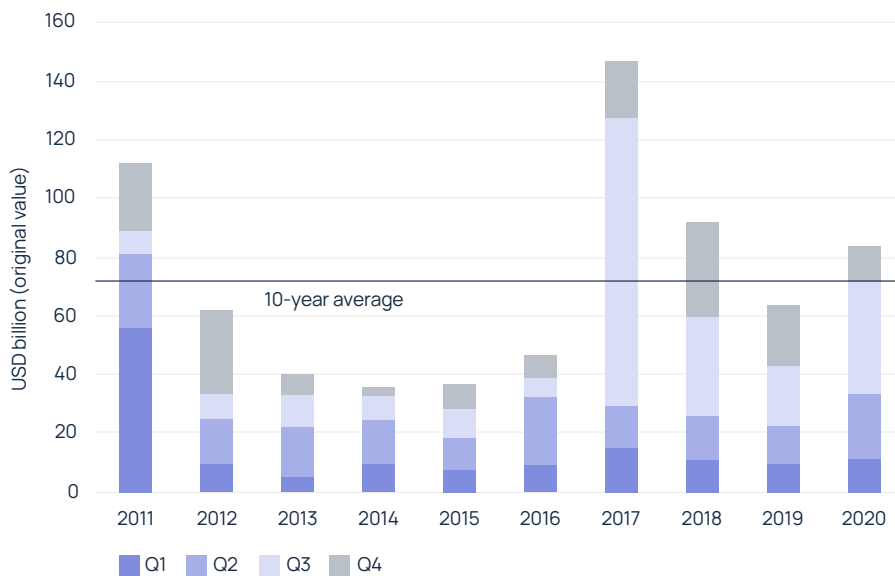


<sup>1</sup>This is a point estimate within ranges depending on loss experience, exposure and other client-specific conditions, and masks pockets of significant challenge for certain risks.



**Figure 4: Global insured catastrophe losses by quarter – 2011 to 2020**

(Source: HX Nova Portal)



Whilst Figure 4 shows that insured catastrophe losses last year (excluding COVID-19 claims) did not reach the record levels of 2017, and typically fell within carriers' budgeted levels, successive years of above-average losses, and a corresponding uptick in activity, have accentuated concerns about climate change. This has prompted markets to reconsider pricing levels to account for increased frequency and severity of weather events. Some buyers in a position to do so decided to take higher net positions rather than pay what they considered to be uneconomical prices for frequency protection. There was also increased interest in parametric products, as buyers explored alternative coverages.

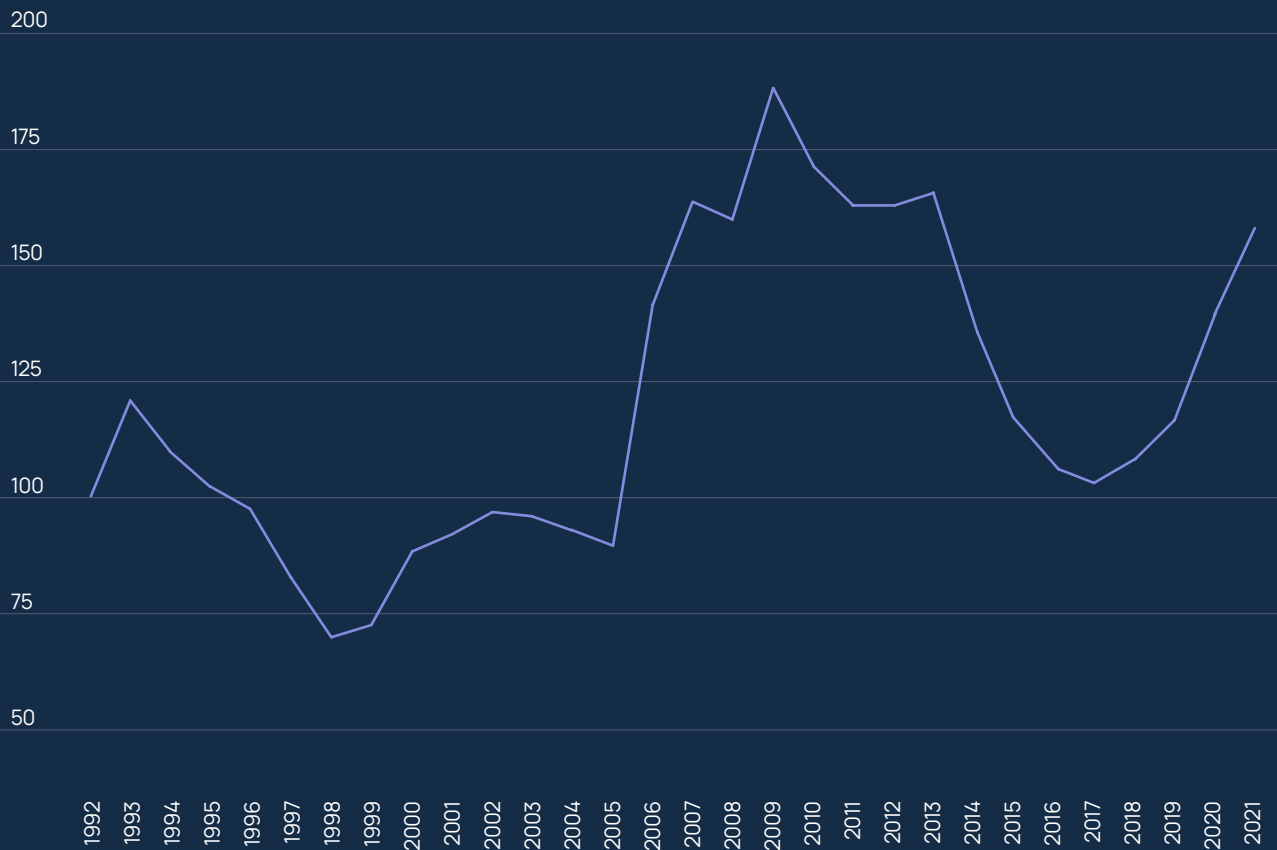
Programmes in North America led the charge at 1 January 2021, with an average rate-on-line increase of 8.5%. Outcomes here reflected record activity during the North Atlantic hurricane season, with a total of six hurricanes making U.S. landfall, Hurricane Laura being the most costly, and another year of devastating wildfires along the U.S. Pacific Coast. An unusually severe derecho event in the Midwest added to the frequency of large loss events in the U.S. last year.

Catastrophe activity was more subdued outside the United States, resulting in more modest risk-adjusted rate increases (typically in the low-to-mid-single-digit range) in Europe, Asia and elsewhere at 1 January 2021. A notable development was nevertheless observed in Europe: the almost habitual experience of flat-to-down renewals relented, as the balance of power shifted slightly towards markets who were able to point to low margins and significant COVID-related business interruption losses emanating from European insurers.

## Retrocession

Another year of losses and limited capacity in the retrocession market resulted in risk-adjusted retrocession catastrophe excess-of-loss rates-on-line rising by 13%<sup>1</sup> on average at 1 January 2021 (see Figure 5). Although capital inflows, including record catastrophe bond issuance and new and existing carriers' equity and debt raises, capped rises below early expectations, four consecutive years of price increases has seen the cost of retrocession protection return to levels last recorded at 1 January 2013 following the Tohoku and Christchurch earthquakes, Thai floods and Superstorm Sandy. Or, to put it differently, the soft market declines have now reversed fully. This equates to a cumulative increase of more than 50% since the nadir in 2017.

**Figure 5: Howden Risk-Adjusted Non-marine Retrocession Catastrophe Rate-on-Line Index – 1992 to 2021** (Source: HX Nova Portal)



Despite the draw of a more attractive pricing environment, investor appetite to back collateralised reinsurance or sidecar transactions was held back in some quarters by heightened risk aversion following successive years of losses and lacklustre performance. Persistent adverse development on prior years, concerns about COVID-19 business interruption claims, 2020 U.S. catastrophe events and increased scrutiny around climate change drove risk premia higher. Markets also looked to provide greater coverage clarity by moving towards named perils only, as well as imposing exclusionary language around cyber and communicable disease.

The impact on supply was significant; third-party capital is estimated to have provided up to 80% of capacity for the retrocession market before last year's pullback. The catastrophe bond market fared better through the dislocation, with investors attracted by its liquidity, peril specificity, certainty and diversification, and issuers appreciative of a cost-effective alternative.

Due to the succession of moderately-sized catastrophe events in 2020, frequency covers once again bore the brunt of losses. Aggregate protection was consequently at a premium at the 1 January 2021 renewal.

Left confronting increased spend for a fourth consecutive year, some strongly-capitalised retrocession buyers considered retaining more risk. More leveraged reinsurers, meanwhile, looked to restructure programmes to assist affordability, for example, by moving from aggregate covers to per occurrence, narrowing coverage from all perils to named perils or accessing the catastrophe bond market where capacity availability was more favourable.



