Global (re)insurance: Underlying profitability improves at H1 but inflation and rate deceleration remain concerns

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Strategic & Financial Analytics
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Summary

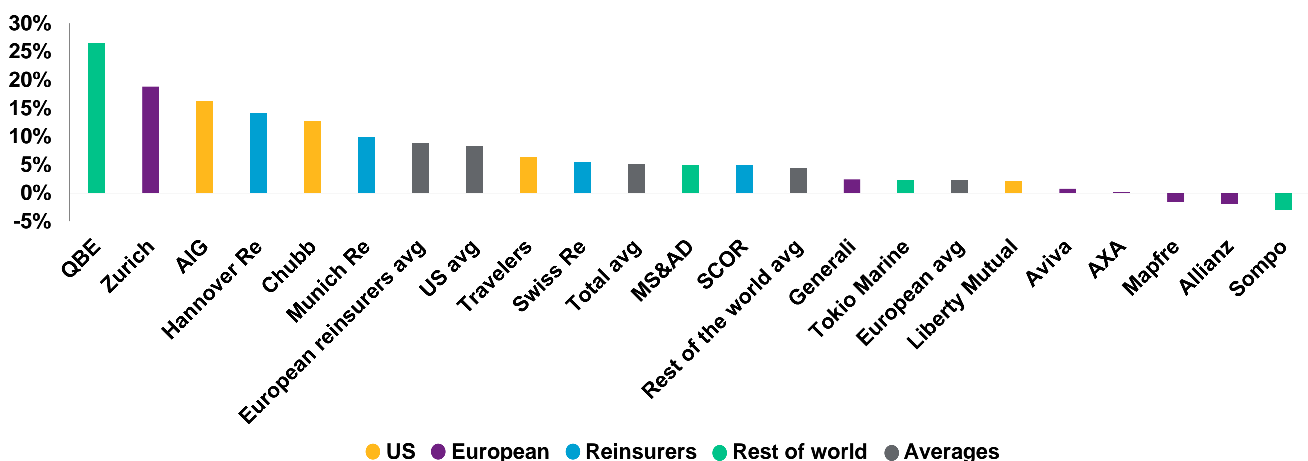
- This note summarises the key themes emerging from global (re)insurers' H1 2021 results[1]
- We track 18 of the biggest (re)insurers globally who have meaningful commercial lines or reinsurance operations
- Continued favourable pricing, particularly for commercial lines business, supported meaningful premium growth for the majority of the (re)insurers we track
- Underlying combined ratios improved significantly in H1 due to rate increases outstripping claim trends. Headline combined ratios also improved, supported by lower than normal personal lines loss frequency, and, for many, robust reserve releases, and came despite a higher than average level of nat cat losses
- European solvency ratios improved at H1 21, largely returning to end-2019 pre-COVID levels. H1 21 solvency improvement was mainly due to a rise in risk-free interest rates compared to year-end 2020 levels. This provided a boost to sector solvency as the reduction in liabilities, which are discounted at risk-free rates under Solvency II, exceeded the reduction in bond portfolio values. Rising equity markets and retained profitability also provided support
- As was the case following Q1 results, analyst consensus earnings estimates edged up due to higher than anticipated premium growth and underlying profitability
- Despite the strong H1, two concerns weigh on the outlook: the decelerating rating environment and the prospect of higher inflation

Continued favourable pricing, particularly for commercial lines business, supported meaningful premium growth for the majority of the (re)insurers we track

The majority of the (re)insurers reported further growth in premium in H1 21. Double digit premium increases were reported by six of the (re)insurers. The largest premium increase was QBE's rise of 26% which was supported by substantial growth of its North America crop business, partly due to rising commodity prices.

Growth was largely fuelled by continued favourable pricing for commercial lines business. Rate increases for reinsurance and retail insurance also supported premium growth, albeit to a lesser extent. Management teams are typically expecting favourable pricing to continue for the remainder of the year and into 2022, although some cautioned that rate increases going forward are likely to be less significant, and indeed have already started to ease in certain parts of their portfolios.

