AM Best
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AM Best's Market Segment Report: 2023 Outlooks

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AM Best's Market Segment Outlooks

1 Market Segme nt Outlook: US Life/Annuity

4 Market Segment Outlook:US Health

8 Market Segment Outlook: Global Reinsurance

12 Market Segment Outlook: US Commercial Lines

17 Market Segment Outlook: US Personal Lines

20 Market Segment Outlook: Delegated Underwriting Authority Enterprises

November 28, 2022

Market Segment Outlook: US Life/Annuity

Our outlook for the L/A industry remains at Stable, owing to high levels of risk-based capitalization and strong liquidity, among other positives, as well as a number of ongoing concerns

AM Best is maintaining its Stable outlook for the US life/annuity segment. Notable factors include the following:

- High levels of risk-based capitalization and favorable earnings
- Strong liquidity profiles
- Product de-risking and regular stress testing as part of improvements to risk management practices
- Pricing discipline, with robust sales of new business in both life and annuity products

In addition, companies have benefited from a variety of innovative initiatives, covering a range from products to systems to staffing. The segment has benefitted from cost savings and a pandemic-driven acceleration in product and systems modernization. In the ongoing search for growth, the segment is engaging with consumers through new distribution channels; cross-selling and direct-to-consumer (DTC) opportunities have also helped diversify insurers' overall distribution strategies. Systems modernization and the growing use of non-traditional insurance talent such as data scientists have created opportunities to better mine the vast amount of data accumulated over the years. Data segmentation has allowed refinement of target markets, identification of new markets, and improvement in the overall customer experience. All of these strategies have helped the industry build upon the overall prominence that life and annuity insurance gained during the pandemic.

We are maintaining the Stable outlook on the segment but note ongoing concerns, including:

- Market volatility in the US and global economies, including rapidly rising interest rates and inflation
- Significant exposures to structured securities, private debt, and real estate
- War for talent amid labor shortages and flexible work alternatives
- Legacy liabilities in risky product offerings, including long-term care, universal life with secondary guarantees, and variable annuities with living benefits

Forward-Looking Capital Management Remains Key

Macro-economic challenges such as inflation and capital markets volatility are expected to hamper profitability compared with prior years. In addition, rising interest rates have decreased the value of bondholdings, which has led to unrealized losses on fixed maturities. However, bonds maturing over the near term may benefit, as insurers can reinvest proceeds at higher rates. Uncertainty about the direction and pace of interest rate changes further demonstrates the need for both a strong asset-liability matching program and routine rigorous stress testing of insurers' portfolios.

Credit losses in both commercial mortgages and fixed-income assets have thus far been largely muted. Structured credit and commercial mortgages continue to pose some risk, but we

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2022-154

have not yet seen a material rise in impairments and believe overall risk to the industry currently remains manageable. The collateralized loan obligation market—to which the life insurance industry remains considerably exposed—remains a concern, albeit at lower tranche levels, due to inflationary pressures and recession fears.

The Stable outlook for the segment is driven largely by the industry's solid capital management, which remains at the forefront of many companies' enterprise risk management (ERM) programs. Despite earnings volatility, capital markets gains and diversified earnings streams have helped offset the mortality impacts of COVID-19. L/A insurers' ERM frameworks have also helped them navigate through the pandemic. Death claims impacted earnings mainly during the first quarter of 2022, and many leading companies generated record sales and reported solid earnings performance in the second and third quarters of the year. There were some notable exceptions, however, as spiking interest rates have significantly impacted the third quarter earnings of companies with interest sensitive liabilities and their ERM programs were put to the test.

Life/annuity insurance is a long-term business that relies on short-term liquidity to meet policyholder obligations. Insurers with strong liquidity management are able to bear long-term investment risk to achieve their required return hurdles. This challenge—while always present for insurers—will require a greater emphasis on liquidity management in the current environment of rising interest rates and potential credit losses. This, coupled with liabilities that have less certain cash flows due to embedded market risks, further demonstrates to insurers the importance of sound liquidity management in uncertain times.

Record Annuity Sales Growth

According to LIMRA, annuity sales have steadily grown in 2022. During the second quarter of 2022, US annuity sales increased 22% to $77.5 billion, the highest quarterly sales figures ever recorded by LIMRA. The growth was due mainly to ongoing equity market declines, coupled with rising interest rates, which has led to solid growth of 76% for fixed-rate, deferred annuity sales and 19% for fixed-indexed annuity (FIA) sales compared with the same period in 2021. Recently, we have seen many companies launch multi-year guaranteed annuities (MYGA) due to the attractive spreads. The formation of several new private equity and asset management-backed insurers has added much capacity to the market recently. This is a trend that we expect will continue, as the spread between the cost of liabilities and potential investment returns remains attractive.

A renewed interest in life insurance has also been a contributing factor. New life insurance annualized premiums increased 17% in the first quarter of 2022, for a fifth consecutive quarter of double-digit premium growth, according to LIMRA. This momentum may slow for rest of the year but remain positive and is nonetheless favorable to the industry's outlook.

Cautious Optimism about COVID Mortality

The mortality impact of COVID has dampened operating earnings, but the increase in claims has been manageable—COVID claims numbers trended lower in the second half of 2022. Additionally, companies have found new ways to sell their products and manage their people through the pandemic. Some companies have also benefited from their mixed books of business, which, by combining mortality and longevity exposures, have created a natural hedge.

M&A Continues with New Market Participants

We are still seeing an abundance of capital looking to be deployed in the life and annuity segments by investment managers and private equity firms. These new entrants have contributed to an intensified competitive environment as they look to acquire legacy blocks of business. This activity has drawn the attention of some legislators. Although these new participants don't necessarily

pose a problem directly due to the legal form of ownership, there are many issues to consider. One is the time horizon of the capital deployed. Private equity generally invests over shorter time horizons, while life/annuity insurance is a long-term proposition. This must be fully appreciated by new entrants to the segment if they are to succeed. Another consideration is the growing use of structured assets to achieve investment yields that will outperform that of the cedent.

Market dynamics are also motivating liability-side balance sheet restructuring, as many established insurers continue to move towards fee-based businesses. In other cases, the capital required to support certain riskier products may be driving the shedding of legacy businesses. We expect M&A to continue, but—due to current economic conditions—whether it will be at the same pace as last year is unclear.

ERM Is as Important as Ever

Another important factor is the use of risk management. In the post-financial crisis world, many companies saw their investment in ERM pay off—particularly larger companies that have the scale to support the extra costs for people and systems. Stress-testing and a strong corporate governance structure consisting of risk management committees that address key risks have become integral to the operations of many insurers. This has been a contributing factor to better sizing the capital required to support the business. In addition, workplace challenges such as cyber risk and the war for talent remain front of mind for many insurance executives and operational risk managers.

Accounting Changes and Reporting Challenges

As noted in the past, the full impact of changing accounting standards in 2023 has yet to be determined. Long-duration targeted improvement (LDTI) will change GAAP accounting for life/annuity insurance, but it is not expected to change the fundamentals of the entities we rate. The updated standards will demand significant resources from companies, including collaboration among actuaries, accountants, IT staff, and other professionals.

