Rethinking Reinsurance: How Insurers Can Succeed in Today’s Risk-Funding Landscape

Today’s insurance industry is at a crossroads. Insurers are challenged as climate-related catastrophes worsen, cyber threats increase, and reinsurance remains costly and restrictive. Because reinsurers have recovered their lost profitability, they are now operating from a position of strength. The current situation has important implications for primary insurers with ceded reinsurance operations. Reinsurers will need to become more selective in the risks they write to defend existing levels of profitability. They’ll also need to improve operational inefficiency through digitization of processes. As market conditions evolve, there is still time for primary insurers to course-correct to adapt and thrive in this new world of risk.

Leading insurance market threats and trends

Climate change

Climate change has quickly become one of the most important risks faced by insurers, as evidenced by CATs increasing in frequence and intensity.

Damage from global natural disasters in 2023 totaled $380 billion in economic losses, driven by significant earthquakes and severe convective storm (SCS) activity in the US and Europe.

In the US, 2023 economic losses from natural disasters hit $114 billion. As a point of comparison, total insured losses due to natural disasters in 2015 was $28 billion.

The 2023 natural catastrophes included 23 events resulting in $1 billion or more in damages, including drought, flood, severe storms, tropical cyclones, and the deadliest U.S. wildfire in over a century, which occurred on the Hawaiian island of Maui in 2023.

The 2023 catastrophic losses had a huge impact on the insurance marketplace. According to Swiss Re, global insured losses from natural catastrophes were nearly $110 billion, marking the fourth consecutive year of insured CAT totals above $100 billion.[1]

There was also a record-breaking number of US SCS resulting in over $50 billion in insured losses, making SCS the costliest peril for reinsurers that year, according to CoreLogic.

Insurers' bottom line did not go unscathed. PC360 reported that the P&C industry produced a $21.2 net underwriting loss in 2023.[2] The homeowners' sector was the main driver due to elevated natural catastrophes and higher replacement costs.[3]

In 2024, temperatures continued to climb. Earth saw its hottest August ever recorded this year.[4] The 2024 hurricane season in the U.S. has so far included back-to-back major losses from Hurricane Helene of up to $47.5 billion and Hurricane Milton up to $34 billion, according to CoreLogic.

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>
> **-PC360**

Cyber threats

Cyber insurance is being threatened by the evolving nature of cyber threats. Insurers are seeing a rise in demand for cyber coverage as well as premium growth, with premiums expected to reach $23 billion by 2025. However, this line of business has seen high claim amounts and loss ratios. Essentially, insurers did not have enough historical data to accurately price cyber risk, and reinsurers added exclusions to their cyber coverage, so major events hit primary insurers hard.

Now we're seeing significant rate increases, as insurers seek to balance the need for profitability with the demands of increasing coverage and capacity.

