Swiss Re Institute

sigma 50 YEARS

News release

Improved economic momentum alone will not close current profitability gaps in major non-life insurance markets, *sigma* says

- Non-life underwriting margins in major western markets and Japan need to improve by around 5 to 9 percentage points in order to deliver sustainable returns
- Supportive macroeconomic developments alone are unlikely to close this existing profitability gap
- Premium rate increases are needed to restore profitability to sustainable levels
- Insurance stocks have delivered profitability on par with other sectors over the long run, and offer diversification benefits
- Investments in technology will lead to efficiency gains in the longer run

Zurich, 8 September 2018 – Worldwide, most major non-life insurance markets are in a phase of below-average profitability. The latest *sigma* report from the Swiss Re Institute, "Profitability in non-life insurance: mind the gap", assesses the existing earnings gap in the non-life insurance sector. The analysis shows that insurers in major western markets and Japan need to improve underwriting margins (underwriting profit as a percentage of premiums) by around 5 to 9 percentage points if they are to deliver desired return on equity (ROE) of 10% in the future. Current economic momentum will benefit future profitability through higher interest rates and investment returns but it won't be enough to close the gaps. At the same time, tighter labour markets are expected to push up wage and claims inflation. Thus, premium rates need to increase more than claims trends to achieve sustainable improvement in profitability.

The global non-life insurance sector is at a weak phase of the profitability cycle, reflecting soft underwriting conditions, weak investment performance and the high level of capital funds. Sector ROE slipped further to 6% last year, from 7% in 2016 and the roughly 9% achieved annually between 2013 and 2015.

2017 cat season may have triggered an inflection point

Underwriting conditions are still soft in 2018, particularly in commercial insurance, but seem to be passing through an inflection point. This is on account of the large hurricane losses in 2017 which set the stage for a price correction. Commercial line premium rates started to rise at the end of 2017.

Media Relations, Zurich
Telephone +41 43 285 7171

Thomas Holzheu
Telephone +1 914 828 6502

Roman Lechner
Telephone +41 34 285 23 44

Dr Jérôme Jean Haegeli
Telephone +41 43 285 86 92

Swiss Re Ltd
Mythenquai 50/60
CH-8022 Zurich

Telephone +41 43 285 2121
Fax +41 43 285 2999

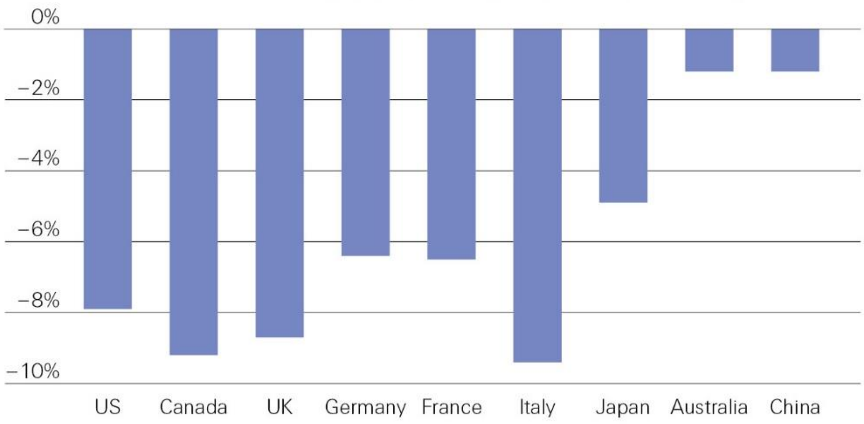
www.swissre.com
@SwissRe

"The catastrophe losses in 2017 sparked a modest change in market dynamics", says Edouard Schmid, Swiss Re Group Chief Underwriting Officer. "However, it remains to be seen how strong and sustainable the market firming is. Rate increases for accounts and commercial lines of business not affected by the catastrophe losses, for instance, have been below initial expectations." In personal lines, there has been moderate rate hardening in several key markets for a few years already.

Premium rates need to increase substantially to restore profitability

In spite of the modest premium rate hardening, the *sigma* shows that more work to improve underwriting performance needs to be done if current shortfalls in profitability are to be redressed. Underwriting margins need to improve by around 5 to 9 percentage points in major western markets and Japan to deliver the desired ROE of 10% to investors.