The segment may see more disruptions as competition evolves, business models change, automation and artificial intelligence advance, and ESG (environmental, social, and governance) awareness grows. Managing risk accurately through uncertainty necessitates a thorough review of strategies to reveal vulnerabilities. Risk culture goes hand in hand with risk management. Poor enterprise risk management can quickly place a company in distress.

Cautionary Market Dynamics

Moving into 2023, we believe the challenges the segment faces will be manageable because of prudent capital and liquidity management, profitability, and ERM practices. Although higher interest rates create an economic benefit owing to improved investment yields, other dynamics in the industry should continue to be monitored. These include market-sensitive lapse rates, asset credit risk, and the ongoing need to attract talent. Insurers who are able to manage technological improvements and transform for the better have the potential to drive the industry forward.

As always, any material unexpected change could drive a review of our outlook, as we continue to monitor adverse factors that could negatively pressuring the industry.

December 1, 2022

Market Segment Outlook: US Health

Our outlook remains at Stable, owing to declining pressure from COVID-19 medical costs and strong levels of risk-adjusted capitalization, among other factors—both positive and negative

AM Best is maintaining its outlook for the US health insurance industry for 2023 at Stable, based on the following factors:

- Declining pressure from COVID-19 medical costs
- Diversified revenues and earnings for large insurers and industry overall
- Strong levels of risk-adjusted capitalization
- A rise in investment income due to changing interest rate environment

Counterbalancing factors include the following:

- The negative impact of unrealized losses due to investment market volatility
- Anticipated end of the Public Health Emergency (PHE) and Medicaid eligibility redeterminations
- Possible increase in utilization and intensity of medical services
- Impact of inflationary pressures from providers and potential economic weakness in the commercial segment

The US health insurance industry reported strong underwriting results in 2021 and through the first six months of 2022. Carriers saw a decline in the profitability of the commercial segment in 2021 and 2022, driven primarily by higher COVID-19 costs. However, earnings from government business remained very strong, supported by elevated margins in the Medicaid segment due to the continued PHE and lack of eligibility checks. Insurers with diversified lines of business found themselves in a better financial position than carriers with revenue and earnings concentrations in the commercial segment. However, the anticipated end of the PHE and Medicaid redetermination will dampen Medicaid results in 2023.

Despite the strong overall earnings through the first six months of 2022, capital and surplus was negatively impacted by sizeable unrealized losses, which counterbalanced about a third of underwriting gains. Given the direction of interest rates, unrealized losses are likely to grow through the end of 2022 and into 2023.

As a result, AM Best expects the industry's capitalization to decline in 2022 but to remain solid, to support underwriting and investments risks. The decline due to unrealized losses is viewed as temporary in nature, and, as fixed-income holdings mature, insurers will have an opportunity to recover the losses and reinvest proceeds at a higher rate.

AM Best does have concerns about smaller, less diversified carriers and their ability to withstand challenges from investment market volatility, as well as potential pressures on the commercial segment due to economic decline. Less diversified companies did not experience the favorable earnings of the past two years from government programs, particularly Medicaid, which helped bolster capital levels.

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2022-153

Anticipating the End of the PHE

The main change tied to the end of the PHE is the redetermination of Medicaid eligibility. Medicaid has supported the industry's revenue and earnings growth since the early days of the pandemic—it became the main source of industry earnings in 2021. As states are not allowed to conduct Medicaid eligibility checks during the PHE, membership and revenue stayed above historical levels. In addition, utilization in the Medicaid segment remained relatively low, resulting in higher profitability for carriers. Many industry participants believe that, during 2021 and 2022, many Medicaid members experienced changes in circumstances, including employment status, which provided access to other health insurance coverage. As a result, these members reduced or completely stopped using their Medicaid coverage. The general industry estimates that 30%-35% of Medicaid members who have joined the program since 2020 will remain eligible for the program once redeterminations are completed.

States will have 12 months to complete their eligibility checks after the PHE ends, but many states may lack proper resources to undertake and complete the task in a timely manner. Additional Medicaid funding provided by the federal government will be discontinued at the end of the quarter in which the PHE concludes, which may prompt some states to complete the redetermination process quickly. Carriers will likely continue to have elevated Medicaid membership during 2023 and even into 2024, although this may differ by state. Insurers may try to identify members who are likely to lose their Medicaid eligibility and proactively reach out to offer enrollment into ACA exchange products where appropriate. Overall, AM Best expects the Medicaid segment's revenue and profitability to moderate in 2023 following the end of the PHE.

While not related to the end of the PHE, the federal government supply of vaccines and treatment is expected to run out in the near term without any additional funding appropriated by Congress. Insurance companies will have to cover some of the costs paid by the government in both 2021 and 2022—for example, costs for COVID-19 vaccines. In addition, the end of government funded purchasing is likely to lead to some price increases for both vaccines and treatments. The magnitude of impact will depend on the severity and persistency of COVID-19, but many carriers are budgeting for the annual cost of at least one COVID-19 booster shot per member.

Changes in COVID-19 Cases and Costs

The health insurance industry was materially impacted by COVID-19 claims starting in the second half of 2021 and through the first six months of 2022. The unexpected surge of the Delta and Omicron variants and the mass scale of the disease constituted a significant change from the original COVID-19 costs in 2020 and resulted in much higher-than-anticipated medical claims for many carriers in 2021. The bulk of COVID-19 costs hit the commercial segment, as working age adults resumed their normal activities but seniors remained relatively cautious. Many smaller and less diversified companies with concentrations in the commercial business faced sizeable underwriting losses. Large carriers and those with exposure to the Medicaid and Medicare segments were able to offset weaker results in commercial business with the persistently stronger profitability in government lines.

However, the overall industry saw a decline in COVID-19 costs starting in the third quarter of 2022, as both case counts and severity dropped. Carriers do not foresee a repeat of the spike in COVID-19 claims that occurred in late 2021/early 2022; they expect that COVID-19 expenses will level off and ease pressure on the commercial segment. Despite the potential for seasonal fluctuation, a large number of market participants believe that overall costs are unlikely to reach the previous scale, given that most of the population has already experienced at least one case of COVID-19.

Elective Utilization Expected To Increase

The utilization of elective medical services was disrupted by pandemic starting in 2020. The industry expected the return of regular utilization and a potential spike in claims due to missed diagnostic services, but the majority of carriers reported lower non-COVID claims in both 2021 and 2022 compared with pre-pandemic levels.

For 2023, carriers are again budgeting higher utilization and an increase in severity. Insurers are concerned that the expenses for some already high-cost conditions may be materially impacted by many newly approved treatments, including gene therapies. The cost of these therapies can run into millions of dollars per case and significantly pressure smaller insurers in particular. However, small and medium-sized companies usually utilize excess of loss reinsurance to protect themselves against such catastrophic losses.