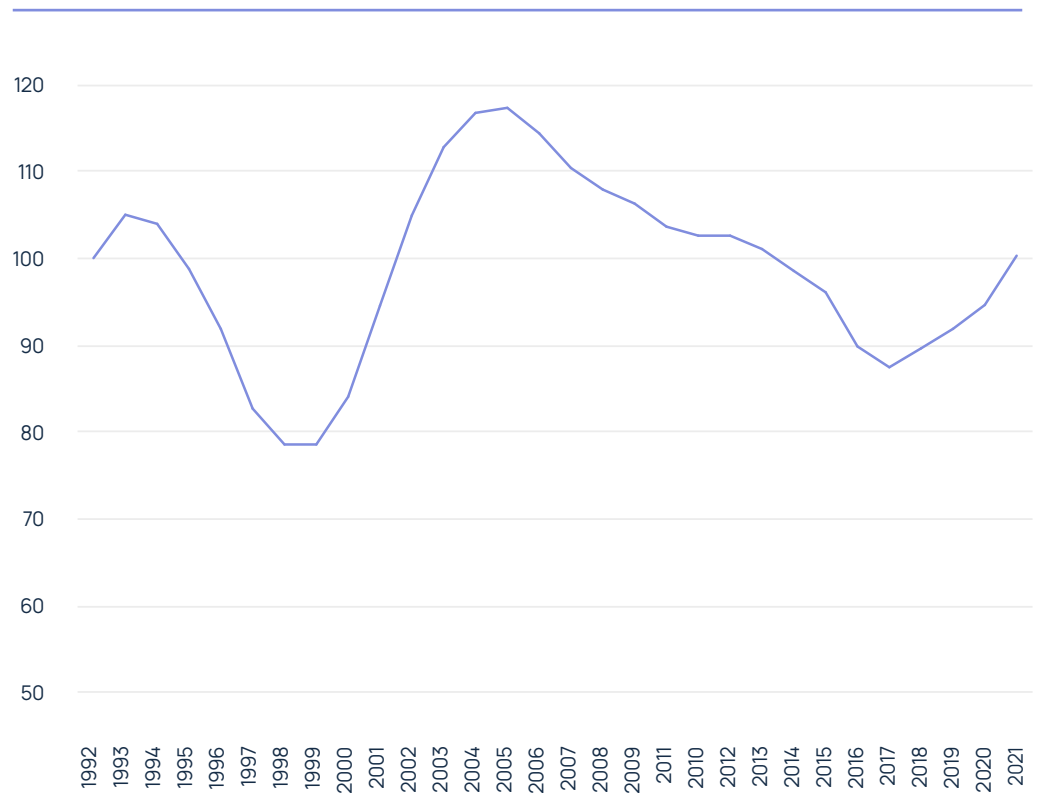
**PERSISTENT ADVERSE DEVELOPMENT  
ON PRIOR YEARS, CONCERNS ABOUT  
COVID-19 BUSINESS INTERRUPTION  
CLAIMS, 2020 U.S. CATASTROPHE  
EVENTS AND INCREASED SCRUTINY  
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RISK PREMIA HIGHER.**

## Casualty reinsurance

Casualty reinsurance rates-on-line, including adjustments for exposure changes and ceding commissions, rose by 6%<sup>1</sup> on average at 1 January 2021 (see Figure 6). This was a marked increase on the corresponding data point recorded in 2020 (of 3%).

**Figure 6: Howden London Market Casualty Risk-Adjusted Reinsurance Rate-on-Line Index - 1992 to 2021**

(Source: HX Nova Portal)



The U.S. casualty market (outside of workers' compensation) continued to provide the impetus for long-tail market firming. Tightening was also observed in a number of territories outside of the U.S. at 1 January 2021, leading to higher pricing in certain liability lines in Europe and Asia.

Higher loss cost trends and lower interest rates were key inflating factors, pushing up pricing overall for all but the top performers, although there were some (not insignificant) offsets from reduced claims frequency in certain areas. Negotiations around terms and conditions were equally consequential at 1 January 2021, with wordings for pandemic and cyber under particularly close scrutiny. This often led to more exclusions, although cedents with strong track records and accessible information generally received more favourable terms.

Rising rates on underlying business in the U.S. especially somewhat mitigated pressure on ceding commissions, although outcomes varied depending on book performance. Certain strongly performing or much improved accounts achieved increases whilst decreases were generally recorded for those that did not perform as well. Reinsurers were resolute in pursuing higher pricing for excess-of-loss programmes, although there was some degree of differentiation to account for portfolio characteristics and profitability. Reinsurers also had to weigh cedents' disposition to increase retentions if pricing demands were considered to be excessive.

U.S. commercial auto remains firmly in hard market territory, and evidence of increased frequency and severity is now evident in other liability lines, including directors and officers, general liability and professional liability. This was driven by a range of established factors, including a more aggressive plaintiffs' bar, higher litigation costs, rising jury awards, statute of limitation extensions, increased class action suits and loss potential from emerging risks, such as opioid addiction. These loss inflating elements are creating considerable uncertainty around back-book reserve development.

Adding to this long list of headwinds, COVID-19 is, of course, a compounding factor. Whilst COVID-19-related liability losses will be slow to emerge, possibly taking months or even years to develop fully (new waves of insolvencies cannot be ruled out at this stage), the pandemic, and subsequent quantitative easing on the part of governments, has brought immediate pressure to investment returns. Yields are likely to remain at historical lows for longer, having been negative for certain government securities prior to COVID. Risk carriers are now clearly unable to rely on investment income to compensate for increased loss trends, particularly with costs escalating to such a degree.

## Securing relevance

2020 was historic by any measure. The lives of billions of people have been redefined by COVID-19, a global health crisis that brought with it shutdowns, financial market turbulence, economic dislocation and civil unrest. The manifestation of systemic risks emerged elsewhere too. The effects of climate change were again in focus, as the frequency of extreme weather events pushed the boundaries of historical precedent. There is also a growing recognition of the huge risk aggregations associated with catastrophic cyber attacks. The rapidly evolving risk landscape exacerbated risk aversion in the insurance and reinsurance market, with carriers' appetites responding accordingly.

2021 will be no less challenging: COVID will continue to be a major hindrance to economic activity, even with a successful vaccine roll-out. The insurance sector nevertheless confronts these challenges from a position of strength. The importance of risk transfer comes to the fore during times of extreme uncertainty, and the market has once again played a crucial role in shoring up economic resilience during the COVID crisis by paying claims worth tens of billions of dollars worldwide and continuing to underwrite complex risks.

Carriers' risk tolerances have nevertheless been tested, and the reputation of the market has undeniably been damaged by disputes over business interruption coverage, even if most court rulings have upheld contractual language so far. With pricing momentum in both commercial insurance and reinsurance likely to hold through 2021, businesses will continue to feel the strain at a time when many face huge and potentially existential financial pressures.

The sector must now live up to its responsibility of offering coverage that meets rapidly changing client needs, as well as ensuring that costs are appropriate for the level of risk assumed. Whilst conditions have unquestionably become more difficult, this is still a well-functioning market and it is incumbent on all stakeholders – brokers and risk carriers alike – to apply all of the knowledge and expertise available in creating products for new and increasingly intangible risks and seizing the opportunity to secure long-term relevance.

Howden exists to provide differentiated advice to clients. We have a deep understanding of market dynamics and are renowned for developing creative client solutions through different market cycles.

With high levels of uncertainty pervading the market, insurance and reinsurance buyers require detailed insights and analysis into key drivers.

**HOWDEN WILL LEAD THE DISCUSSION AND PROVIDE BEST-IN-CLASS RISK TRANSFER ADVICE TO SUPPORT CLIENTS IN MANAGING MARKET CHANGE.**

# 2020: one for the books

2020 was always going to be a milestone year, with dates fixed for pivotal U.S. elections and the U.K.'s formal withdrawal from the European Union.

Despite the important long-term consequences of both these events, 2020 will be remembered as the year of COVID-19.



**COVID-19 IS A GLOBAL HEALTH CRISIS FIRST AND FOREMOST, BUT IT HAS ALSO BROUGHT ABOUT A HUGE ECONOMIC SHOCK. INTEREST RATES HAVE FALLEN EVEN FURTHER AND PUBLIC DEBT HAS SOARED, RAISING QUESTIONS ABOUT THE LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES.**



## A macroeconomic shock

COVID-19 is first and foremost a global health crisis, but it has also brought about a huge economic shock. In an effort to suppress the spread of the virus, governments worldwide have shutdown economies and restricted freedoms to a degree not seen outside of wartime.

In order to counter the danger of a sustained economic malaise, governments and central banks moved quickly to provide liquidity and stability to financial markets, as economic growth slowed and asset prices plummeted. These combined policy responses represent the largest since the final year of World War II.<sup>2</sup> Interest rates have fallen even further – into negative territory in some countries – and public debt has soared, raising questions about the long-term sustainability of public finances.

Despite deteriorating economic fundamentals, markets rallied strongly from April onwards (see Figure 7), prompting warnings about a growing disconnect between asset prices and fiscal realities. Increased inequality, especially in developed nations, may become a legacy of COVID-19, with disparities likely becoming even more accentuated with the potential for significantly higher unemployment and insolvencies, as government support is gradually phased out. Talk of a 'K'-shaped recovery has become commonplace with disproportionate impacts on certain populations and sectors.

**Figure 7: Performance of major equity markets in 2020 in local currency**

(Source: HX Analytics, Bloomberg data)