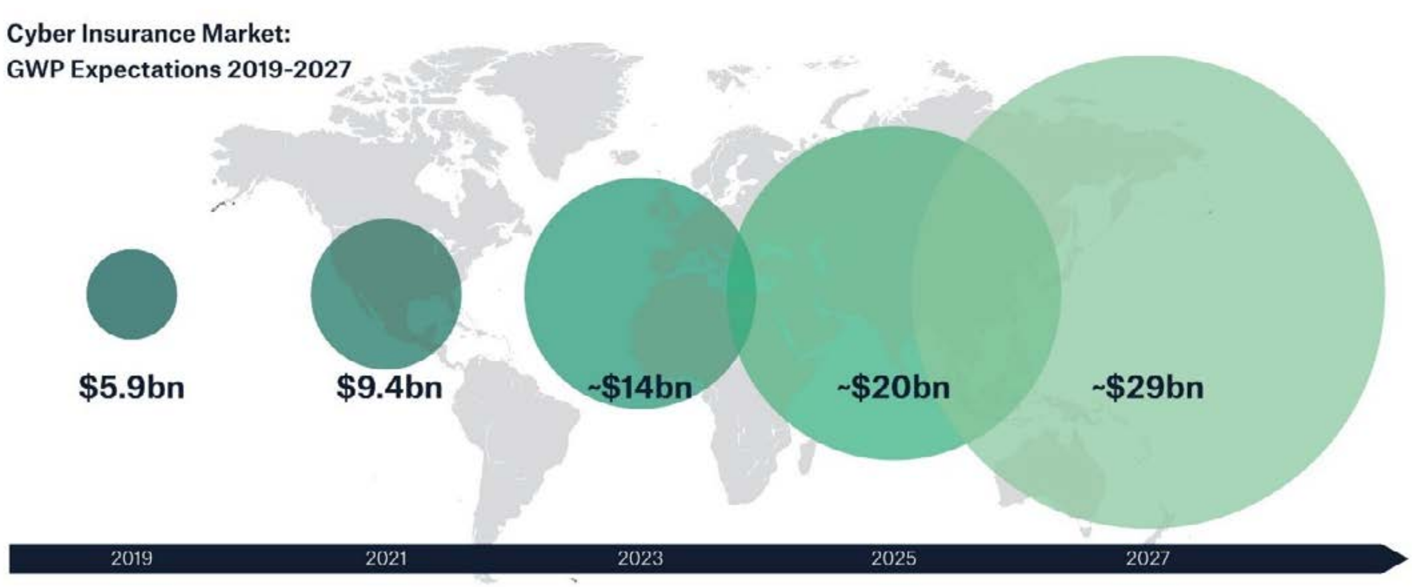
According to MunichRe, cyber risk continues to increase, driven by rapid technological advances.[5] For example, the CrowdStrike software glitch in July 2024 resulted in 8.5 million systems crashing, the largest outage ever. According to Insurance Business Magazine, the CrowdStrike event could prompt companies to reassess their insurance needs, realizing they might be underinsured or exposed to certain risks – something brokers must address with their clients[6]

Parametric insurance

Due to increasing loss costs from catastrophes, some insurers are looking to cede risks with parametric insurance. Unlike traditional insurance, which requires reimbursing the actual damages after an event, parametric insurance uses predefined parameters, such as the magnitude of an earthquake, the amount of rainfall, or the wind speed of a hurricane. If the event meets or exceeds the agreed-upon threshold, based on a trusted third-party metric, the policyholder receives the payout quickly, regardless of the actual damage incurred.

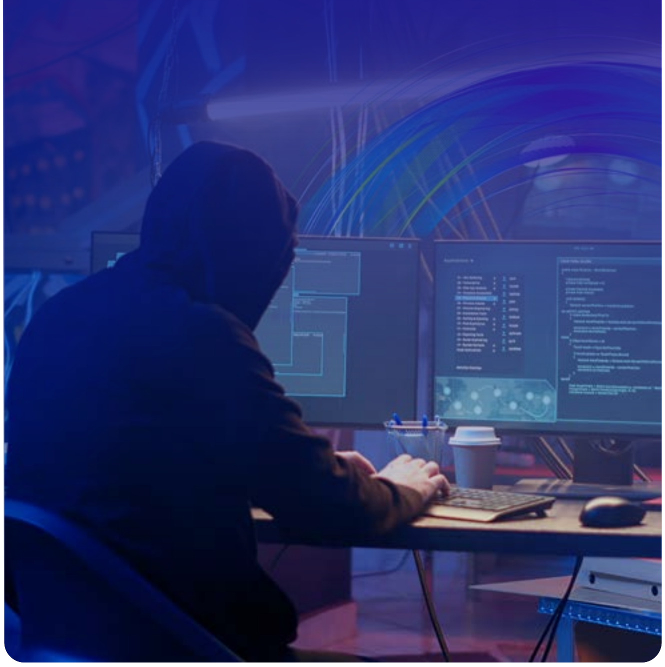
It offers the advantage to insurers of quick payouts and clear, straightforward terms. The disadvantage of parametric insurance is that payments are pre-determined, regardless of full replacement costs, so policyholders may not have the funds to cover all the damages.