Growth in P&C premiums – H1 2021 vs H1 2020[2]



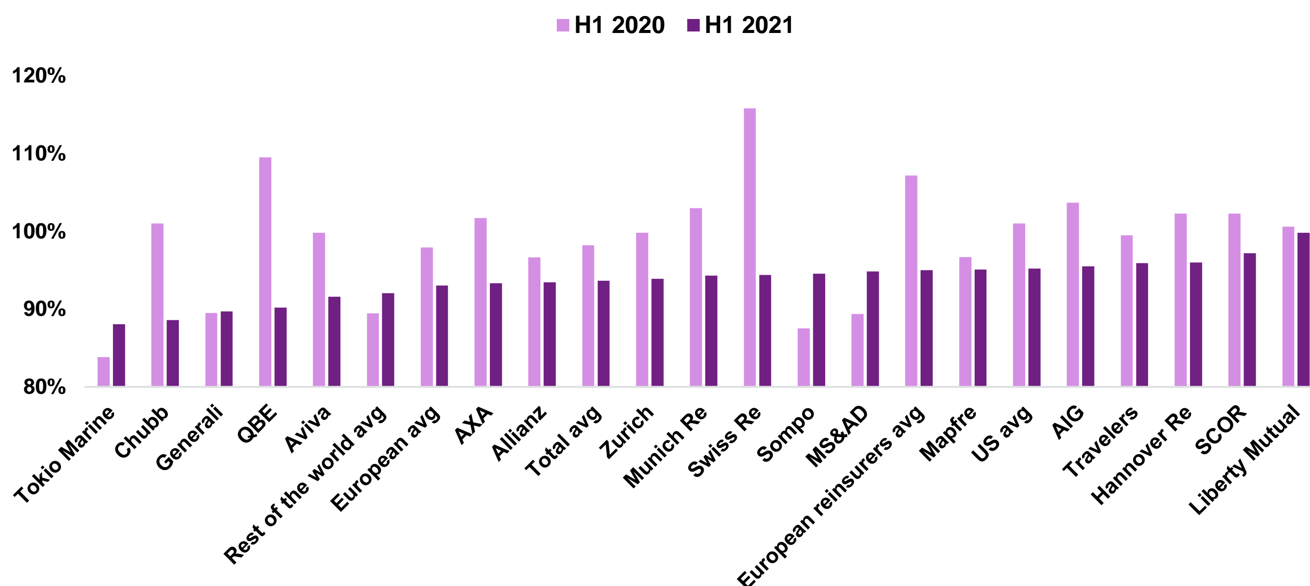
Source: Company disclosures, Willis Re

1 Unless otherwise indicated, we are referring to the January-June 2021 period. For the three Japanese insurers who have a March year-end, this aligns with their Q4 20 and Q1 21 reporting periods.
2 Except as noted, premiums are net premiums written. For Aviva, Hannover Re, Munich Re, and Mapfre, premiums are net earned premium. For AXA, premiums are P&C segment gross revenue.

Strong improvement in headline and underlying combined ratios

H1 underwriting results, as was seen in Q1, were exceptionally strong. The average combined ratio for the (re)insurers was 93.7%, with every company posting a sub-100% combined ratio. This performance was much improved versus H1 2020, which included significant COVID losses, and came despite a higher than average level of nat cat losses (although a lighter Q2 partly compensated for winter storm Uri in Q1). The result was aided by lower than normal loss frequency in personal lines due to the continuing COVID impact, and, for many, robust reserve releases. Most importantly, though, (re)insurers are also legitimately pointing to improved underlying results, with rate increases outstripping claim trends. A number of companies pointed to 2-3 percentage points of underlying improvement.