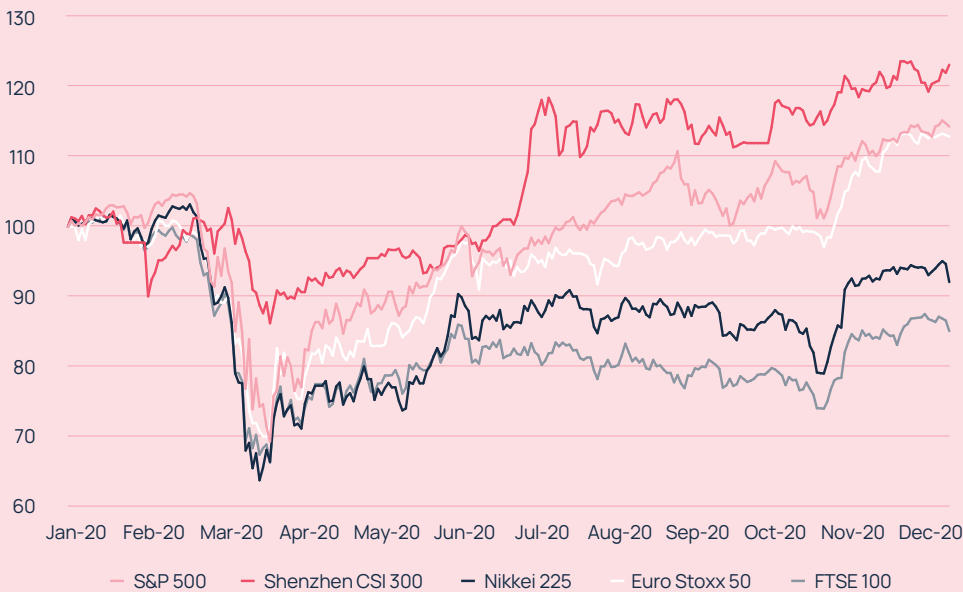


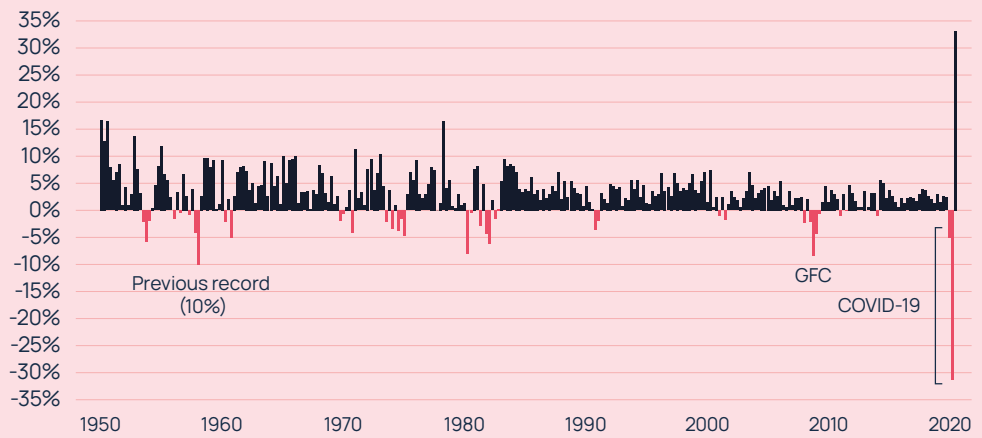
Figure 8 shows that the U.S. economy suffered its sharpest post-war contraction in the second quarter of 2020, when GDP fell by an annualised 31.4%.<sup>3</sup> The slump, coming on top of an annualised 5% contraction in Q1, was more than three times as sharp as the previous record (-10% in 1958). Nothing in recent memory comes close – the worst quarter during the global financial crisis (GFC) saw a decline of 8.4%. There was nevertheless an immediate bounce in Q3, as restrictions were lifted and the economy grew by a (record) annualised rate of 33.1%.

<sup>2</sup> See Congressional Budget Office, An Update to the Budget Outlook: 2020 to 2030; U.K. Office for Budget Responsibility, Fiscal sustainability report + Summer Economic Update Measures, 21 August 2020; International Monetary Fund, International Financial Statistics; The World Bank, International Debt Statistics, compare to Abbas, S. Ali, Nazim Belhocine, Asmaa El Ganainy and Mark Horton. "Historical Patterns of Public Debt, Evidence from a New Database," IMF Economic Review, May 2011, page 10.

<sup>3</sup> The U.S. government reports quarterly GDP as an annualised rate, which measures the change in output from the same quarter one year earlier. This differs from some other countries who measure quarterly changes to economic output on a sequential basis.

**Figure 8: Annualised U.S. GDP by quarter – 1950 to 2020**

(Source: U.S. Bureau of Economic Analysis)

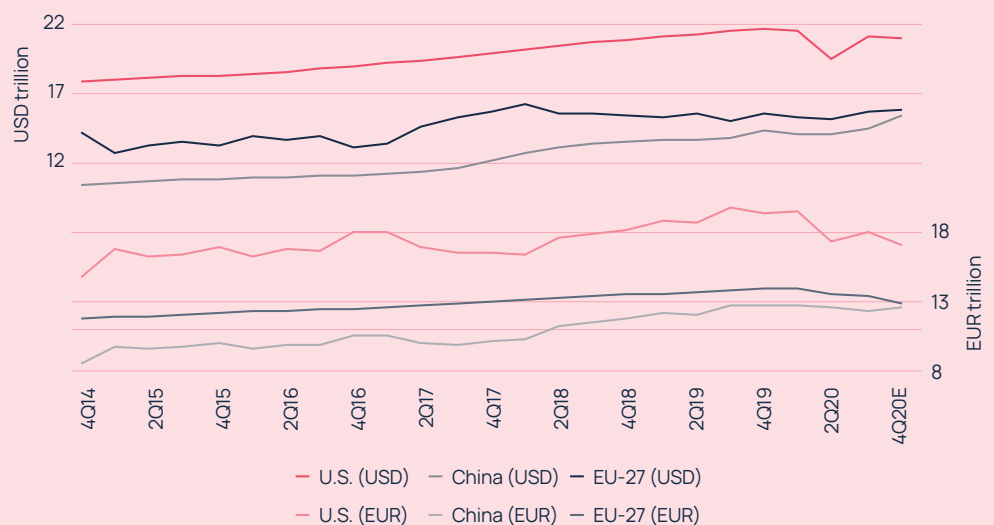


Looking beyond these volatile quarterly swings, which were replicated across most developed countries, it is clear that COVID caused significant changes to the balance of global economic output.

Figure 9 shows the economic effects caused by COVID in dollars (left hand scale) and in euros (right hand scale). Although currency fluctuations obscure the picture somewhat, it is clear that the size of the Chinese economy nearly reached that of the EU-27 for the first time ever in 2020, thanks to the relatively benign Chinese economic experience compared to significant contraction in the west, with Europe no exception. If Chinese nominal GDP exceeds the EU's in 2021, COVID will have been the catalyst.

**Figure 9: GDP at current prices, rolling 12 months – 2014 to 2020**

(Source: U.S. Bureau of Economic Analysis, Eurostat, National Bureau of Statistics of China, International Monetary Fund World Economic Outlook, Bloomberg consensus of economist forecasts)



With several countries now battling new waves of COVID infections, economic activity could continue to wane significantly through the winter. Even factoring in a successful vaccine roll-out in 2021, output in advanced economies will likely not recover fully until later this year at the earliest and even longer for some developing economies.

## (Re)insurance retrospective

### Top line headwinds

A deep recession with accompanying low, even negative interest rates, has important implications for the (re)insurance sector. The close relationship between GDP and insurance premiums is well established in the long run, and demand for insurance typically declines when business volume falls.

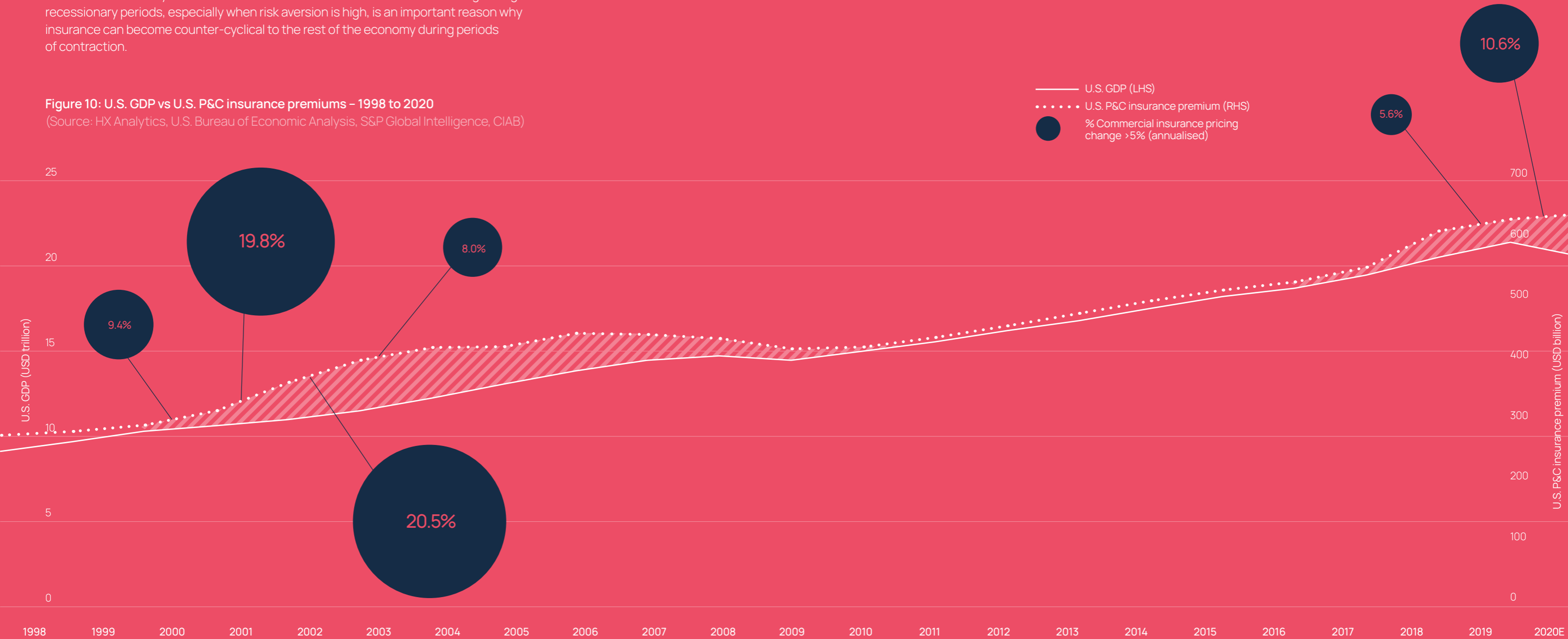
This correlation is illustrated in Figure 10, which charts U.S. GDP and U.S. P&C insurance premiums from 1998. Two notable exceptions emerge, however: the deviation in the early 2000s coincided with prolonged (re)insurance market hardening, helping to propel premium growth ahead of GDP growth before returning to trend as pricing reversed and economic activity recovered from the downturn of 2001. Market hardening during recessionary periods, especially when risk aversion is high, is an important reason why insurance can become counter-cyclical to the rest of the economy during periods of contraction.

**Figure 10: U.S. GDP vs U.S. P&C insurance premiums – 1998 to 2020**

(Source: HX Analytics, U.S. Bureau of Economic Analysis, S&P Global Intelligence, CIAB)

This is likely occurring now, although with isolated variances by class of business (for example, premiums for personal lines and workers' compensation have declined significantly as both volume and pricing fell). Despite the U.S. economy shrinking by an estimated 4% in 2020 – the deepest post-war annual decline – commercial pricing momentum has provided a considerable offset that has bolstered commercial writers' top lines and, in aggregate, helped sustain non-life premium growth for the year.

