NEWSLETTER
INSURANCE AND FINANCE

THE GENEVA ASSOCIATION

No. 15, February 2015

The Global Economic and Re/insurance Market Outlook—Economic Outlook

By Kurt Karl[+]

Aside from the U.S., growth in many of the other major economic regions slowed into the middle of 2014. The euro area weakened significantly in the second quarter as Germany's economy contracted. Nevertheless, euro area average growth in 2014 was significantly stronger than in 2013, due to the statistical effects resulting from a strong second half in 2013 and first quarter in 2014. Another bright spot is the U.K., with fairly robust growth in 2014. Growth in China has been a little lower than expected and Japan's economy shrank more than expected in the second quarter of 2014 in the aftermath of a sales tax hike. Many emerging markets are strengthening, but the outlook has become more uncertain given the expectation that the U.S. Federal Reserve (Fed) will begin raising interest rates next year. Insurers and reinsurers premium growth will be close to nominal gross domestic product (GDP) growth in the advanced economies and a bit stronger than nominal GDP in the emerging markets.

Overall, however, the global economy is still expected to improve modestly in 2015, with slightly stronger growth in many countries, especially the U.S. The improvement in the U.S. will come from stronger consumer spending, investment and home building. Growth is also expected to improve in the euro area, but not in China, Japan or the U.K. Of the major emerging markets, Brazil and India are expected to have stronger growth, while growth in Russia could be negative, given the sanctions and drop in oil prices. The projection for slightly faster global growth in 2015 is consistent with International Monetary Fund (IMF) and World Bank (WB) forecasts. These institutions both have growth increasing by about 0.2 percentage points in 2015, to 3.5 per cent from 3.3 per cent this year (IMF) and to 3 per cent from 2.8 per cent (WB). The greatest downside risk is a major slowdown in the euro area leading to a deflationary period of stagnation.

Monetary policy is expected to tighten next year in the U.S. and U.K., with both countries raising their policy rates, and remains highly accommodative in the euro area and Japan. This divergence of monetary policies will very likely strengthen the U.S. dollar and U.K. pound against the euro and the yen. China continues to try to steer its economy towards economic growth with subdued credit expansion. This is not an easy task and the risk of a hard landing remains.

In this macroeconomic environment, yields on benchmark government bonds are forecast to rise at a more rapid pace in the U.S. and U.K. than in the euro area and Japan. As growth strengthens and the Fed raises rates, the yield on the 10-year Treasury note will climb to 3.5 per cent by end of next year and to 4.5 per cent by end-2016. Yields in the U.K. will rise to similar levels, but yields in the euro area and Japan will move up by less than 100 basis points by end-2016. Though rates will be rising, insurers and reinsurers face declining investment yields on their bond portfolios for a couple more years yet, as higher yielding bonds mature and are replaced with the current lower yielding bonds.

[+] Chief Economist, Swiss Re.

Re/insurance capacity

There have been two key factors which have recently affected reinsurance and insurance (re/insurance) capacity. First, the below average catastrophe year in 2013, which added USD 18bn to capacity, as well as the 2014 catastrophe year, which was also a below average cat year. In addition, it is key that there have been low North American hurricane losses since 2005, which is important for the alternative capital (AC) market. Much of the risk taken on by AC is North America hurricane risk, so this capacity has had a lucky run of low losses.

The second factor for capacity has been the benign development of claims on casualty business, resulting in major reserve releases. These have added to profits and capital in the industry. From about 2006 to 2011, this created a softening market with declining casualty prices. About 2011, the surveys of primary insurance in the U.S. indicated a slight move upwards, but this has recently been very mixed. Some markets have had price rises, some declines, so prices have been fairly flat overall. But, in any case, underwriting has remained remarkably disciplined. This could be due to the low investment yield environment. Since profits for casualty business is more dependent than property business for profits from investments, insurers and reinsurers have needed to be conservative in pricing the new casualty business.

Property cycle and AC

AC has grown rapidly in recent years. Overall, the size of the market is now about USD 59bn, compared to global capacity in reinsurance of about USD 570bn, according to Aon. To a certain extent, the low interest rate environment has driven capital into catastrophe bond funds, as investors—hedge funds and pension funds—in search for yield. The inflows need to be invested for the cat bond funds to obtain their fees, but there were simply insufficient cat bonds available. Thus, a new investment vehicle was created, collateralised reinsurance, and it is this type of AC which has been growing rapidly for the past few years.