In 2023, healthcare costs are expected to be positively impacted by the growing volume of value-based care and a partial shift of risk from insurance companies to providers. The industry continues to implement value-based programs and assist providers to proactively identify members' care needs. Innovative tools and strategies such as virtual care or shifting care from clinical settings to homes will lead to a gradual but steady reduction in overall care costs.

Inflation and Potential Recessionary Pressure

For the past several decades, the increase in health insurance costs has far outpaced overall inflation. That has changed somewhat in 2022—general inflation is at its highest level in 30 years but increases in health insurance costs have been relatively consistent with historical averages. When general inflation accelerates, health insurance trails behind since it takes time for higher wages and medical supplies and equipment costs to be reflected in contracted rates.

Healthcare infrastructure, including hospitals and providers, has experienced significant wage and general inflation. Insurance carriers will likely be seeing greater rate pressure from providers when contracts are negotiated and renewed in 2023. However, most insurance carriers have two- to three-year contracts with providers, so only a portion of the contracts are renewed each year. Furthermore, insurers may face challenges passing higher medical costs on to employer groups in 2023 and may have to make products and benefits adjustments to partially offset higher rates.

Recession is a negative factor for the health insurance industry since job losses lead to membership declines in the commercial segment. Group membership declines can become an issue for carriers in 2023 should a recession materialize and unemployment rise. However, the balance of membership and revenue between commercial and government business for the health insurance industry has changed substantially since the Great Recession of 2007-2009. The industry has become more diversified and less dependent on the commercial segment. Medicare Advantage and Medicaid are generally less affected by a recession and can even gain membership during an economic downturn. However, for smaller carriers with concentrations in commercial business, a recession can be a significant negative factor if membership drops and pressures their economies of scale.

Investment Markets and Interest Rates

Health insurance obligations are short-term, leading to relatively smaller reserves than for other types of insurance and limiting the dependence on investment income and interest rates. However, health insurers' investment portfolios are composed of mostly fixed-income investments, which are subject to sizeable unrealized losses in the event of a sharp rise in interest rates. Unrealized losses will negatively affect the segment's capital and surplus and risk-adjusted capitalization in 2022 and into 2023. However, the average duration of insurers' fixed-income portfolio is less than six years,

and carriers have an opportunity to reinvest at higher rates when bonds mature—which will lead to higher investment income and ease pressure on underwriting, especially for smaller carriers.

The industry maintains a good level of liquidity, as many large and medium-sized insurers have access to additional funds through lines of credit and Federal Home Loan Bank borrowings. Most publicly traded insurers have issued debt in recent months, although at higher interest rates. Such financial flexibility protects carriers from the potential need to sell investment holdings at a loss during a downturn. In addition, a shorter claims payment cycle and improved data analytics allow insurers to better anticipate liquidity needs.

Non-profit and mutual carriers with sizeable exposures to higher-risk assets may see material fluctuations in their investment portfolios due to market volatility. However, many of these carriers have very high risk-adjusted capitalization levels, and even with some decline due to investment value declines, capitalization is likely to remain more than sufficient to support the organizations' risks. Health insurers who turn to higher-risk assets to increase yields may face less pressure in 2023, as higher interest rates will ensure more investment income from lower risk instruments. Investing in higher-quality, lower-risk assets will have a positive impact on risk-adjusted capitalization.

Top ERM Considerations

The industry has recorded stable to growing earnings and has solidified prudent practices for capital and liquidity management in recent years. As a result, many companies shifted the focus of their enterprise risk management (ERM) from financial performance to operational issues. Many of the health insurers AM Best rates consider human capital the greatest risk for 2022-2023; they are concerned that a lack of available hires can negatively impact their ability to meet strategic goals and transition to new ways of serving customers. To mitigate this risk, carriers are becoming more flexible about hiring, with a growing volume of remote working arrangements. However, smaller companies in local geographies will find themselves in new competition for talent with large diverse organizations. Another notable operational risk for insurers with growing vertical integration segments is maintaining organizational cohesion and effectively integrating new elements into an enterprise. This is partially mitigated by rotating executives among organizational segments and implementing clear strategies to incorporate new technologies and tools into insurance products and services.

November 30, 2022

Market Segment Outlook: Global Reinsurance

The outlook remains at Stable, as positive factors are counterbalanced by negative ones

AM Best is maintaining its Stable outlook on the global reinsurance segment. Market conditions are highly uncertain. Despite most drivers not being seen as stable in isolation, overall a number of positive factors are counterbalanced by negative ones.

The main negative drivers are listed below:

- Heightened natural catastrophe activity continues to test investor risk tolerance levels. This is compounded by geo-political and economic uncertainty.
- Despite improving pricing trends and tighter terms and conditions, new capital is cautious and so far has not been forthcoming. Similar constraints are seen on the ILS (insurance-linked securities) side, particularly for retro capacity.
- The segment remains well capitalized, but ongoing interest rate hikes and volatile investment markets have materially reduced shareholders' equity on a market value basis.
- Inflationary pressures and the risk of recession make profitability targets more challenging over the long term.

These negative factors offset a number of positive ones, such as:

- Positive pricing momentum and enhanced market discipline continue, including tighter terms and conditions.
- Demand for reinsurance capacity continues to grow, as primary carriers look for stable results and capital efficiency in an uncertain environment.
- Some major players are starting to stabilize their results by reducing property cat exposures or benefitting from a diversified business mix, including significant life books in the case of the largest reinsurers.

Volatile Property Cat Activity Continues To Dampen Investor Appetite

Negative pressures on reinsurers' results over the last few years have been driven not only by traditional natural catastrophe events, but also by the growth of secondary perils, the pandemic, and, more recently, the Ukraine-Russia conflict. This has been compounded by financial, economic, social, and geo-political uncertainty in general. Although the segment remains well capitalized, the instability of financial results and inability of most players to meet their cost of capital has tested investors' risk tolerance. This has been more evident in the ILS markets, including retro, which, owing to severe losses and trapped capital issues, has been unable to expand or re-load in recent years and continues to experience a significant flight to quality when allocating capital.

Anticipated rate increases started to attract new capital in 2019, based on the expectation that natural catastrophe activity would subside and return to average historical levels—which has been negated by the devastating Hurricane Ian, estimated to be one of the costliest insured events in recent history. But even without major catastrophic events, the accumulation of

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2022-158

small to medium-sized events has had a material impact on claims ratios, sometimes at unexpected times of the year (e.g., Winter Storm Uri in Texas) or outside their usual geographical scope (e.g., Hurricane Ida, affecting areas as far north as Canada). Extremely unusual events (such as the Bernd system floods in Western Europe) are occurring, as wildfires and floods increase in frequency and severity worldwide.

The perception of volatility and uncertainty has been magnified for reinsurers, on the asset and liability side of the balance sheet as well as on the bottom line. Investors may not feel as comfortable as they did before these issues emerged—and this is even truer for catastrophe risks, which were traditionally considered high severity, low frequency. But when the frequency component rises beyond a certain tolerance threshold—which seems to be the case after five years of losses—investors will naturally reassess their positions and their return expectations.