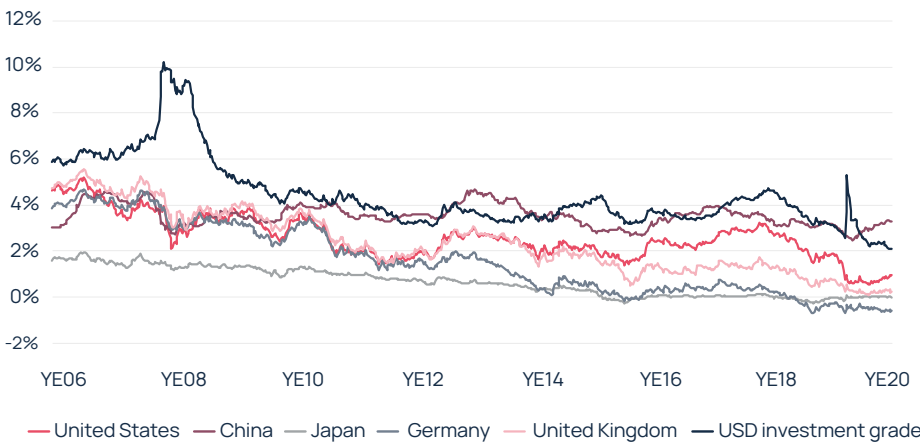
This points to continued P&C premium income growth in 2021 on the back of global economic recovery and pricing momentum, although businesses are likely to consider taking larger deductibles or buying less limit to offset the increasing cost of the product and meet their increasingly strained budget targets.



## Investment volatility

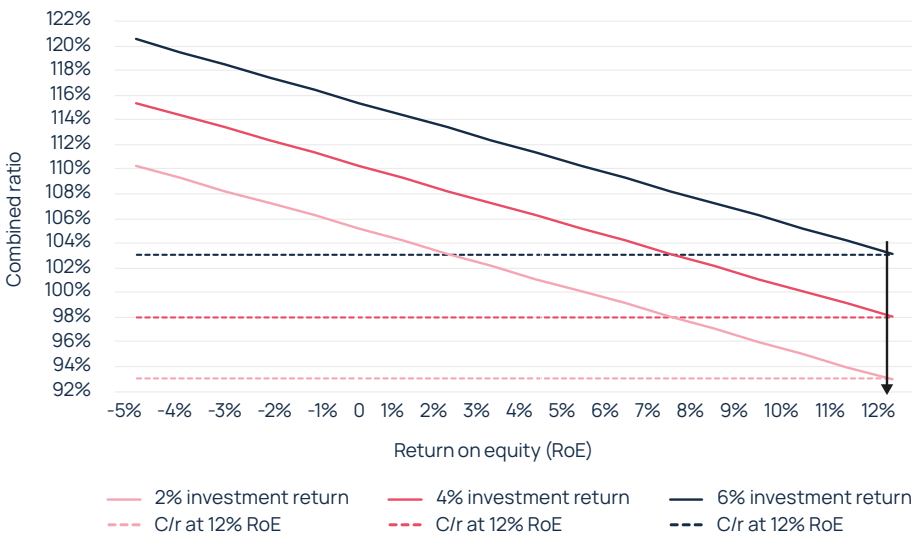
The COVID crisis has also brought serious pressure to the asset side of carriers' balance sheets. Perhaps the largest indirect impact of COVID-19 on (re)insurers is the legacy of lower sustained interest rates. Yields are even negative for certain government securities, including Germany (see Figure 11), with commensurate effects on investment grade fixed income securities now so prevalent on carriers' balance sheets.

**Figure 11: 10-year government and U.S. investment grade corporate bond yields – 2006 to YE 2020**  
 (Source: HX Analytics, Bloomberg data)



Declining investment returns make underwriting profitably an imperative. Figure 12 shows how a 200 bps decrease in yield requires a combined ratio improvement of roughly 500 bps to maintain a consistent return on equity for the average carrier. Coming amidst a particularly adverse loss environment, carriers' determination to achieve rate that is above loss trends is now crystallising.

**Figure 12: Impact of investment returns on return on equity**  
 (Source: HX Analytics)



## Covid losses: knowns and unknowns

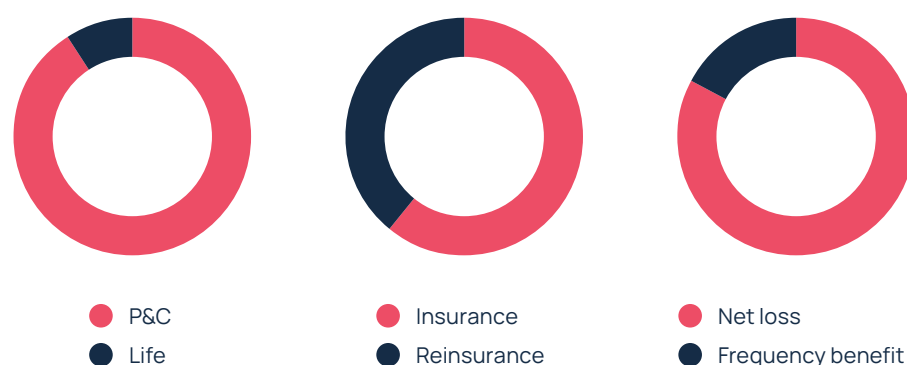
Beyond the macroeconomic impacts, COVID-19 has brought what was already a challenging risk landscape into sharp focus. Whilst pandemic was a 'known' (white swan) risk, mandatory lockdown orders were not (more akin to black swan). The decision by governments to prioritise public health over economic activity meant the bulk of insured losses were pushed away from the life market and into the P&C market, the opposite of what was modelled for a global pandemic.

The economic costs of COVID-19 are considerable, running into the trillions of dollars. The ultimate cost to the (re)insurance sector is still unknown – complex coverage disputes around business interruption where litigation is still at an early stage, and longer-tail liability consequences ensure an unpredictable claims settlement process. Years are likely to pass before claims develop fully.

(Re)insurance carriers reported approximately USD 30 billion of COVID-19 losses as at 1 January 2021, the bulk of which are incurred but not reported. Reinsurance accounts for more than a third of announced losses so far, but this has the potential to evolve, as losses mount and cedents and counterparties work through treaty recoveries.

**Figure 13: Breakdown of COVID-19 (re)insured reported loss**

(Source: HX Analytics, HSBC)



Some areas, such as motor, have benefitted from frequency tailwinds due to moderated activity in certain areas, reducing the gross claims burden. With COVID-19-related restrictions likely to continue into Q1 or Q2 this year, carriers writing personal lines business are especially likely to see these frequency benefits continue, albeit perhaps to a lesser degree.

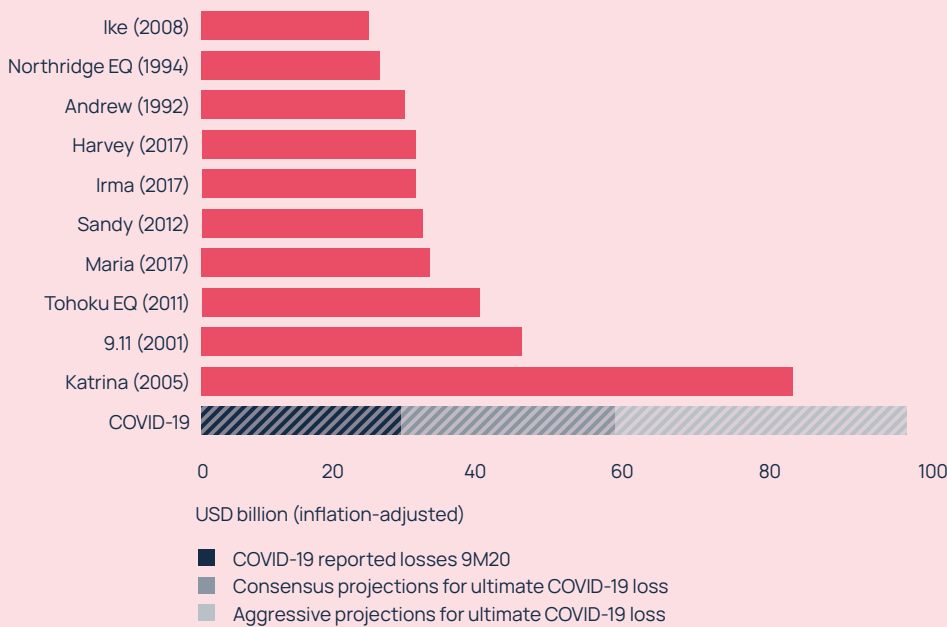
The same logic applies to losses. New or rolling lockdowns are inevitable through winter amidst resurging infection rates. Additionally, reported losses have so far been predominantly focused on short-tail lines, but longer-tail liability claims will also emerge over time. The Prudential Regulation Authority (PRA) in the U.K. has already flagged what it sees as carriers' 'optimistic' reserving for COVID liability losses. Whilst longer-tail claim payments will obviously be spread over a prolonged period, allowing carriers to drip feed claims over several quarters, it also exacerbates the sentiment of uncertainty taking hold in the market, with specific concerns about aggressive actions from an already vigorous plaintiffs' bar.

## A historic (but manageable) loss

Figure 14 shows how different ultimate loss scenarios for COVID compare to historical insured catastrophe events. The first (shaded black) COVID block shows reported COVID claims at 3Q20, making it a moderate-sized 'major' loss. The second block, which is a loose market consensus range for COVID loss projections, would likely see the event rival or surpass the cost of the 9.11 terrorist attacks. The third range captures some of the more aggressive estimates released, where rhetoric has honed in on the largest event ever, or even a USD 100 billion underwriting loss.