While parametric insurance has been traditionally used in developing countries, U.S. insurers are increasingly looking to implement parametric policies. According to AON, many risk buyers remain challenged to find adequate coverage to address a growing protection gap, especially for their CAT-prone exposures and other risks. Parametric is an alternative solution that has grown in utilization to insure against a variety of perils in any market conditions.[7]



"Reinsurers have been raising their rates, seeking higher attachment points, pulling back from aggregate cover, and offering stricter terms in conditions"

-Datos



Changing reinsurance structure and products

According to Datos Insights, reinsurers have been raising their rates, seeking higher attachment points, pulling back from aggregate cover, and offering stricter terms in conditions.[8] Massive events like Covid-19 as well as unprecedented levels of natural catastrophes have prompted reinsurers to include restrictive new exclusions to get CAT placements done. Additional changes in the reinsurance market include greater scrutiny of primary insurers' risk profiles. Some CAT risk profiles based on historical data points are now viewed as unreliable.

Reinsurers are increasing their use of multi-year treaties, establishing long-term relationships that provide for better budgeting and risk management, while limiting uncertainty. As reinsurers look to guard profitability, primary insurers are left with less attractive reinsurance terms and, in some cases, less capacity.

Nearly 70% of Aon's Capital Poll respondents reported that their retentions increased for programs renewing in 2023.[9] This has led to significant volatility in primary insurers' results over the year, a situation not helped by natural catastrophe losses.

Along with facing restrictive terms, insurers are also limited when it comes to cedents. For example, the U.S. reinsurance market is dominated by a small number of large reinsurers. All of these factors have put reinsurers in the driver's seat, challenging primary insurers to get the cover they need on the terms they can afford.

Primary insurers' operational challenges

Given the realities of increasing losses and evolving risks, primary reinsurers need to be attentive to ceding enough risk to ensure they remain profitable. But operational inefficiencies can impede those efforts; insurers' reinsurance processes have suffered from auditability issues and a general lack of investment. In addition, there is an overall problem with risk modeling. Old models can't apply to today's more frequent and severe catastrophes, while new models are not yet fully trusted by reinsurers.

In addition, many insurers still manage reinsurance programs using siloed, manual processes including spreadsheets, word processing programs, and PDFs. Celent reports that "Some of these insurers have discovered that, at best, they could not provide accurate snapshots and projections to senior management, investors, and rating agencies; at worst, they have hundreds of millions of dollars of unrecoverable reinsurance recoverables or dubious out-of-compliance or illegal reinsurance contracts."[10]

Being able to access timely, accurate data on their book of business remains a struggle for insurers. A Deloitte survey on Ceded Reinsurance found that 71% of participating insurers said that late data leads to manual activity, workarounds, and inaccuracies. Furthermore, 57% said they have no single source for the data they need.[11]

Another challenge is that today's staffing shortages and knowledge silos are set to worsen as 50% of the current workforce is expected to retire by 2028.[12] The deep industry knowledge of your most senior professionals will soon disappear, which underscores the need for systematic and automated record keeping.

"2/3 of all data processing across the ceded reinsurance process is still reliant on some form of manual handling"

-Deloitte

Operating in the new reinsurance environment

Because of the interdependent relationship between cedent insurers and reinsurers, it's important to understand how reinsurers are reshaping expectations for the industry, and what insurers must do to be more competitive. After recent years of heavy losses, reinsurers have taken measures to regain and keep their profitability. One approach they've employed is creating complex contracts to balance insurer needs with reinsurer risk appetites.[13]

Complicated reinsurer contracts require a level of sophisticated information handling that many insurers don't possess. A key reason is because the reinsurance function within primary insurance companies has received minimal IT investment. Yet many primary insurers are using systems that aren't fit for purpose and can't be adapted to new needs. Primary insurers that want to improve their position with reinsurers will need advanced capabilities, particularly systems with AI/ML. These can be used to improve and automate numerous reinsurance-related functions, such as summarization and categorization, incorporating new data sources, and generating product recommendations.[14]

