

Insurance

Risk Managemen

Consulting



Most policyholders don't realize that by the time they receive quotes or a policy, the capital covering their risk has already made its way through many different stakeholders who influence the policyholder's premium, deductibles, limits, and terms and conditions (T&C). A better understanding of the insurance supply chain will allow insureds to untangle the complicated web of factors that impact the pricing and coverage they receive.

Investors at the top of the insurance supply chain are demanding more reasonable returns on investment. In recent years, reinsurers have struggled to achieve returns above their cost of capital. Compounded by increased loss costs from climate change, social inflation and economic inflation, the difficult conditions upstream in the insurance supply chain are being passed downstream to policyholders.

The following graphic is a simplified analogy used to illustrate this process.

## **EVENT** THE SUPPLY CHAIN **EFFECT Supply of Capital** = Raw materials INVESTMENT Insurers must deploy more capacity to ROI or LOSS Persistently high inflation has driven up • For example, Insurance linked cover the exact same risks they did one replacement costs. year ago. Increased Demand securities are derivatives or security for Capacity instruments linked to insurance risks. An insured loss underlying the security affects the ILS value. In high interest rate environments, **Retrocessional Capacity** = Supplier risky investments like ILS draw fewer Rising interest rates offer investors investors/less capital because their alternative "risk-free" options, making Smaller reinsurers use retro capacity performance is influenced by insured risky investments less attractive. to transfer risk. loss events. Decreased Supply of Capital/Capacity Larger reinsurers might skip this step and go directly to capital markets. Rising interest rates have created **Reinsurance Capacity** = Manufacturer mark-to-market declines in the value of "Paper losses" still require insurers to Primary insurers (cedants) transfer fixed income assets held by carriers. If hold more cash on hand to meet capital these assets are not sold, then the losses adequacy requirements. **Decreased** risk to reinsurers. are not realized. These are referred to as Supply of Capital/Capacity **Cedant Capacity** = Distributor • Primary insurers offer policies to insureds and pay losses. Paying massive losses contributes to capital Insured losses for 2021 and 2022 erosion. Global reinsurance dedicated capital **Broker** = Retailer were \$116 billion and \$140 billion totaled \$638 billion at full-year 2022. This is respectively. Policyholder = Consumer of Capital/Capacity

## Cost of capital

When reinsurers are able to source capital from both outside investors and premiums paid, the supply of capital increases, making it easier for reinsurers to meet capacity demands. When less capital flows in at the top of the supply chain, supply decreases and reinsurers must change how they meet demand. The burden for the supply of capital shifts heavily to premiums paid instead of being shared with invested capital. The policyholder will eventually feel the changes that reinsurers make.

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## Implications for insureds

Reinsurers responded to the increased cost of capital by increasing rates, deductibles and attachment points at which reinsurance coverage kicks in and reducing the amount of capacity they are offering to primary insurers. These trends are passed down to policyholders who can expect increased premiums/rates, decreased capacity, increased deductibles, and tighter terms and conditions.

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