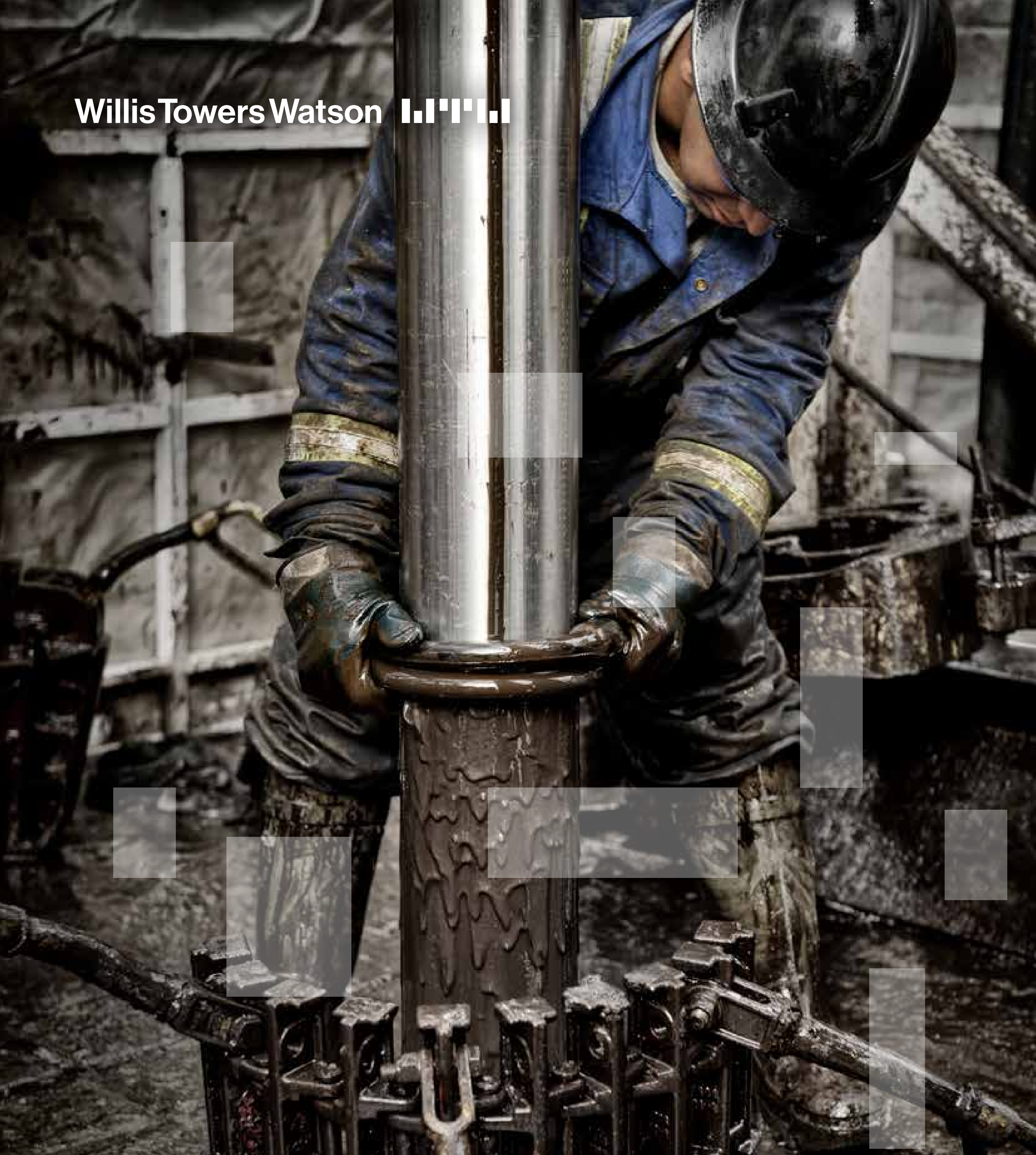

Willis Towers Watson

The turning of the screw

Why the market hardening process can only intensify - for now

EMR Update November 2019

EMR Update November 2019

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Market Capacity Figures

The figures quoted in this Review are obtained from individual insurers as part of an annual review conducted in January each year. They are solicited from the insurance markets on the basis of securing their maximum theoretical capacity in US$ for any one risk. Although of course this capacity is offered to all buyers and their brokers, the individual capacity figures for each insurer provided to us are confidential and remain the intellectual property of Willis Towers Watson.