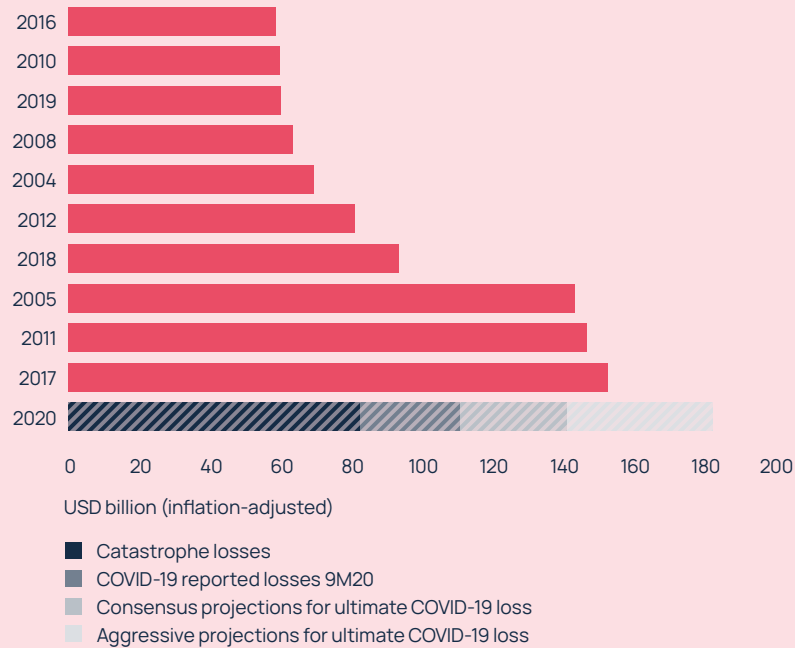
**Figure 14: COVID-19 loss projections vs top 10 insured catastrophe losses**

(Source: HX Nova Portal)



When catastrophe losses are added to the equation, 2020, at a minimum, was a USD 100 billion loss year and could rival, or even surpass, 2017 as the biggest loss year ever should COVID claims come in at the higher-end of expectations.

**Figure 15: Consensus projections for 2020 vs top 10 largest loss years**  
 (Source: HX Nova Portal)



In spite of its large scale, COVID will be a manageable loss of the industry. Perhaps the more enduring legacy of the pandemic for risk managers and underwriters will be altered perceptions of risk, especially around events that are systemic in nature. COVID is a reminder that certain systemic perils do not conform to long-held assumptions around correlations, boundaries and duration.

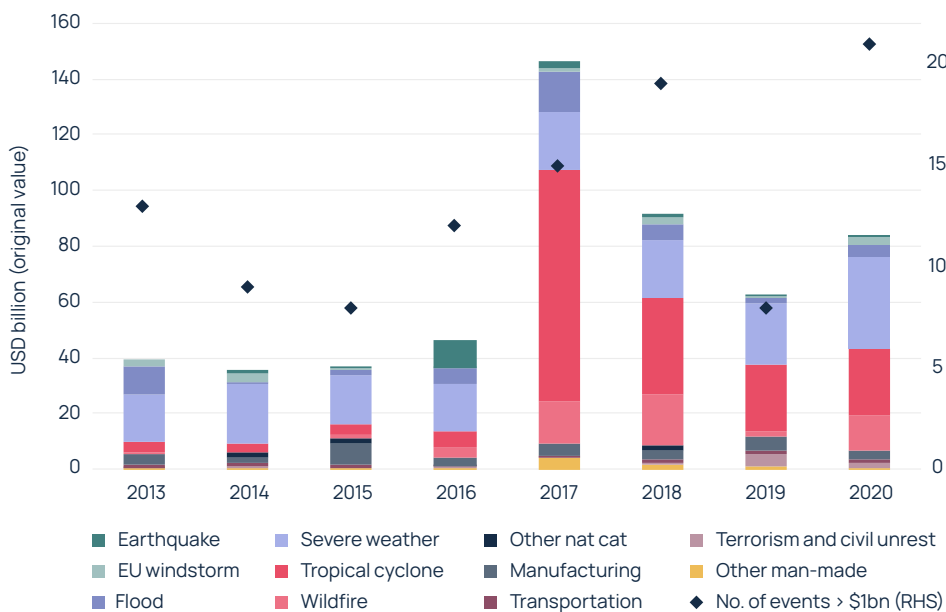
## SYSTEMIC RISKS CHALLENGE THE PROVISION OF INSURABILITY AND REQUIRE ALL STAKEHOLDERS – INCLUDING LARGE CORPORATIONS, UNDERWRITERS AND GOVERNMENTS – TO WORK TOGETHER TO CREATE BETTER SOLUTIONS FOR FUTURE EVENTS.

Whilst government backstops are likely to be needed for some of the more catastrophic scenarios, the (re)insurance market must play a central – and risk-bearing – role which drives the agenda and moves product offerings away from physical damage contracts towards bespoke solutions for intangible risks.

## Catastrophes: increased frequency

There was no respite from more conventional property losses in 2020, as elevated catastrophe frequency, including 21 separate events in excess of USD 1 billion, led to another above-average loss of USD 84 billion (see Figure 16). Taking insured catastrophe losses (excluding COVID-19) in aggregate since the start of 2017, the (re)insurance sector has paid out nearly USD 400 billion in catastrophe claims. This compares to just USD 160 billion for the previous four-year period, with the bulk of the difference stemming from tropical cyclones, other severe weather and wildfires.

**Figure 16: Global insured catastrophe losses by peril – 2013 to 2020**  
(Source: HX Nova Portal)



Activity last year was notable for the busiest North Atlantic hurricane season on record, after the formation of 30 named storms beat the previous record of 29 in 2005. A total of 10 hurricanes made landfall in 2020, three as major hurricanes. The cost borne by the (re)insurance sector was nevertheless far less than 2005 and 2017, as all six hurricanes that hit the U.S. coastline (Hanna, Isaias, Laura, Sally, Delta and Zeta) avoided densely populated areas. The two most powerful hurricanes of the season, Eta and Iota, came ashore in Nicaragua, causing widespread (but mostly uninsured) devastation.

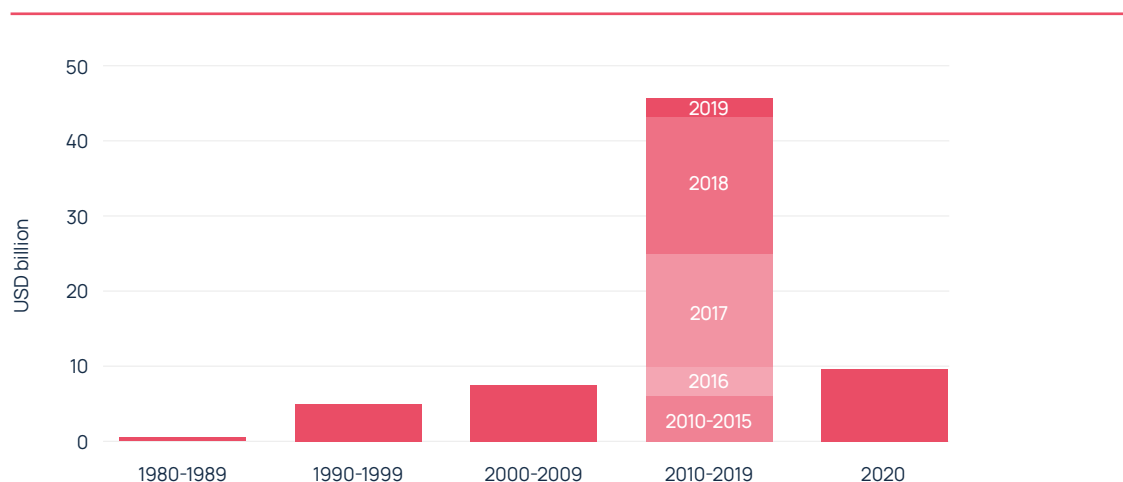
Perils once regarded as attritional or non-peak also contributed significantly to insured losses in 2020. Figure 16 shows that non-peak perils have been the biggest component of loss for the sector since 2013 in all but one year (2017). The trend continued in 2020, as record breaking wildfires along the U.S. Pacific Coast and an unusually severe derecho wind event in the Midwest were amongst the most expensive events of the year. Severe weather, made up mostly of U.S. severe convective storm events, was the costliest peril in 2020, roughly equal to reported COVID claims to date.

The accumulation of 'non-peak' perils globally has forced carriers to reassess their views of risk. Assumptions around wildfires specifically are being recalibrated, particularly in relation to climate change and demographic / population changes. For five successive years, wildfires in the U.S. (2017, 2018 and 2020), Canada (2016) and Australia (2019/20) have generated losses at a quantum associated with peak perils such as hurricanes and earthquakes (see Figure 17). In California alone, wildfires since 2016 are estimated to have caused insured damage of close to USD 40 billion.



**Figure 17: Global wildfire insured losses by decade – 1980 to 2020**

(Source: HX Nova Portal)



More extreme weather events and, by extension, climate change raise important questions about the utility of catastrophe models. Expectations of increased frequency and severity linked to climate change present real challenges for tools that rely heavily on historical data and past experience to inform modelled assumptions and output. Risk managers are now routinely asking to see the effect of adjustments in catastrophe models in order to account for future climate change exposures – even where not previously experienced.

This is true for North Atlantic hurricanes, which meteorologists expect to become more powerful in future, given the relationship between storm intensity and sea surface temperatures. Commercial models must incorporate a forward looking view on how future sea surface temperatures and rising sea levels, for example, will impact hurricane strength and storm surge damage. The interaction of the primary peril (wind) and secondary impacts (storm surge and flooding) is also likely to become increasingly complex in a rapidly changing climate. This is not currently adequately addressed.

With this being the case for hurricane risks, even greater hurdles will be encountered for non-peak natural perils such as wildfires, convective storms and floods, not only because of climate variability, but also because these are already underdeveloped as modelled perils. Collaborations with academia and other institutions will be an important part of the process in ensuring catastrophe models incorporate a longer-term view of climate risk and carriers offer innovative solutions to account for climate change.

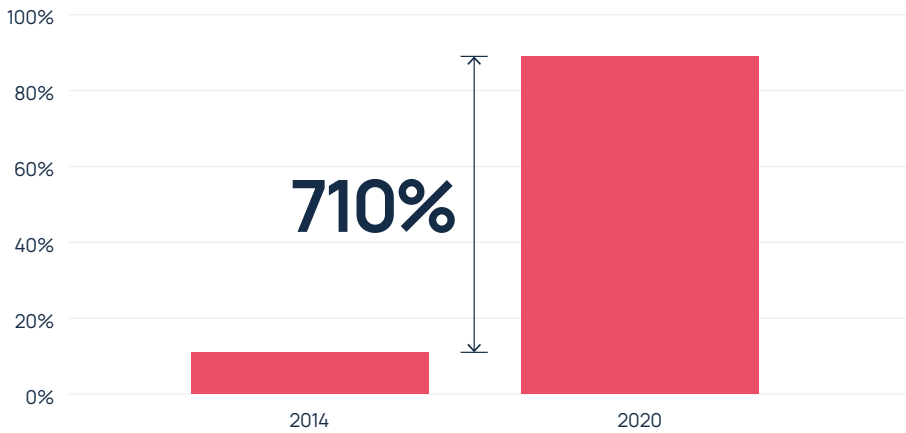
## Sting in the long tail

The final 'macro' trend of note in 2020 centred on rising liability loss cost trends, or 'social inflation' to use market jargon, which has coincided with significant performance deterioration (and pricing increases) in several liability lines of business.