Improving data quality and availability is also critical. A Deloitte survey found that over two thirds of all data processing across the ceded reinsurance process is still reliant on some form of manual handling, either to transform the data itself or to transfer it between applications. This means that teams are spending too much time on data manipulation and not enough on analysis.[15]

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Insurer imperatives to compete successfully

The new reality is that insurers are retaining greater levels of risk while paying more for reinsurance – all at a time when increasingly intense CATs and other factors are putting pressure on profits. Primary reinsurers must face the new challenges to move forward from a position of strength.

How insurers should pivot to master the new environment:

Upgrade legacy system

Deloitte has noted that "Reinsurance portfolios are growing in complexity, but many are still administered with a mix of aging technology and manual processing." [16] The complex terms of today's reinsurer contracts cannot be handled by spreadsheets and decades-old legacy systems. Upgraded systems will give insurers the ability to address complex contract terms. With new systems in place, insurers can also prevent gaps in data quality, improve auditability and compliance, and make significant improvements in claims leakage.

Insurers can position themselves for better reinsurance terms by improving the workflow of information between their business and reinsurers. This is another area where modernizing systems will make a positive impact. In fact, "what-if" scenarios can be generated by AI to identify the most profitable portfolio going into renewals.

Improve data quality

Data issues are a further obstacle to obtaining favorable terms on reinsurance contracts. Take property insurance, for example. If you want better pricing on reinsurance, you'll need to provide much more granular underwriting information about structural materials, historical weather patterns, environmental factors, and more. Many mid-sized and smaller insurers' don't have this at their fingertips. Deloitte has stated that "a lack of data governance, strategy, quality controls, and other challenges makes it difficult to support strategic decision-making, measure success or effectiveness, decide accurate pricing, and identify exposure to risks."[17] Data quality also impacts the accuracy of an insurer's risk profile. Datos suggests that leveraging third party data and analytics tools can provide strong returns in this area.[18]

Incorporate AI capabilities

Insurance companies that want to thrive in today's aggressive global business landscape need to leverage data and analytics better than ever before. That could include uploading their existing spreadsheets into an LLM to analyze portfolio-level risk. Insurers can also gain efficiencies by incorporating AI into contract creation and other parts of the business.

Explore alternatives to traditional reinsurance

When insurers have more robust technical capabilities, they will be better equipped to explore alternatives to the major reinsurance companies. For example, international markets may offer better reinsurance pricing and terms than what's available on the U.S. markets. But insurer systems will need to be sophisticated enough to support international regulatory requirements that come with doing business in Europe and Asia.

Mitigate risks from aging workforce

The U.S. has entered the "peak 65" era, with more Americans turning 65 through 2027 than any time in history.[19] Insurers need to act now to prevent specialized knowledge from walking out the door as the mass retirement of senior professionals occurs. This is particularly profound in ceded reinsurance, with its specialized knowledge and complex processes.

Accenture has stated that "the industry will not be able to replace 400,000 open positions one-to-one. And even if it did, the amount of knowledge loss with 50% of the workforce retiring is enormous. This is where cognitive technology comes in as part of the solution."[20] Applying new solutions like generative AI, intelligent text ingestion, and other supportive technologies can help bridge the talent gap. Generative AI can lessen the impact of exiting professionals by extracting contract terms instead of it remaining a human task.

Navigating the new reinsurance landscape – and beyond

There's no denying that the new realities of more costly and restrictive reinsurance are putting pressure on primary insurers to adapt. But there is an upside. Today's investments in a more disciplined approach to data management, risk profile development, and workflow improvements will reap long-term benefits. By investing in new systems, tearing down information silos, and getting more creative in ceding risk, insurers will thrive in the current market conditions and set themselves up for future success.

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