Theoretically, at least, there should be a price high enough to compensate for that level of uncertainty, but few reinsurers feel that rate increases have reached that point yet, although the impact of Hurricane Ian is likely to accelerate pricing momentum at the January renewals. What's more, reinsurers strongly prefer stable results over the potential for larger but volatile profit margins. For the last two to three years, reinsurers have been shifting covers to higher layers of protection, raising deductibles, lowering limits, adding explicit exclusions, avoiding aggregate covers, restricting specific perils and geographies, and generally becoming more selective with their cedents to mitigate adverse selection and credit risk—all this at a time when cedents themselves are craving more stable results and have put protecting their balance sheets at the top of their priority list.

Some companies have been actively shrinking their property cat exposures or even modifying their organizational structures and exiting altogether, although a few players—including some of the largest European reinsurers—seem to see the current environment as an opportunity to improve profit margins and consolidate their market positions even further. Although the largest European reinsurance groups remain more cautious when it comes to risk selection, their longer-term views on catastrophe risks tend to be influenced by much greater risk diversification (including their life and primary businesses), size, and financial flexibility, supported by less of a reliance on the currently constrained retro markets or by better access to ILS capital.

Pricing Continues To Improve—But Is It Enough?

No one questions the improvement in global reinsurance rates since 2018. As in any other previous cycle, the pace at which rates continue to rise varies widely depending on the class of business or territory, and whether a particular account has experienced recent losses. Generally, reinsurers—particularly property cat writers—have been lagging primary carriers and retro providers.

The pace at which pricing continues to harden for property catastrophe exposures, however, seems to be accelerating. Guy Carpenter has calculated a rise of 15% for its US Property Catastrophe Rate-On-Line (ROL) index between January and July 2022. Such an increase has not been seen since 2006 and is leading to speculation that the end-of-year renewals may witness a "true" hardening that eventually turns the corner for reinsurers. The recent losses from Hurricane Ian may strengthen those expectations.

However, we also need to acknowledge that the index itself is just catching up with levels last seen in 2009. Conditions in Florida—where problems stem from the low credit quality of cedents, concerns about widespread fraud, litigiousness, and a challenging regulatory environment—cannot be wholly attributed to the growing volatility of property catastrophe perils. Florida's pricing movements may not necessarily be a good indicator of what's expected for other cat-exposed

territories in the next renewal cycle. For example, price improvements in Europe have been more modest, despite the unexpected impact of the Bernd floods last year, as well as the more recent hailstorms in France.

Pricing for property cat seems likely to continue rising sharply into next year. An increase in demand is also expected to reflect the effects from inflation and higher sums insured. Primary carriers feel the pressure—even more than reinsurers—to stabilize their results and protect their balance sheets. As such, demand for reinsurance continues to grow.

Rate improvements in casualty and specialty lines, however, have slowed down. Margins remain attractive given the recent claims experience. Due to attractive pricing conditions, interest for cyber risks remains strong but is still typically accompanied by cautious growth and strict control of cover limits.

The big question at the moment is about the potential impact that inflation—which remains stubbornly high across the world—may have on ultimate claims. A problem that was originally considered temporary (caused mainly by pandemic-related supply chain disruptions) has become more of a long-term concern. This has led, as expected, to steep and ongoing increases in interest rates, with their consequential impact on the stock and credit markets, as well as on economic activity in general.

Global Reinsurance Segment Remains Well Capitalized But Deployment Is Cautious And Unrealized Investment Losses Are Significant

AM Best's estimates for available traditional capital for the global reinsurance segment indicated another year of expansion in 2021 after a period of stagnation between 2016 and 2018. One of the key drivers for this growth was the increase in investment values during 2021, mainly in equities. For year-end 2022—based on how the investment markets have reacted so far to the interest rate hikes, as well as fears of sustained inflation and a potential recession—we expect a decline in overall available capital. Since a significant proportion of this decline is explained by unrealized investment losses on fixed-income instruments, a careful assessment of a company's liquidity needs and its ability to hold assets to maturity is crucial as part of their balance sheet strength assessment.

Although the segment remains well capitalized, an important distinction has to be made between "available" and "dedicated" or "deployed" capital—"available" does not translate automatically into "dedicated." That available capital has been plentiful—over the last five years less than 85% was needed to support a BCAR (Best's Capital Adequacy Ratio) assessment of "Strongest"—has fortunately not translated into a lack of underwriting discipline. Reinsurers remain focused on stabilizing results and consistently working to meet their cost of capital—which still constitutes a mixed bag. Given the current market uncertainty, most players feel the need to keep a material amount of dry powder to protect their balance sheets against market fluctuations and to deploy resources prudently when the right opportunities arise

Unlike previous hardening cycles, new capital has not had a material impact on market conditions. After early signs of enthusiasm and the emergence of a few start-ups since 2019, execution has been slow and inconsistent. Regulatory and recruitment delays have played a role. Business plans have been downsized or changed suddenly based on opportunistic deals rather than on solid strategies. Several projects have not yet seen the light of day. Crucially, investors remain extremely cautious.

Third-party capital, while typically is expected to react more swiftly to market conditions, seems subject to the same level of skepticism. More restrictive covers, terms, and conditions

are commonplace. Despite higher demand and improved pricing, the volatility of recent claims remains the key issue. Issues with regard to trapped capital have not gone away completely. "Loss creep" remains well within the memory of investors.

Will the 2023 renewals mark a turning point for a true hardening market, able to attract new capital in droves and expand supply? Will third-party capital providers move first, as they have in previous cycles, taking advantage of the current retrenchment from traditional players and driving a new softening trend? Trying to predict the future is even more complicated nowadays, because how the year-end renewals go will depend heavily on actual claims activity and on where the global economy goes.

Given the elevated catastrophe activity experienced this year, asset market volatility, continued geo-political angst, inflationary pressures and recession fears, uncertainty could remain so high that few investors will feel comfortable deploying capital regardless of the price. A few new entrants will still try, but their impact is likely to be limited in a market in which rates could continue to rise in response to more limited dedicated capacity.

The importance of property cat risks and cyber is likely to continue to grow even further, in a world exposed to worrying climate trends and expanding digitization. Robust modelling, adequate pricing, and strong risk management tools for both risk categories remain a clear challenge. They are essential for (re)insurers to feel comfortable with their pricing and risk selection—even to determine what they consider insurable or not. In the short term, exiting certain risks and restricting covers may be justified and likely the only course of action. Long term, however, if the reinsurance segment does not develop more innovative solutions, its role and its relevance to the broader economy may be dramatically diminished.

December 6, 2022

Market Segment Outlook: US Commercial Lines

Our outlook remains at Stable, as positive factors are countered by near-term concerns

AM Best is maintaining its outlook for the US commercial lines segment at Stable. Key factors supporting the outlook include the following:

- Sustained strong underwriting performance throughout the pandemic and amid the current economic volatility
- Sharply higher fixed-income re-investment rates, which will bolster profitability in virtually all lines, especially casualty
- Positive pricing momentum—though past its peak—throughout the segment, with the notable exception of workers' compensation
- Still favorable aggregate prior period reserve development, despite general tapering in reserve margins and segments such as commercial auto
- The diminishing impact of the pandemic on commercial lines insurers, reflecting in part almost universally favorable rulings on many business interruption coverage disputes

The segment maintains solid risk-adjusted capital, reflecting its generally conservative investment profile and hold-to-maturity strategy with respect to fixed-income securities, as well as its moderate and generally well reinsured catastrophe exposures, notwithstanding smaller premium rate increases and the impact of rising inflationary pressures on both property and casualty lines.