Combined ratios – H1 2021 vs H1 2020[3]



Source: Company disclosures, Willis Re

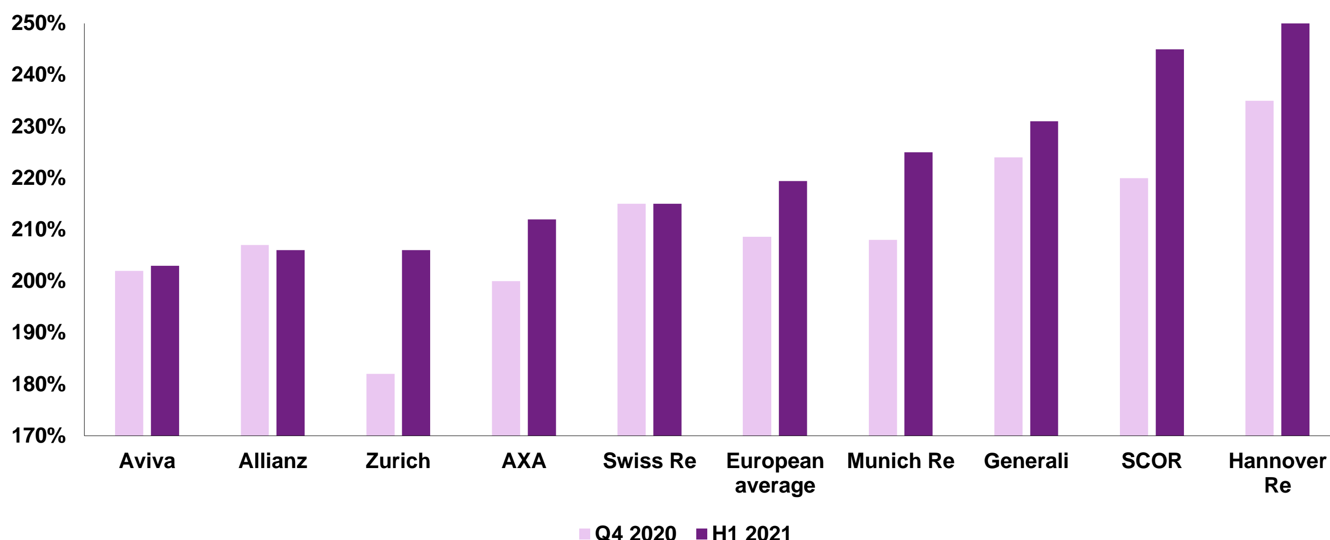
Strong European sector solvency raises expectations for improved capital returns

European sector solvency increased to 219% at H1 21 (Year-end 2020: 209%), which is a return to the pre-COVID level at year-end 2019. The key driver of the improvement in solvency during H1 21 was an inflation related rise in risk-free interest rates which occurred in Q1. Although this trend partially reversed in Q2 as inflation concerns eased, risk-free rates at H1 21 remained above year-end 2020 levels. This provided a boost to sector solvency as the reduction in liabilities, which are discounted at risk-free rates under Solvency II, exceeded the reduction in bond portfolio values. Rising equity markets and retained profitability also supported improvement in solvency during H1. As was the case at Q1, sector solvency remains at the upper end of management guidance levels. Although some of this buffer will be used to fund growth, we expect improved capital returns in 2021 and 2022.

While US-based companies report their risk-based capital (RBC) measure only on the full year, it is worth noting that the National Association of Insurance Commissioners have agreed changes to the calculation, expected to be applicable for year-end 2021 reporting, that will reduce the capital charge for ceded catastrophe exposure (part of the 'R-Cat' charge) by approximately 60%. For companies with significant cat exposure and large catastrophe programs (such as Florida writers), this could have a significant beneficial impact come February 2022 when RBC is reported as part of company annual filings.

[3] Combined ratios for the three Japanese insurers relate to these companies' domestic operations rather than their group-wide activities. Combined ratios for Swiss Re and Munich Re relate to their P&C reinsurance segments.