The factors attributed to social inflation are more societal than economic and include an aggressive and active plaintiffs' bar, higher litigation costs, anti-corporate sentiment (especially amidst a perception of rising inequality), 'nuclear' jury awards, the growing use of third-party litigation financing (see Figure 18 on page 28 – an upward trend that is going to continue) and increased class action lawsuits. Social inflation has been predominantly a U.S. phenomenon, but there is now growing evidence that similar trends are manifesting themselves in other countries, including Australia, Canada and the United Kingdom.

**Figure 18: Use of litigation finance by U.S. law firms - 2014 vs 2020**

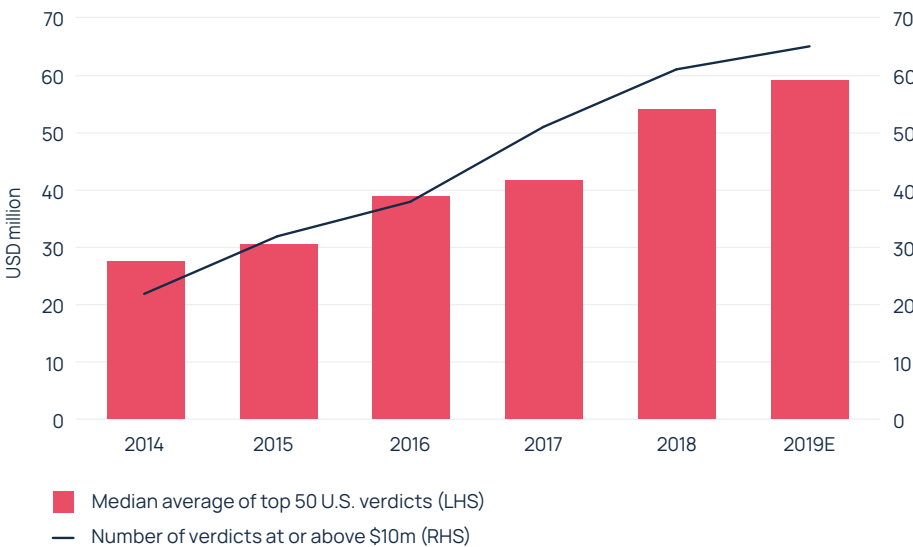
(Source: Burford Research, HX Analytics)



Whilst these factors can be difficult to quantify, available data point to an increasingly adverse claims environment. Figure 19 shows the median average of nuclear verdicts in the U.S. has more than doubled since 2014, with an even more rapid increase in the number of verdicts at or above USD 10 million. Federal securities class actions (and costs) have also spiked since 2017, with the number of cases exceeding 400 for three successive years (see Figure 20). There has been a corresponding jump in median settlement values in the last two years.

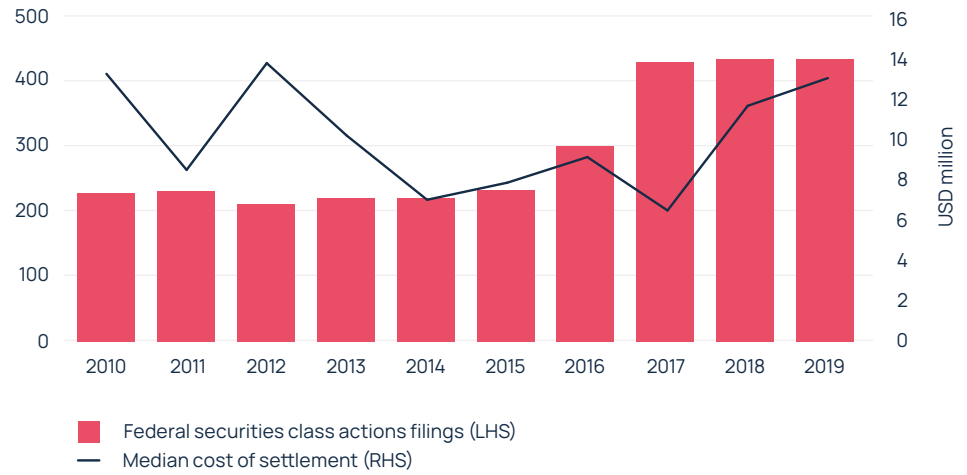
**Figure 19: Verdict and settlement data in United States - 2014 to 2019**

(Source: HX Analytics, Swiss Re, Shaub, Ahmuty, Citrin & Spratt, Jefferies)



**Figure 20: Number and median settlement values of securities class actions – 2010 to 2019**

(Source: HX Analytics, National Economic Research Associates)

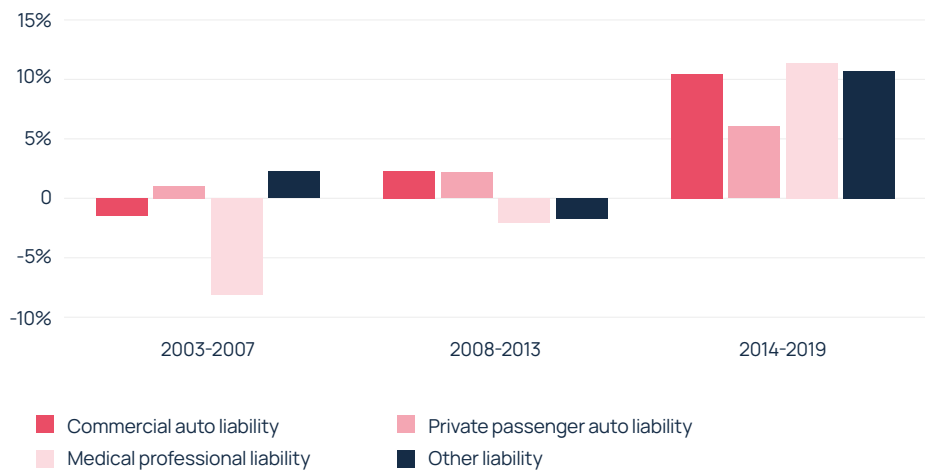


This is indicative of increased loss frequency and severity across a number of long-tail lines. Figure 21 shows how annualised changes in incurred losses for select U.S. liability lines accelerated rapidly for carriers between 2014 and 2019 compared to previous periods. The market has not experienced such adverse liability loss trends since the crisis of the late 1990s and early 2000s.

Any short-term claims experience relief from COVID-19 notwithstanding – for example, due to court closures and backlogs – social inflation trends look set to continue and even accelerate in 2021, absent tort reform. Developing trends like opioid addiction or statute of limitation extensions are only likely to exacerbate the adverse environment, and compound the uncertainty and concern around reserve adequacy.

**Figure 21: Annualised change in incurred losses for select U.S. liability lines**

(Source: HX Analytics, National Association of Insurance Commissioners)



# 2021: charting the year ahead

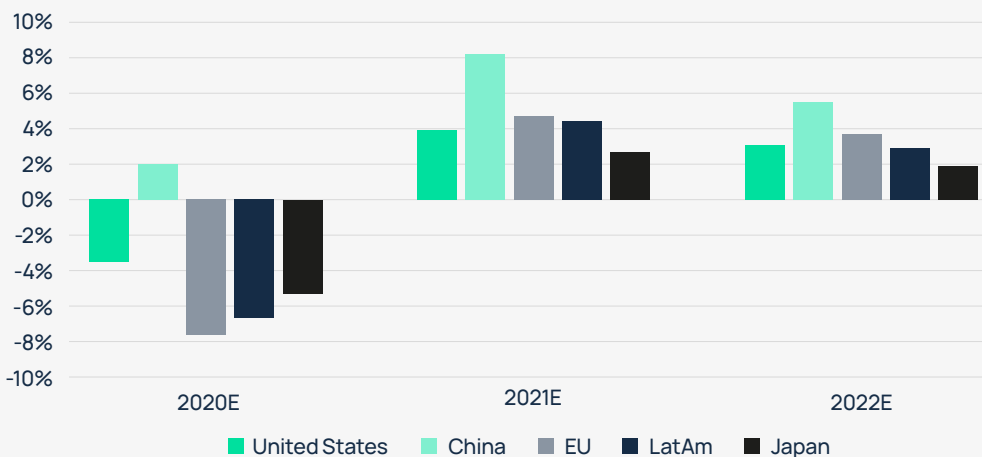
## A shot in the arm

After what can be described as a tumultuous year at best, hopes in 2021 rest firmly on a successful vaccine rollout to restore a semblance of normality to peoples' lives and to limit the already considerable economic damage.

The situation remains precarious in the near-term but there are reasons to be optimistic.

**Figure 22: Annual GDP growth projections – 2020 to 2022**

(HX Analytics, Bloomberg data)





# CONFIDENCE IN THE EFFICACY OF VACCINES IS GROWING, FUELLING HOPES THAT HERD IMMUNITY, AND THE CONCOMITANT ECONOMIC BENEFITS, CAN BE ATTAINED LATER THIS YEAR.

Figure 22 shows that consensus forecasts for GDP growth in most regions point to a robust recovery in 2021 and 2022, even if economic output is likely to lag pre-COVID-19 projections.