Near-term concerns include the following:

- Stubbornly elevated economic inflation, reflecting supply-chain disruptions and increased commodity and labor costs, primarily affecting loss costs in property lines
- Expectations of a commensurate rise in social inflation, including jury awards and litigation costs, affecting loss costs in casualty lines, in terms of both prospective underwriting and reserve margins
- Growing fears of an economic recession in 2023, including disruptions in important economic segments and workforce dislocation, with a potential impact on certain professional liability segments and other lines
- Pressure on risk-adjusted capitalization—despite continued strength—owing to sharply contracted equity market valuations and higher interest rates
- Increasing reinsurance costs and reduced coverage capacity in the aftermath of Hurricane Ian

Pressures on the US commercial lines segment have clearly increased in 2022, affecting both balance sheet strength and operating performance, although the impact varies by insurers and lines of business. The shock to equity market valuations, interest rate-driven mark-to-market devaluations of bond portfolios, and persistently high economic inflation and expectations of a commensurate rise in social inflation, are being felt by insurers across virtually all lines of business.

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2022-155

The Stable outlook on the US commercial segment reflects AM Best's expectation that, on balance, the segment will remain profitable, its risk-adjusted capital will remain sound, and the segment will be resilient in the face of these near- and longer-term challenges. The outlook furthermore considers that the underlying outlooks for all but four of the lines of business in the segment (commercial auto, general liability, professional liability, and medical professional liability) also remain Stable, driven to varying degrees by headwinds and tailwinds discussed in this report, as well as unique, line-specific considerations.

Robust Underwriting Performance Across Major Commercial and Specialty Lines

Commercial lines insurers have reported positive robust underwriting results through the third quarter of 2022 and are expected to continue to do so, driven by strong net premiums earned on the heels of prior year rate increases and continued growth in net premiums written. With the notable exception of workers' compensation, year-to-date renewal rate changes have been strong. Segment earnings have also benefited from lower catastrophe losses for the commercial lines in 2022—notwithstanding the severity of Hurricane Ian in the third quarter—as well as from higher underlying underwriting gains and net favorable prior year reserve development. Favorable prior year reserve development has been driven primarily by better-than-expected loss experience in workers' compensation, sustaining a multi-year trend, partially countered by additions to reserves for asbestos, environmental, and other mass-tort prior year liabilities.

Although commercial insurers face a diverse underwriting landscape, companies are increasingly leveraging technology and innovative products to enhance underwriting and pricing decisions, with greater visibility into profitability at the account level. A more direct focus on loss control and claims management has impacted both frequency and severity. Despite ongoing structural challenges that can materially affect performance, the segment has benefited from improved technical pricing and is well positioned to meet both short- and long-term challenges.

Pricing Off Its Peak, Still Favorable Across Most Major Commercial Lines

Following a multi-year peak in late 2020/early 2021, premium rates for most of the major commercial lines remained robust through 2021 and continued to rise in 2022, albeit at a slower pace, with rate-on-rate pricing gains fueling commercial insurers' underwriting performance through the current year and into 2023. A notable exception has been workers' compensation, whose multi-year underwriting performance has been the strongest of the segment and whose premium rates are also the most tightly regulated, resulting in ongoing premium rate decreases in 2022—this despite continued favorable margins, reflecting both higher payroll and total pricing for the line, as well as still favorable reserve development from prior years.

Recent premium growth has been led by major accounts and specialty lines, followed by middle market and the more commodity-like small commercial account business. Financial lines have seen a modest decline, due primarily to sharp reductions in IPOs and M&A. Overall rates (excluding workers' compensation) have been up in the mid-single digits, while total pricing, which includes rates and exposures, have increased in the high single digits.

Because of the impact of the decline in workers' compensation rates (which will be offset partly by the impact of rising wages) and sustained increases in nearly all other lines, direct premiums written are expected to grow only modestly, in the mid- to high single digits.

If not for inflationary pressures, as well as the prospect of sharply higher reinvestment rates on fixed income securities portfolios, AM Best would expect further downward pressure on premium rates. However, early indications suggest that insurers are mindful of the multiple economic headwinds and crosswinds and that pricing strength may regain traction in response to rising costs

across the board and to the impact of heightened market volatility on capitalization and rising costs of reinsurance protection, especially post-Hurricane Ian.

Inflation Cutting into Margins and Pricing Increases in Property & Liability Lines

The most notable adverse trend facing US commercial insurers, and the economy overall, has been the persistent surge in inflationary pressures for both goods and services, as wage growth has lifted employment costs. The US Consumer Price Index (CPI) all goods urban index rose 8.2% as of third quarter 2022 from the same period in 2021, sustaining the 8.3% recorded for the prior rolling 12-month period, and a pace of inflation not seen in over 30 years. Notwithstanding US Treasury efforts to combat inflation with rising rates, insurer loss costs are likely to continue to rise, as ongoing supply chain issues and labor shortages continue to push up prices for a variety of consumer goods and the materials, as well as repairs or replacement of damaged property. Rising cost estimates will also be reflected in a reduction in the benefit of further reserve releases on business written in prior years, as those reserves were likely established under more benign assumptions.

Inflationary pressures are affecting not only the property lines. The general rise in claims demands, settlements, and judgments—social inflation—is highly relevant for casualty lines, as these trends not only impact future claims but also require continual re-evaluation of existing claims reserves. These lines—with the exception of commercial auto liability—benefited from the material favorable loss reserve development during most of the last decade. Over time, however, the extent of favorable development has declined, due in part to the rise in claims costs—particularly in general liability and medical malpractice, both of which have seen adverse development in more recent years. As public attention shifts from the pandemic and its impact back to other issues, AM Best expects to see a return of the negative trends in social inflation and associated issues, such as litigation financing.

Commercial insurers will therefore need to remain vigilant about inflation, in terms of both pricing and reserving and across both long- and short-tail lines of business. AM Best views the market as being reasonably disciplined; however, given loss cost inflation and likely slowing growth in exposures owing to uncertain economic conditions, casualty rates in most classes will need to rise at an accelerated rate—or the industry will fail to keep pace.

Capital Market Volatility Impacts Balance Sheets, but Higher Interest Rates To Fuel Returns

Inflationary pressures have affected commercial insurers' prospective underwriting and reserving margins, but the sharp increase in capital market volatility and rising interest rates through the third quarter of 2022 have significantly eroded the market values of their equity and fixed-income securities portfolios. Nevertheless, US commercial insurers' securities portfolios remain overwhelmingly invested in investment-grade fixed-income securities generally held to maturity (thereby significantly mitigating the likelihood of realized investment losses), and equity portfolios, though significant, are carried net of deferred tax liabilities, which helps dampen the impact of market declines on insurers' capital.