Solvency ratios – H1 2021 vs Q4 2020[4]

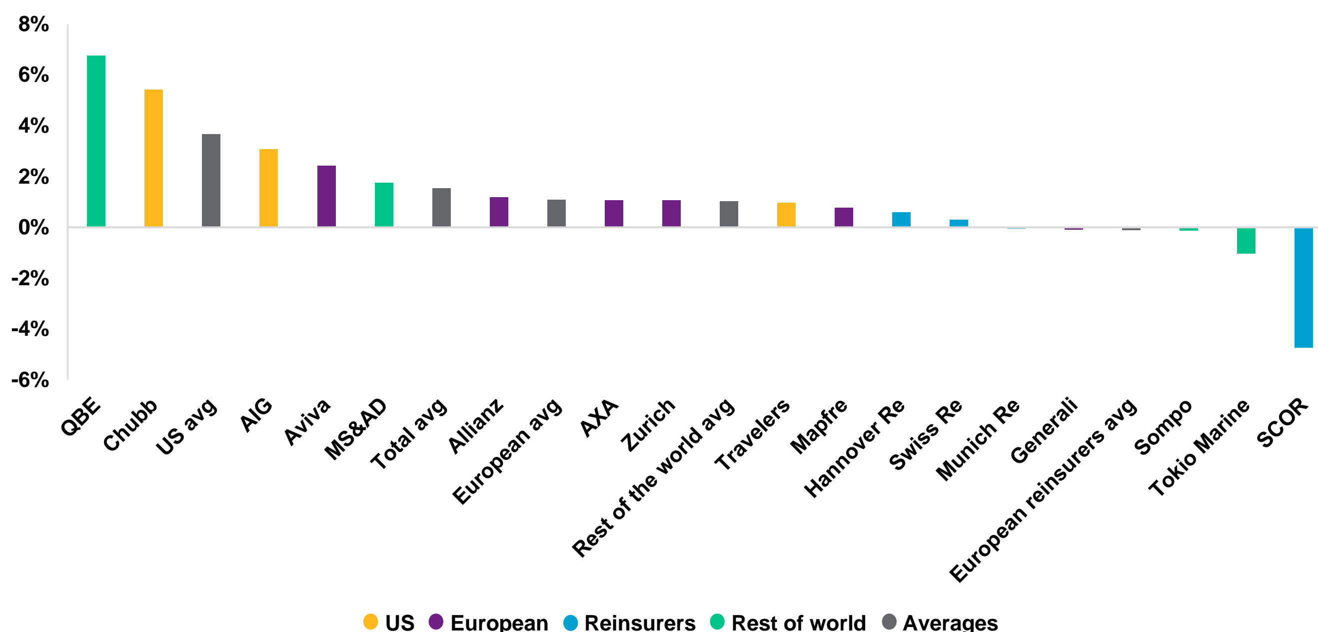


Source: Company disclosures, Willis Re

Above analyst consensus premium growth and underlying profitability drive EPS estimates higher

As was the case following Q1 results, analyst consensus earnings estimates have edged up as a result of the strong H1 results. Analyst consensus estimates for 2022 EPS (which are uncontaminated by any one-off impacts in H1 2021) rose by 1.4% on average, with the US commercial lines companies rising the most, by 3.4% on average. The main drivers were better than expected premium growth and underlying combined ratios. QBE and Chubb each have seen nearly 5% increases in consensus. SCOR is the exception, with consensus down by nearly 5%. A large life retrocession transaction with Covea has freed up capital but analysts have also factored in an expected loss of future earnings.

Change in consensus 2022 EPS estimates[5]