## Covid loss development

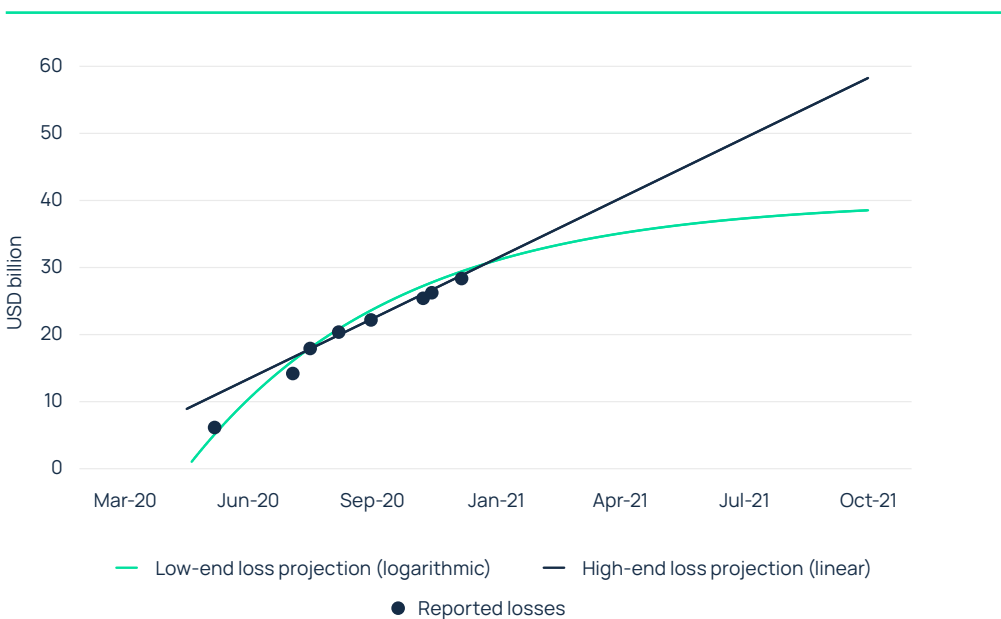
The lifting of restrictions and the resumption of economic growth in 2021 will have an important effect on the (re)insurance sector, not least the ultimate cost of COVID claims borne by the market. Figure 23 plots aggregated reported losses through 2020 and projects forward with a couple of scenarios that take a straight line and more flattening trajectory up to the end of October this year.

The divergence is substantial – the difference being something close to the largest loss ever for the private (re)insurance market<sup>4</sup> compared to an event more akin to a moderate hurricane loss, spread over the best part of two years. Even under the more aggressive (linear) scenario, reported losses would need to be sustained on their current trajectory into 2023 to approach the USD 100 billion figure predicted by some.

Which scenario most accurately depicts reality will become clearer this year. Whilst capacity and risk appetite will clearly be shaped by the answer, (re)insurers are strongly positioned to trade through and, whatever the outcome, will benefit from the removal of the COVID uncertainty overhang.

**Figure 23: Reported COVID claims in 2020 and projections of market loss up to 10M21**

(Source: HX Analytics, HSBC)



<sup>4</sup> Hurricane Katrina is the most expensive insured catastrophe event on record, at approximately USD 80 billion in real terms, but this estimate includes National Flood Insurance Program losses, which is a government funded scheme.

## Rebirth of the market cycle?

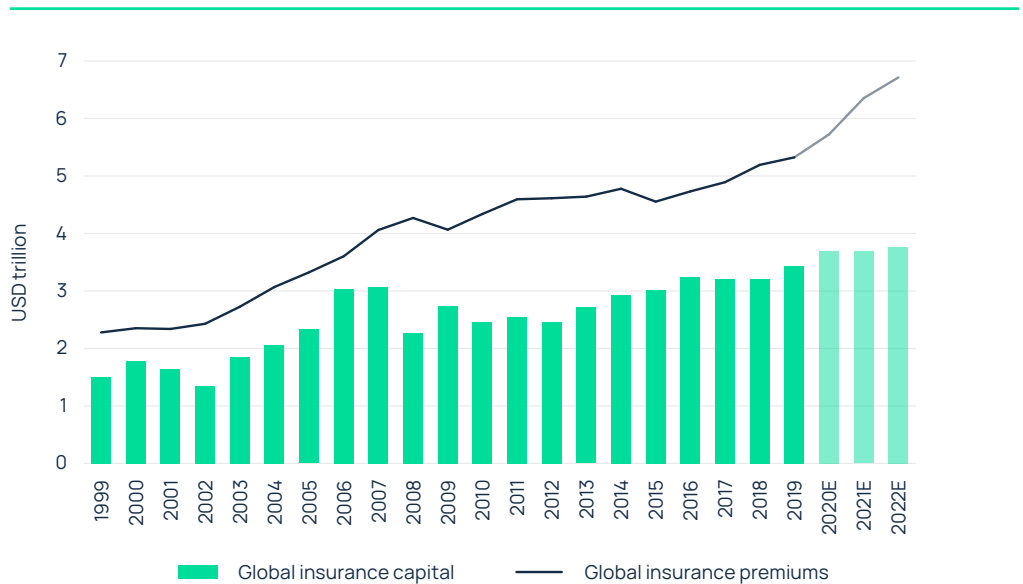
This raises one of the more important and contentious points of 2021: namely, whether market conditions will deteriorate further for (re)insurance buyers and coalesce in a prolonged period of price rises.

The catalysts for market hardening – the factors addressed in the previous section: lower for longer interest rates, increased frequency and severity of natural catastrophes and social inflation – appear structural rather than cyclical, which should support continued price discipline. COVID-19 has only magnified their effect.

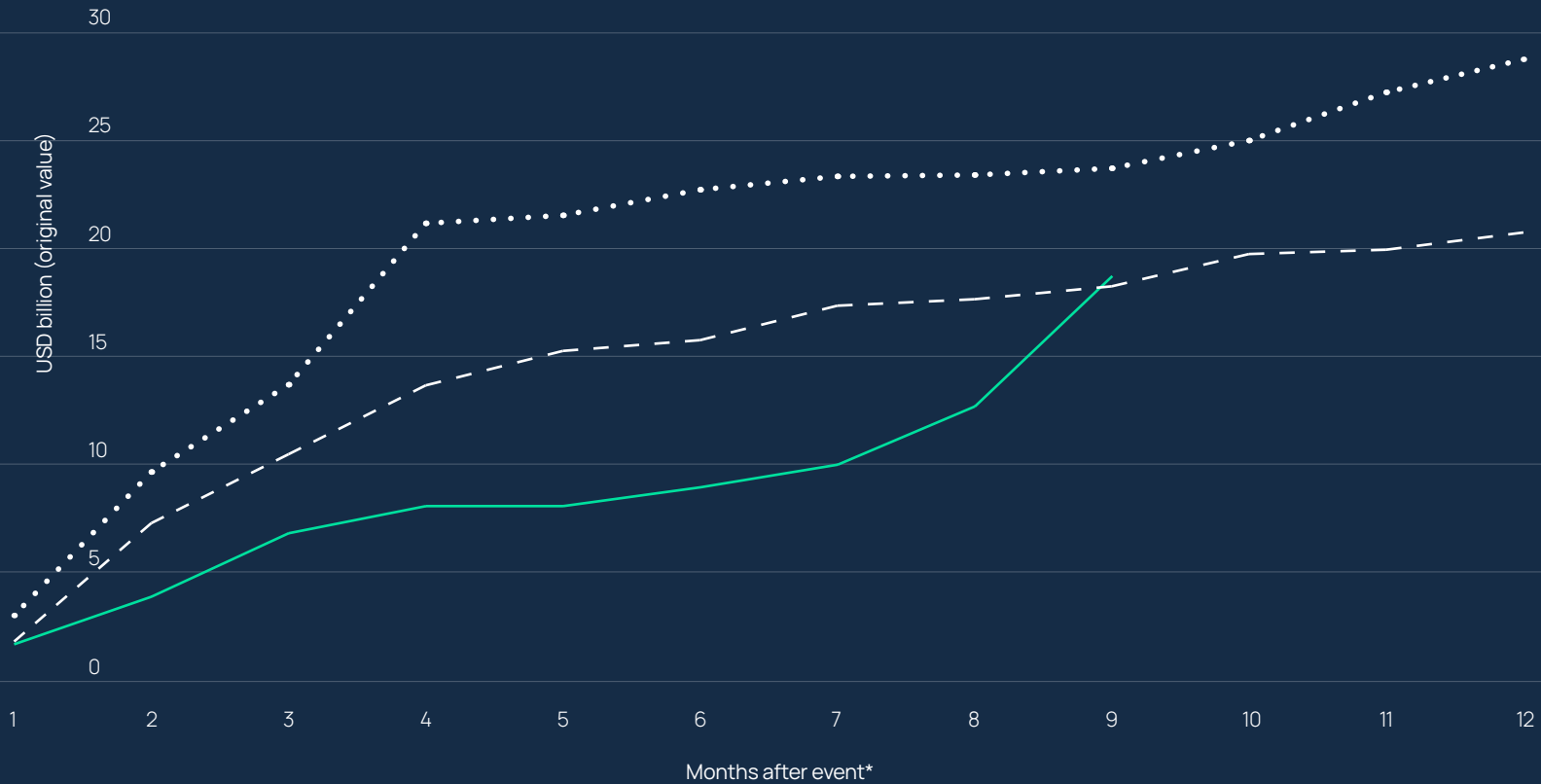
It is nevertheless worth reiterating here that the sector overall confronts these headwinds from a position of strength. Figure 24 shows that Howden's estimate of global insurance capital reached record levels in 2020, and is expected to remain broadly stable this year and next when it should support strong premium growth.

**Figure 24: Global insurance capital and premium (all lines) – 1999 to 2022E**

(Source: HX Analytics, Swiss Re, World Bank)



Capital impairment in 2020 has been offset by new capital generation. Significant raises post COVID by existing carriers, as well as the birth of several new companies, have led to comparisons with the capital generation that followed the 9.11 terrorist attacks and Hurricanes Katrina, Rita and Wilma (otherwise known as the Class of 2001 and the Class of 2005).

**Figure 25: Quantum and timeline of cumulative capital raising in 2020 vs 2005 and 2001**(Source: HX Analytics, S&P, Artemis)<sup>5</sup>

- — — 9.11 (2001)
- Katrina (2005)
- COVID-19 (2020)

\* Month 0 is September for 9.11, August for Katrina and March for COVID-19.

Figure 25 shows that the (re)insurance sector attracted substantial amounts of new capital in 2001/02 and 2005/06 to compensate for loss of capital and reduced capacity. 2020's inflows are now in the same range, with close to USD 20 billion of capital entering the market between March and the year end.<sup>5</sup> Additional fundraising is expected in 2021, following the trends established in 2001 and 2005, when capital inflows only started to stabilise 12 months after the date the of the event.