The silver lining for commercial insurers, given their medium- to longer-term liability durations, is that operating performance will strengthen significantly as free cash flows and maturing fixed-income portfolios roll over into sharply higher interest-rate bearing bonds. Over the past decade, insurers have had to generate more substantial underwriting profitability to offset the impact of persistently low interest rates. The current rate environment, however, will play well into their generally shortened portfolio durations, allowing commercial insurers to finally achieve the portfolio yields they've waited for years to return. Insurers' new challenge will be to avoid sacrificing underwriting pricing adequacy and to keep their attention on maintaining adequate risk-adjusted returns.

Impact of Pandemic Subsides as Litigation Uncertainties Resolve and Claims Trends Normalize

The effect of the pandemic on the performance of the commercial segment has been modest across most lines of business. In some lines, the decline in loss frequency more than offset any increases in severity, with commercial auto and workers' compensation being cases in point. Meanwhile, litigation related to denial of coverage for business interruption claims has almost universally been resolved in favor of insurers, with many cases dismissed without proceeding to trial.

Thus, the segment's normalized combined ratio, which eliminates the effect of catastrophe losses and loss reserve development, improved broadly in 2021, although some of the improvement in the loss ratio was countered by a deterioration in the expense ratio because of suppressed premium growth and by higher costs associated with property lines, including commercial auto physical damage.

With the return of court dockets to full productivity—notwithstanding a push to release the case backlog—and a sustained period of significant return-to-workplace activity, AM Best expects that claims trends will return to historical levels, although the "new normal" will not necessarily match pre-pandemic trends.

Emerging Classes of Potential Litigation Merit Continued Vigilance by Casualty Insurers

Emerging Materials & Technology

In addition to well-established areas of litigation, the emergence of new sources of liability is an ever-present exposure for commercial casualty insurers, particularly in light of evolving legal and social attitudes toward dietary and other substances, the implementation of new chemical and materials technologies, genetic engineering research, and other trends. Additional concern appears warranted with respect to potential long-term liability costs related to (1) herbicides and pesticides in use over the course of multiple decades, (2) "nutraceuticals" such as dietary supplements, and (3) "forever chemicals" in commercial household products and industrial production facilities that could lead to bodily harm or impairment of real property asset values or affect drinking water—all of which may present fertile ground for mass tort litigation in the years ahead. The emergence of 5G technology has already prompted significant concern in digital/national security as well as aviation with respect to flight safety, an area of potentially incalculable exposure.

Climate-Related Exposures

Commercial insurers also face challenges in assessing the nature and scope of exposures relating to climate risk. The variability in the commercial lines' reported results in recent years is largely a reflection of the variability in catastrophe losses each year. The segment has been subject to an increase in the frequency of more severe events, driven not just by climate risk but also by demographics and rising costs to repair and replace damaged property. The effects of these factors on the segment are material and will persist over the long term. To be successful, companies have adapted by innovative use of technology and product design, as well as adopting firm underwriting objectives and incorporating assessments of these risks in their enterprise risk strategies. The segment's ongoing core underwriting and overall operating profitability, which contribute to steady risk-adjusted capital strength, reflect the resilience of the companies in the market.

Litigation Financing

Also worthy of note is the evolution of litigation financing, in which third-party investor groups (often private equity firms or hedge funds) provide up-front financing to plaintiff attorneys involved in personal injury and liability litigation in return for a share in the ultimate jury award or settlement. Litigation financing has become a significant factor in mass tort litigation and often results in costly verdicts.

Commercial Lines Insurers Remain Strongly Capitalized To Absorb Impact of Headwinds

In AM Best's view, notwithstanding the growing headwinds brought on by rising inflationary pressures, increasingly volatile capital markets, and some attrition in the segment's pricing power, the US commercial lines segment remains solidly capitalized on a risk-adjusted basis. This view considers the segment's generally conservative investment profile and hold-to-maturity strategy with respect to its predominantly investment-grade fixed income securities portfolios and limited equity exposures, as well as its consistently sound aggregate reserve position and enhanced risk management discipline across underwriting, claims, and actuarial disciplines—which are essential to navigating a highly dynamic market environment. Finally, the reinvestment of new cash flows at sharply higher rates than current portfolio yields should provide a strong tailwind for both long- and short-tail commercial lines.

December 6, 2022

Market Segment Outlook: US Personal Lines

The outlook for the segment remains at Negative, due primarily to the personal auto line's results, among other factors

AM Best's outlook for the US personal lines segment remains at Negative. The outlook had been Stable for a number of years until September 2022, when it was revised owing to the following factors:

- Deterioration in reported results for the personal auto line
- Rising loss cost severity, driven by inflationary pressures
- Challenges maintaining rate adequacy
- Restrictive regulatory environment
- Elevated reinsurance costs and potential reinsurance capacity constraints
- Heightened catastrophic loss volatility

Factors offsetting these negative pressures include the following:

- Robust risk-adjusted capitalization and sufficient liquidity
- Acceleration of digital transformation/technology adoption
- Fostering of innovation in operations and risk management

Inflationary Pressures & Rate Adequacy Challenges

The negative outlook on the personal lines segment outlook is due to the significant deterioration in reported results for the personal auto lines of business. Liability and physical damage account for approximately two thirds of the segment's results. AM Best estimates that, through the first nine months of 2022, the private passenger auto liability loss ratio deteriorated by nearly 11 points relative to the prior year period, while the auto physical damage loss ratio deteriorated by approximately 16 points. Given the persistently high loss costs, a return to underwriting profitability for the auto segment over the near term appears highly unlikely.

Many carriers continue to pursue rate adequacy in response to rising loss cost severity, but their ability to stay ahead of current trends has been a challenge. The increase in loss severity has been driven by several factors: the higher rate of fatalities, increases in the costs to repair newer vehicles, higher used car prices, supply chain and labor market challenges, and rising medical costs. The return to more normal frequency levels following the pandemic lockdowns has led to further profitability pressures. Many companies in the personal auto segment have pursued rate increases in response to these trends, but the timeliness and effectiveness have varied, as the process is complex and varies by regulatory jurisdiction. However, carriers ahead of the curve in terms of rate adequacy and pricing sophistication have likely built on existing competitive advantages.

Distracted driving continues to play a part in loss trends and will likely remain an industry issue. In addition, newer vehicles with enhanced safety features account for a growing percentage of vehicles on the road, which may ultimately impact frequency favorably, but

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2022-159

their repair costs are higher. With access to needed parts and—just as important—qualified labor limited, the cycle time for repairs has lengthened considerably, resulting in additional loss cost pressures. According to the St. Louis Federal Reserve, cost increases for the auto industry are not limited to just microprocessors, given that automotive parts overall saw an increase of approximately 20% over the past year.