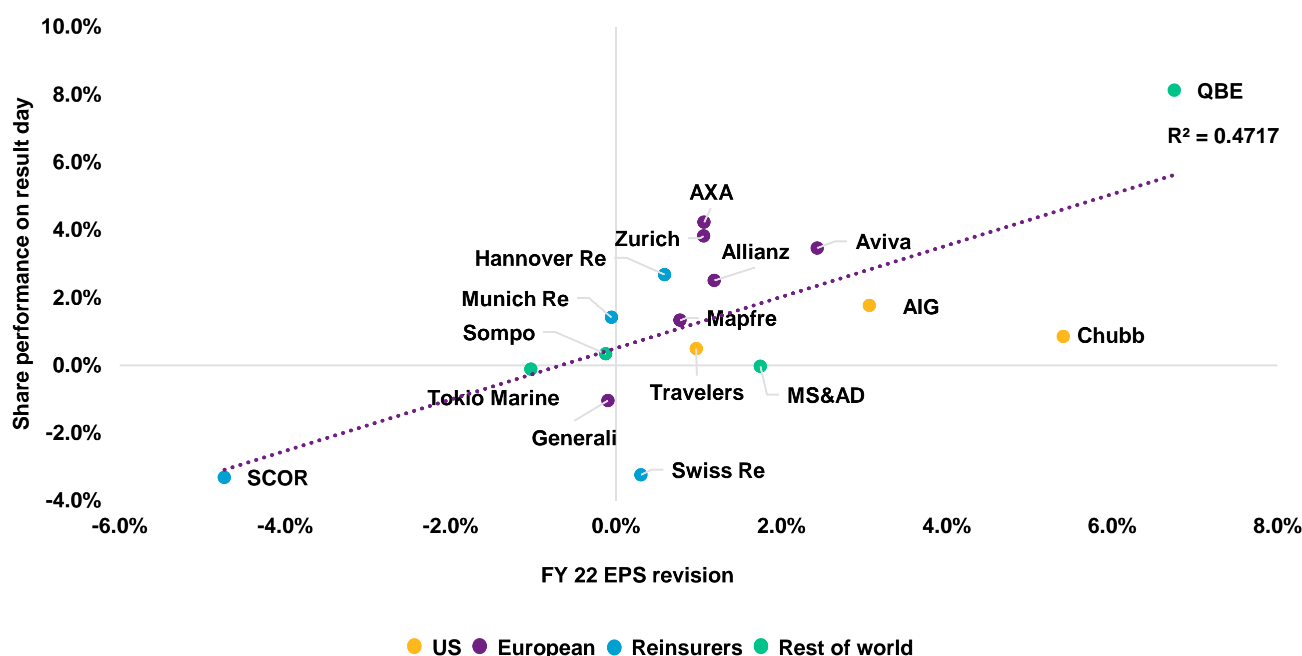
Source: Capital IQ

As the scatter diagram on page 4 shows, stock performances on the day of results broadly track how consensus estimates have moved, with a strong performance from QBE and weak from SCOR. In general, share prices have reacted well, justifiably well in our view, to the strong H1 reporting season. The S&P 500 P&C, for example, is up 4.6% since the end of July, well ahead of the

[4] Swiss Re's H1 21 solvency is not available; Q4 20 solvency is used as an estimate for H1 21.
[5] Consensus EPS estimates five days after results vs one day prior. For MS&AD, Sompo and Tokio Marine, EPS estimates for 2022 correspond to y/e March 2023.

1.7% rise in the overall S&P 500. This follows a fairly anemic development in H1 (S&P 500 P&C up 8.0% versus the overall S&P 500 up 14.4%) which most commentators found hard to explain given the backdrop of supportive fundamentals.

Share price performance vs EPS revisions[6]



Despite the strong H1, two concerns continue to weigh on the outlook and, by extension, share price performance. One is the deceleration of the rating environment. This has led to questions about the longevity of the current cyclical upswing. It remains the case, however, that price increases are running well ahead of overall current claims inflation. The second concern is whether inflation will continue to increase.

Inflation concerns weigh on sector

Concerns around the inflation outlook are understandable. Over the past several months, the insurance industry has faced the threat of rising inflation which has not been a significant issue since the 1980's. Recent inflation trends have significantly increased during the post pandemic economic recovery. Whether this result is a "bounce back" effect or a longer-term trend is yet to be determined. However, the negative impact of rising inflation on the insurance industry's financial position is leveraged and multi-faceted affecting both profitability and capital position.

From an underwriting perspective, during times of unanticipated inflation, there is usually an increase in loss ratios given the typical lag in pricing response. In the current pricing cycle, companies appear to be proactively taking pricing action, but it remains to be seen whether it is sufficient. For reinsurance, it is important to note that loss trend on excess of loss layers is higher than ground up trend. This effect increases the relative value of excess of loss reinsurance as an inflation hedge. On the positive side, overall premiums increase with inflation sensitive exposure bases (e.g. sales, payroll) as well as real economic growth.