Figure 1: Underwriting profitability gaps (as percentage of premiums) in nine major markets



Source: Swiss Re Institute

Economic developments alone will not close the profitability gap

Interest rates and non-life insurers' underwriting results are interrelated in the long run. In the past, during periods of higher interest rates, stronger investment returns were offset by larger underwriting losses. By contrast, in the current cycle underwriting results have deteriorated without the benefit of compensating rising yields, as the slow post-crisis recovery has led to a prolonged backdrop of low interest rates.

Underlying economic growth improved strongly in 2017, and this is expected to continue in 2018, putting upward pressure on inflation and interest rates. Central banks in many countries are already withdrawing monetary stimulus to ward off overheating. This signals a changing operating environment for non-life insurers.

"Under the current stronger economic conditions, we expect interest rates in mature markets to continue to rise moderately, which should support insurers' earnings through higher investment returns", says Jérôme Jean Haegeli, Group Chief Economist at Swiss Re. However, "macroeconomic developments alone are unlikely to generate sustained improvement in non-life sector profitability. The trend of declining investment yields has bottomed but at the same time, the increase in long-term interest rates that we foresee is not substantial."

Moreover, tighter labour markets are projected to push up general and claims inflation, creating an offsetting effect on profitability. The accelerating claims inflation will have the added impact of eroding the adequacy of claims reserves and further affirms that, in order to achieve sustainable improvement in sector profitability, insurance premium rate increases in excess of rising claims trends will be needed.

Long-run performance in line with other industries

In its analysis of the profitability cycle, this *sigma* shows that over the long run, insurance companies have delivered a level of profitability comparable with firms in other sectors. In line with these profit trends, a two-decade comparison of non-life insurers' stock market performance suggests at par or even above-par valuation. Furthermore, insurance stocks demonstrate low correlation of price returns with other industry sectors and thus offer value to investors in the form of diversification benefits.

Underlying trends indicate that underwriting cycles are strongly integrated globally and across lines of business. The analysis in the *sigma* identifies a general cyclical pattern, but also some idiosyncratic variations due to natural catastrophe losses and a degree of country- and line-specific pricing trends. Hence, writing non-life business across lines and countries brings diversification benefits to an insurer's underwriting portfolio. Another finding is that the average duration of the cycle seems to have lengthened since the early 1980s, when central banks changed their policy focus toward fighting inflation and large parts of the financial services industry were deregulated.

Investments in technology benefit efficiency and insurability

The pressure on non-life earnings has heightened interest in innovation. Insurers' investments in technology have led to efficiency gains and compressed margins for the distribution system in commoditised lines. In some lines of business, the adoption of technology has also reduced claims costs. The benefits to profitability are initially clouded by the gains being partially passed on to consumers through competition, and also by the cost of investment in technology.

Over the long run, investments in data and advanced analytics improve efficiency, underwriting and the insurability of increasingly complex risks, be it through improved affordability, access or better ability to underwrite new and hard-to-quantify risks.

Swiss Re
Institute

Notes to editors

This year marks the 50th anniversary of *sigma*, Swiss Re's flagship and the insurance industry's leading research publication. Please visit the *sigma* 50-years section on the Swiss Re Institute website to find out more about the evolution of *sigma*, and the breadth and depth of the overall research offering from the Swiss Re Institute: institute.swissre.com/sigma50years

Swiss Re

The Swiss Re Group is one of the world's leading providers of reinsurance, insurance and other forms of insurance-based risk transfer, working to make the world more resilient. It anticipates and manages risk – from natural catastrophes to climate change, from ageing populations to cyber crime. The aim of the Swiss Re Group is to enable society to thrive and progress, creating new opportunities and solutions for its clients. Headquartered in Zurich, Switzerland, where it was founded in 1863, the Swiss Re Group operates through a network of around 80 offices globally. It is organised into three Business Units, each with a distinct strategy and set of objectives contributing to the Group's overall mission.

How to order this *sigma* study:

The English, German, French, and Spanish versions of the *sigma* No 4/2018, "Profitability in non-life insurance: mind the gap" are available electronically on the Swiss Re Institute's website: institute.swissre.com

Printed editions of *sigma* No 4/2018 in English, German, French and Spanish are available. The printed versions in Chinese and Japanese will be available in the near future. Please send your orders, complete with your full postal address, institute@swissre.com

sigma 50 YEARS