Eventually, the growing use of telematics and usage-based insurance may help address loss frequency, as insurers can measure driving behavior in real time or implement additional product innovations such as per-mile insurance. However, this is unlikely to have a meaningful impact over the near term.

Restrictive Regulatory Environment

The regulatory environment remains a key point of consideration when evaluating market conditions. Before the heightened inflationary pressures, carriers were generally able to address rate needs with modest rate increases. Accordingly, the regulatory response to rate adequacy needs had not been a significant barrier to generating adequate operating results.

However, the magnitude of increases has grown, in line with challenging trends in the broader economy. Global supply chain issues and rising labor costs have resulted in stubbornly persistent inflation, which has led the Federal Reserve to raise the federal funds rate by 375 basis points to date, to a range of 3.75% to 4.0%—and may rise above 4% by the end of 2022. As a result, the ability to consistently generate adequate operating results has been challenged. Inflationary trends will eventually plateau, but how long this environment will continue remains highly uncertain.

Reinsurance Costs Remain Elevated

The reinsurance market has weathered significant volatility the past several years, dampened by cat losses and secondary perils, soft market pricing/terms and conditions, and higher demand for cat protection, as well as the unwillingness of traditional carriers to deploy substantially more capacity. Due to Hurricane Ian and the above average catastrophe activity throughout the US in recent years, reinsurers are further re-evaluating their portfolios and risk tolerance levels. Due in a large part to global economic issues, new market entrants and capital providers that have historically followed other large catastrophes are not expected after Hurricane Ian. The recent uptick in inflation, especially the rise in the cost of materials and labor, in addition to supply chain issues and shortages, is adding to the increase in reinsurance costs.

The personal lines segment is still being impacted by higher frequency and severity of storm activity throughout the country. Many primary companies have attempted to manage this trend by increasing their net retention levels while purchasing protection higher in the tower to protect balance sheets. Rising reinsurance costs can pressure both operating performance and balance sheet strength if lower levels of reinsurance protection result in higher net probable maximum losses or net retained losses significant enough to erode surplus. Primary carriers may struggle to pass these higher costs through to their customers due to regulatory hurdles in some states. AM Best and Guy Carpenter estimate that overall reinsurance capital will be down 8.4% in 2022, due largely to investment market performance. Expectations are for the property reinsurance market to continue to firm/harden at least into 2023.

Heightened Catastrophic Loss Volatility

After a number of relatively quiet years of named events, Hurricane Ian struck the west coast of Florida on September 30, with estimated losses ranging from $42 billion to $74 billion. Given the magnitude of Ian and the highly litigious Florida market, escalated loss development will contribute to ongoing pricing and capacity pressures for cedents. Due to climate and demographic changes,

secondary perils (tornadoes, wildfires, straight-line winds, and winter storms) have become just as problematic as more high-profile events such as hurricanes and earthquakes. Depending on the structure and pricing of reinsurance programs, losses associated with these events often fall within companies' net retentions, like the losses in the upper Midwest during the first half of 2022. In recent years, the severity and frequency of these secondary perils have increased substantially. The ability to absorb multiple events both financially and operationally is increasingly important. Insurers throughout the segment continue their efforts on exposure management, strategic agency management, and enhanced reinsurance programs that capture aggregate risks, with varying degrees of success.

Robust Risk-Adjusted Capitalization and Sufficient Liquidity

Economic growth has slowed in the US, going from 5.7% growth in 2021 to an anemic 0.2% projected by the end of 2022. Economic uncertainty has led to depressed consumer and business sentiment, as well as market volatility, creating uncertainty on the asset side of the balance sheet. Persistently high inflation has resulted in a more hawkish monetary policy, manifest through higher interest rates. Equity market downside risk has worsened quite a bit, and higher interest rates will pressure bond market values as well. Widening credit spreads also add to pressures for balance sheet values and investment income. Despite the challenges brought about by inflationary pressures and ongoing equity market volatility, overall risk-adjusted capitalization remains robust. These generally favorable positions provide some cushion to manage the challenges ahead, further supported with positive cash flows.

Accelerated Technology Adoption

In recent years, the best-performing auto and homeowners' insurers have invested significant resources into technology to improve their underwriting and pricing tools. Advances in predictive modeling and pricing analytics, as well as the use of third-party data, have provided carriers more opportunities to pursue profitable growth or manage profitability pressures.

These initiatives escalated during the COVID-19 pandemic, as insurers pivoted quickly to meet both their own business requirements and customer demands. Because of lockdown conditions, remote access was critical for claims, underwriting, and loss control, as well as policy issuance, whether direct or through agency distribution. Companies that were further along upgrading their systems were better positioned to quickly transition while continuing to focus on data analytics.

Insurtech in both the auto and homeowners markets will continue to grow as insurers focus on more effective and efficient ways to reach and service customers. Mobile applications for submitting claims, video chats for claim reviews, and artificial intelligence to support online text and voice chats when generating quotes and servicing claims became a lifeline for many policyholders during the pandemic. We expect this accelerated pace of technology adoption to continue.

Looking Ahead....

AM Best's market segment outlook contemplates the impact of current trends on companies operating in a particular segment over the next 12 months. Our ratings consider how companies manage these factors and trends. The Negative outlook for the personal lines segment indicates that AM Best expects market trends to have a negative impact on companies operating in the segment, but it does not mean that *all* companies operating in the segment also have a Negative outlook. Carriers that are slow to address the challenges ahead or do not have the means, expertise, or technological capabilities to keep pace with changes in the segment will likely face ratings pressure.

December 5, 2022

Market Segment Outlook: Delegated Underwriting Authority Enterprises

DUAEs are increasingly proving their ability to manage a number of emerging risks by leveraging their expertise and intelligent use of data

AM Best is assigning a Positive outlook for the global delegated underwriting authority enterprises (DUAE) market. The Positive outlook reflects AM Best's expectation that this distribution segment will continue to strengthen owing to the growing interest from capacity providers and diverse capital investments, as well as the emergence of specialty expertise and technological advancements. Factors supporting the outlook include the following:

- Ongoing growth throughout this distribution channel, driven by technology, talent, and diverse sources of capital
- Growing interest in program business by capacity providers
- Private equity investments in the delegated underwriting authority market

Near-term concerns include the following:

- A potential pullback of capital and risk-bearing capacity, as well as elevated reinsurance costs
- Looming economic challenges, including stubbornly elevated inflation that will likely impact underwriting and reserve margins

AM Best defines a DUAE as a third-party appointed by a (re)insurer, through contractual agreements, to perform underwriting, claims handling, and other administrative functions on behalf of its partners. DUAEs comprise entities such as managing general agents, cover holders, program administrators, program underwriters, underwriting agencies, and appointed representatives.

DUAE Market Constitutes a Significant Distribution Channel

As an important distribution channel in the US for risks not widely accepted by standard carriers, DUAEs are increasingly proving their ability to manage emerging risks such as cyber and climate by leveraging their expertise and intelligent use of data, as well as pivoting risk strategies in ways that traditional carriers are not accustomed to. The DUAEs' responsiveness to emerging risks is driving investments, technology, and overall growth.