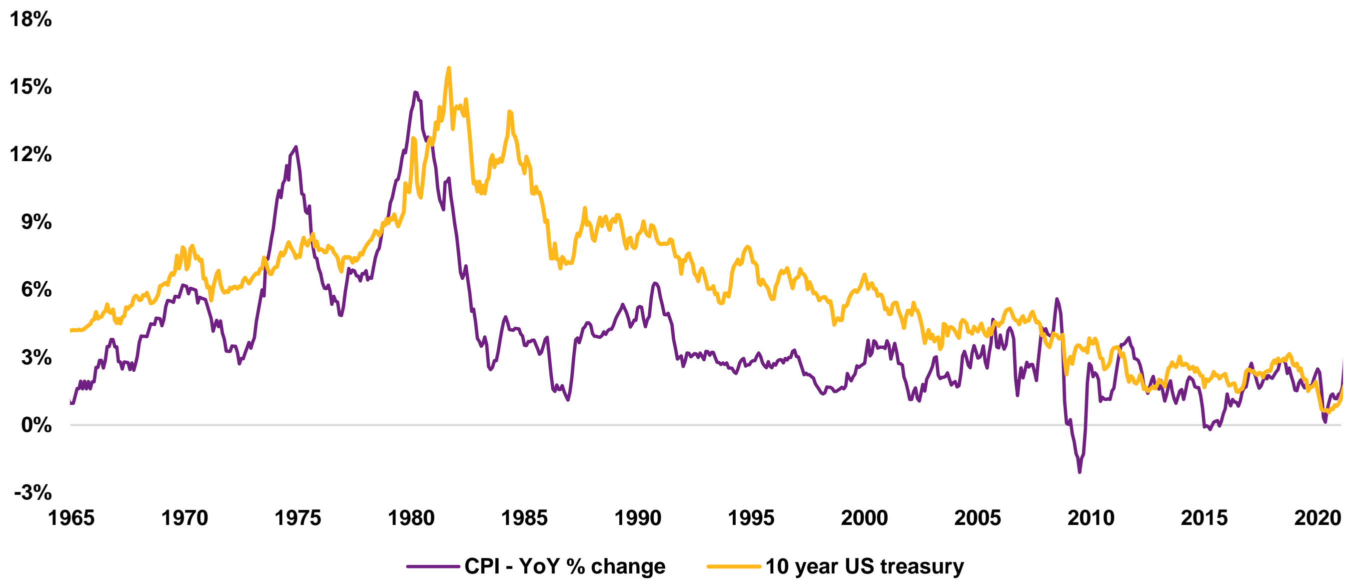
With respect to carried reserves, if inflation spikes above the historical trends reflected in the actuarial reserving data, losses will tend to ultimately develop greater than currently booked. The impact of inflation on long tail reserves is greater as more of incurred losses in older years will be paid out with newly inflated costs. Also, writing long tail business accumulates reserves to a multiple of current premiums magnifying the risk of adverse development. In addition to reserve uncertainty, the economic value of holding reserves has been pressured as recent interest rate increases have lagged the rising trend in inflation making reserve transfer solutions (ADC/LPTs) potentially more attractive.

On the asset side, as inflation rates (or fears) increase, interest rates typically go up. As noted, currently interest rate increases have been more moderate than inflation, but they have increased from their 2020 lows. Given insurance companies hold large bond portfolios whose market prices go down as interest rates go up, this poses a significant risk to their asset values.

[6] Consensus EPS estimates five days after results vs one day prior. For MS&AD, Sompo and Tokio Marine, EPS estimates for 2022 correspond to y/e March 2023.

Therefore, taken as a whole, inflation potentially can put a significant squeeze on a company's profitability and capital position by increasing losses and liabilities while decreasing the value of its assets.[7]

US inflation rate (CPI) vs 10-year US treasury



Source: Capital IQ

[7] Note : Rising interest rates increase regulatory capital levels for Solvency II and certain other regimes which discount liabilities at risk-free rates.

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