<sup>5</sup> This includes publicly available data on equity capital raises by new and incumbent carriers, as well as property catastrophe bonds and sidecars.



## Hard vs soft

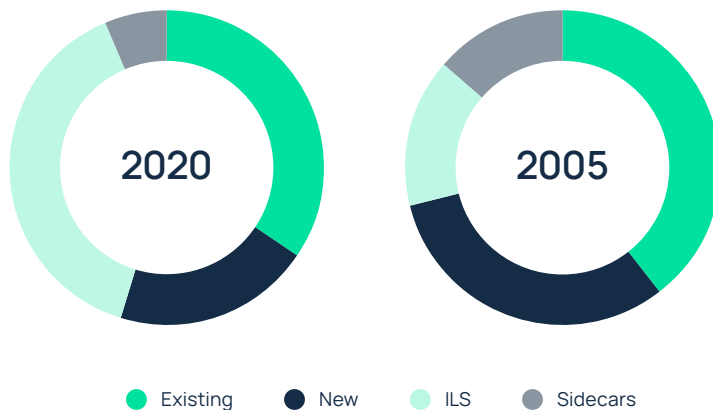
The amount of capital entering the market has triggered much speculation over whether this will choke off the rate momentum that was the source of its origin.

Arguments in favour of a more sustained hard market include:

<p>The amount of capital raised to date (approximately USD 20 billion) is small in the context of the broader market</p>	<p>Not all capital has been raised for growth, as some of the recent raises have been defensive in nature following outsized COVID losses</p>	<p>It will take time for some start-ups and scale-ups to deploy meaningful amounts of capacity (a fifth of new capital has gone to new ventures, although this is a down from nearly a third in 2005 – see Figure 26)</p>	<p>This pricing cycle is being driven by perceptions of risk, not capital supply.</p>
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**Figure 26: Type of capital raise – 2020 vs 2005**

(Source: HX Analytics, S&P, Artemis)



On the flip-side, less bullish observers argue that:

In contrast to previous shock events, there has been a relative lack of capital destruction in real terms in a still well-capitalised market.

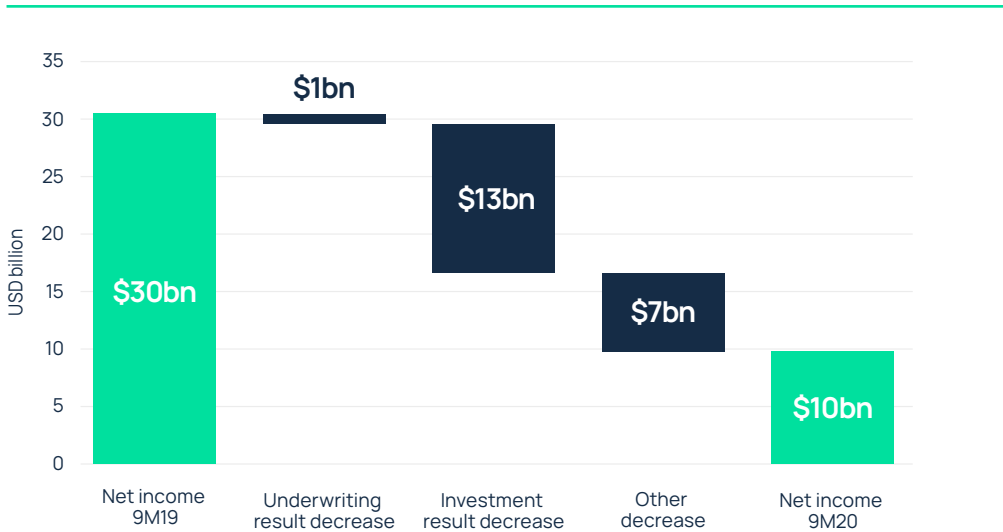
Contrast this with the period that began in 2001, the longest-lasting hard market in recent times, when USD 20 billion of capital raising coincided with the 9.11 terrorist attacks (a USD 40 billion loss) and the liability crisis, which is estimated to have cost the sector tens of billions of dollars in the early 2000s. The result was close to a 20% fall in the sector's capital position at year-end 2002 compared to the previous year.

'Risk-free' returns are obviously much lower today at near or below zero than in 2001, when medium-term government yields were as high as 5%. Carriers argue this makes profitable underwriting and price discipline an imperative. And, as mentioned earlier, there is continued concern about reserve adequacy, coming at a time of rising claims severity and frequency, discount rate pressure and, equally important, more than a decade of soft market conditions and competitive pricing.

Despite all these headwinds, the sector remained profitable in 2020. Even with COVID losses, isolated instances of reserve strengthening, elevated catastrophe activity and low investment income, the HX insurance composite reported USD 10 billion of net income in the first nine months of the year (see Figure 27).

**Figure 27: Drivers of net income from 9M19 to 9M20**

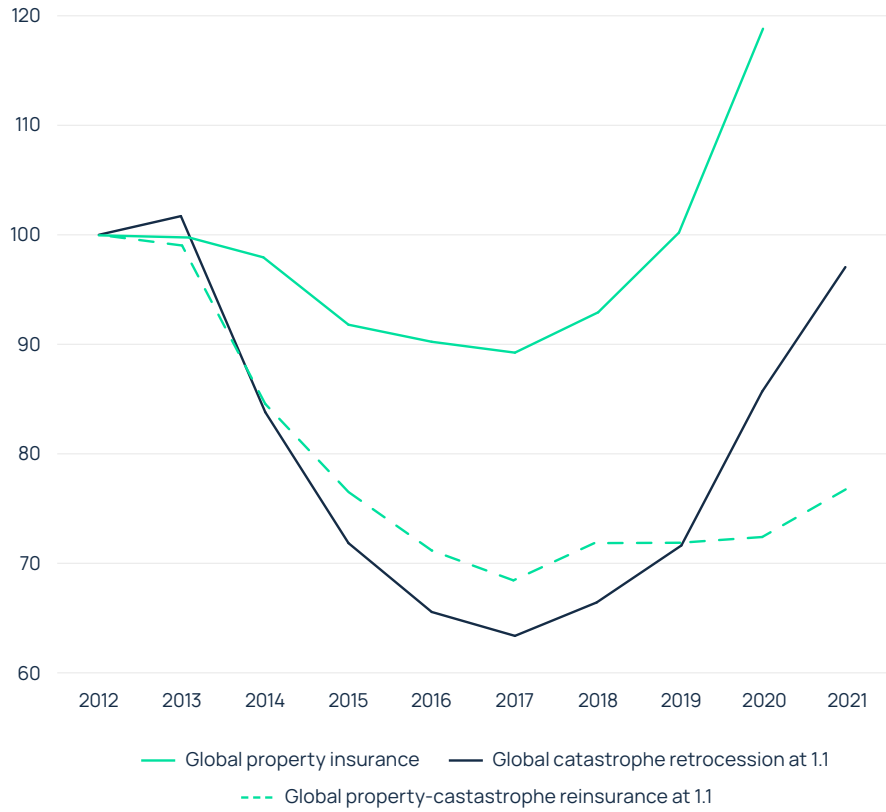
(Source: HX Nova Portal)



This is not to underplay the difficult operating environment: market conditions are the most adverse in over 15 years, and some stressed areas will continue to experience dislocation for a sustained period. Figure 28 shows that the primary and retrocession markets have seen the bulk of price increases since 2017 whilst reinsurance has lagged – the enduring U bend phase of the reinsurance market suggests carriers continue to apply a differentiated approach to rate increases, even after the 1 January 2021 reinsurance renewal.

**Figure 28: Howden pricing index for primary, reinsurance and retrocession markets – 2012 to 2021**

(Source: HX Nova Portal)



This ability to differentiate, even during these challenging times, points to more sophisticated and tailored underwriting in which performance and loss experience drive appetite and capacity deployment. Combined with the sector's strong balance sheet, and the influx of new capital seen in 2020, with more poised to enter in 2021, Howden believes this hard market, although unique, is more akin to 2005 (discriminate and relatively short-lived) rather than 2001 (universal and more prolonged), absent any further unforeseen events.

## Risk and reward

The world of risk transfer finds itself at an important juncture at the beginning of 2021. A series of megatrends – lower investment yields, higher loss cost trends, elevated catastrophe loss activity, concerns over climate change and general risk aversion – have coalesced to bring about one of the hardest markets in recent memory.

The desire for profitable underwriting during what is clearly one of the most significant periods of change in recent memory comes as businesses are facing huge financial pressures, or even fighting for survival.

This is the time for (re)insurers to secure their position as trusted partners. Whilst the pricing environment may be supportive for carriers in 2021, this should not translate into a degree of risk aversion where underwriters accept rate on renewals but shy away from new risks / new business and overlook much needed product innovation. Reality must match the rhetoric around creating new products and achieving both rate growth and exposure growth: it is a matter of long-term relevance.

(Re)insurers have served clients well in the past by learning important lessons from shock events. There is much to draw from the last 12 months. First and foremost, 2020 has reinforced the need to reimagine the issue of insurability in order to respond to the changing needs of (re)insurance buyers and close protection gaps. COVID has brought the growing 'intangibility' of risk into focus, a trend that is only going to accelerate as new technologies continue to redefine risk characteristics.

The global risk landscape is changing like never before, which only serves to underscore the importance of risk transfer. Irrespective of what happens to the market cycle in 2021, the (re)insurance market must seize the opportunity and focus on doing what it has done so well several times over: innovate and develop creative solutions for the changing needs of clients.

This report is the first in a non-periodical series which seeks to provide impactful analysis of highly pertinent client issues. By bringing important sector trends to the fore, Howden will inform the discussion, enabling us to facilitate the most innovative client solutions. We look forward to working closely with insurance and reinsurance companies to do just that, and supporting clients in managing change and securing the best coverage available in the marketplace.

REALITY MUST MATCH THE RHETORIC  
AROUND CREATING NEW PRODUCTS  
AND ACHIEVING BOTH RATE GROWTH  
AND EXPOSURE GROWTH: IT IS A  
MATTER OF LONG-TERM RELEVANCE.

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