Businesses that suffered during the pandemic are now resurging, thanks to the post-pandemic rise in premium rates. Specific niche markets where DUAEs have assisted insurers with access to new business opportunities include cyber insurance. DUAE programs that specialize in cyber have been the beneficiaries of significant investments in their programs. Thus far in 2022, cyber-focused investments are just shy of $1 billion, driven by the DUAEs' ability to capitalize on their expertise and advanced technology to strengthen their distribution channels.

The growth of volatile risks such as exposures to the frequency and severity of US weather-related events in the excess and surplus (E&S) lines market supported the double-digit increase in premium for that market in 2021. Challenges due to secondary perils allow DUAEs to play a vital role in matching these risks and insurers. As admitted carriers continue to retract capacity from property catastrophe risks, the E&S distribution channel will see steady results.

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2022-156

In Europe and Asia-Pacific, the DUAE markets are fragmented. In some countries, DUAEs have long-established operations with high penetration rates; in others, the market is nascent or emerging. The fragmentation in part reflects the way insurance business is transacted/distributed, as well as regulations governing insurance agents and DUAEs in individual countries.

Additionally, DUAEs have proven their attractiveness as employers, with an influx of new talent the last several years. Executives and underwriters may be shifting from the traditional insurance market, as they look for enhanced compensation and equity rewards from DUAEs, but the flexibility of the model is also an incentive for talent with tech experience, such as software developers and data miners. DUAEs are fostering an entrepreneurial culture in their organizations, allowing their key staff to retain agency over their programs and results. Competition for talent from the traditional market and beyond is expected to remain tight, as the market continues to attract diverse sources of capital.

Significant investments in technology allow DUAEs to better analyze data in volatile markets and attract talent from the tech industry. The focus on quality technology is not only about data analysis and modeling—there is a need for continually streamlined technology that can identify untapped niche markets, increase touchpoints with clients, and improve the policyholder experience. Cost efficiencies and accessible technology provide an added benefit.

Early adopters are reaping the benefits of these investments, which provide ample growth opportunities. As technological advancements continue to develop rapidly, investments in the segment will remain a valuable response to supply-side drivers, as carriers and other capacity partners look to navigate hard market conditions. Steady investments in technology, especially those that allow for new ways to analyze data sets, will continue.

Growing Interest from Capacity Providers

Most lines of business have experienced pricing increases and hardening market conditions over the past 12 months. For most DUAEs, however, capacity remains available and sufficient. In contrast, capacity is tighter for new DUAE entrants and certain products (e.g., peak peril property catastrophe exposure).

Global reinsurers' appetites for DUAE business have grown, as they look to diversify and manage counter-party relationships. Additionally, the expansion of participatory fronting companies is providing greater access for reinsurer participation. This acceptance of risk by a fronting company supports the alignment of interest and helps fortify processes, partnerships, underwriting capabilities, claims handling, and management of reinsurance. These factors are the key drivers of the significant expansion in the number of fronting companies globally.

The UK and London markets are among the most developed DUAE markets outside the US, with significant growth in established businesses, new start-ups, and M&A in recent years. Lloyd's, which pulled capacity in 2020 as part of its broader program to reduce its exposure to underperforming businesses, has since expanded capacity and is expected to remain a major source of global DUAE capacity.

Capital supplied by the insurance-linked securities (ILS) market for DUAEs is also expected to continue to grow. ILS capital is seeking to back DUAEs with strong track records, for which the traditional reinsurance market is proving tougher at this time. As DUAEs increasingly look to maintain reinsurance capital, this trend is likely to continue into next year.

Private Equity Investments in DUAE Market Fueling M&A

The segment has attracted more sources of capital from other than traditional carriers or fronting arrangements. DUAEs have shown that they can maintain low balance sheet risk, high free cash flow from operations, and wide EBITDA margins. Private equity investors are taking advantage of opportunities to invest in the segment owing to wider margins from the hard market and a general resistance to economic down cycles.

Private equity capital helps DUAEs scale their businesses, as well as solidify M&A. According to the 2022 Conning Strategic Study Series, 79 acquisitions took place in 2021, more than doubling the previous year's record of 29. M&A growth was also robust in the first half of 2022. Finance costs are rising due to high valuations, but M&A is expected to continue to grow in 2023. M&A is not only a key indicator of synergy in the market, but also an indicator of the amount of capital available.

Longevity of Expanded Sources of Capital

Near-term concerns about sources of capital could become an issue for reinsurers. The growing number of private equity-backed DUAEs raises concerns about the commitment of private equity investors over the long term. A key concern for reinsurers is the longevity of private capital investments given the potential for underperformance by a book of business in volatile markets, especially those with large catastrophe-exposed books. Addressing alignment issues with investors and carriers, such as identifying potential exit strategies, is important.

Looming Economic Challenges

The market faces a number of macroeconomic challenges. Although inflation tends to escalate premium volume, concerns about the impact on current and prior year expected losses is growing. An extended period of accelerating inflation is especially problematic for long-tail lines of business, underscoring the importance of revisiting prior assumptions and adjusting rates. Expectations of a recession in the US will remain a consideration in the market. The DUAE market is likely to see less demand in some classes of business, such as economically sensitive commercial lines, as would be expected in a recessionary environment.

Looking Ahead

DUAEs have become a relied upon distribution channel for insurers of all types and under all market conditions. Talent and technology have played a vital role in adding value to the market. As larger insurance companies struggle with legacy systems and databases, the smaller DUAEs have proven to be agile implementing systems that can perform the risk selection, pricing, and underwriting that are central to insurers' profitability. Furthermore, the influx of professionals with superior underwriting skills and a network of relationships have enhanced the value-add of DUAEs. Given the migration of underwriting talent to DUAEs, ongoing support from reinsurers has been a major driver of the segment's success.

The DUAE market should continue to grow as an attractive option for capacity looking to diversify and access distribution.

GUIDE TO BEST'S MARKET SEGMENT OUTLOOKS

Our market segment outlooks examine the impact of current trends on companies operating in particular segments of the insurance industry over the next 12 months. Typical factors we would consider include current and forecast economic conditions; the regulatory environment and potential changes; emerging product developments; and competitive issues that could impact the success of these companies. Best's ratings take into account the manner in which companies manage these factors and trends.

A Best's Market Segment Outlook, like a Best's Credit Rating Outlook for a company, can be Positive, Negative, or Stable.

Best's Market Segment Outlook	
Positive	A Positive market segment outlook indicates that AM Best expects market trends to have a positive influence on companies operating in the market over the next 12 months. However, a Positive outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Positive.
Negative	A Negative market segment outlook indicates that AM Best expects market trends to have a negative influence on companies operating in the market over the next 12 months. However, a Negative outlook for a particular market segment does not mean that the outlook for all the companies operating in that market segment will be Negative.
Stable	A Stable market segment outlook indicates that AM Best expects market trends to have a neutral influence on companies operating in that market segment over the next 12 months.

We update our market segment outlooks annually, but may revisit them at any time during the year if regulatory, financial, or market conditions warrant.

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