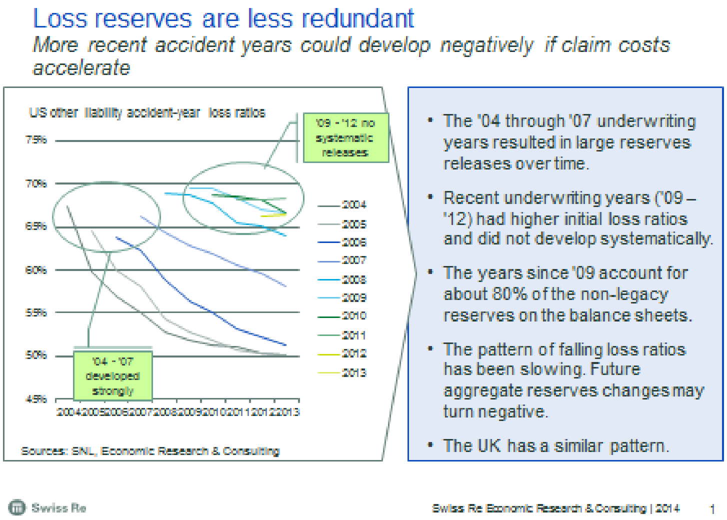
AC has mostly affected catastrophe reinsurance prices in North America, since about 70 per cent of the overall AC market is based on North American hurricane risk. Prices are now close to technical pricing in both the AC market and reinsurance, so maintaining underwriting discipline is now essential for profitability.

On pricing, AC is helping to lower prices and this will continue at least through the January renewals. However, the pace of decline is expected to moderate. AC is also projected to be with us for some time to come, dampening the property cat pricing cycle. This is good for our clients, but not good for re/insurance profitability.

One concern about AC is that it will enter into market segments other than catastrophe property lines. It is difficult to see it getting into casualty lines, because of the long duration of the casualty liabilities, which would be challenging for a hedge fund to manage over several years. Nevertheless, Hedge Fund Re (a rated vehicles backed by hedge funds) is now targeting low volatility casualty business to get float for their hedge fund investment strategy.

The market for AC is untested: it has not yet had to react to a sharp rise in interest rates, nor has there been a major North American hurricane recently. As interest rates rise, there may be less capital flowing into the dedicated cat bond funds. A major hurricane event in North America would also likely discourage the pension fund managers, but perhaps not the hedge fund managers who now often have a cat risk team which is familiar with the cat modelling. On balance, AC is expected to be a part of the market for some time, though its pace of growth is likely to slow as interest rates rise.

AC appears to primarily compete with smaller reinsurers, which mostly provide capital to the market at a competitive price. Larger reinsurers with a full range of services, including training and support on actuarial, underwriting and claims activities, are likely to fare better.



Casualty pricing cycle

Casualty prices began falling after 2006, but have been stable-to-up since 2011. This pricing pattern is unusual: normally, the price increases and drops are very steep. Typically, prices would decline until reserve releases turned into adverse developments, but this has not happened yet and still prices stopped falling.

The benign claims environment is expected to change over the next couple of years for two reasons. First, the underlying drivers of claims-cost escalation (often called claims inflation)—general inflation, wage gains and medical costs—are expected to be accelerating after a long period of moderation. This acceleration will stem from growing economies, tightening labour markets and increased pressure on medical services from an ageing population. Second, the development of accident year loss ratios implies that positive reserve surprises should be coming to an end. In the U.S. and U.K., where we have data, the 2004 accident loss ratio declined for a number of years as the industry was continually surprised by the low claims. These improvements are over. For more recent accident years, the loss ratios are not improving over time—they are basically flat. Thus, there are no new surprises from claims coming—the business has been priced about right, and the claims are coming in as expected. For more on this topic, please see our Swiss Re sigma 4/2014.

Outlook

In conclusion, prices on casualty lines are expected to rise, given that claims are expected to increase and adverse reserve developments are likely to be over within a couple of years. The rise in prices is unlikely to be steep however, because claims cost increases and adverse development are both projected to be modest. The increase in claims should also boost demand for casualty insurance.

On natural catastrophe pricing, prices are expected to remain under pressure at the 2015 renewals, but the decrease in prices is expected to slow. The slowdown in price declines will be facilitated by underwriting discipline—given current price levels this is necessary—and also by reinsurers shedding capital through dividends and stock buybacks.