Willis Towers Watson Energy Loss Database

All loss figures quoted are from our Willis Energy Loss Database. We obtain loss figures for this database from a variety of market sources (including a range of loss adjusters), but we are unable to obtain final adjusted claims figures due to client confidentiality. The figures we therefore receive from our sources include both insured and uninsured losses.

Style

Our Review uses a mixture of American and English spelling, depending on the nationality of the author concerned.

We have used capital letters to describe various classes of insurance products and markets, but otherwise we have used lower case to describe various parts of the energy industry itself.

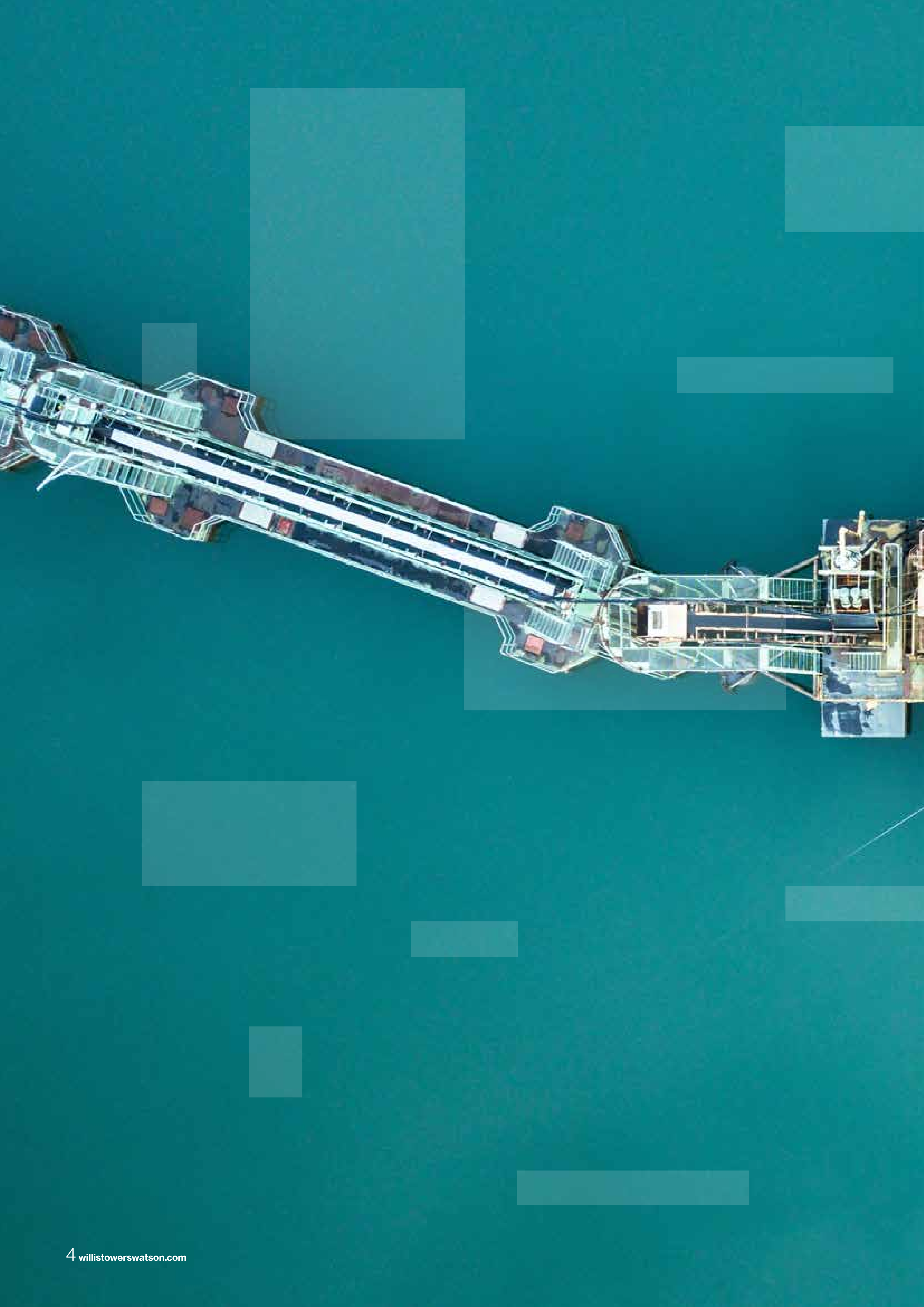
Introduction - the turning of the screw

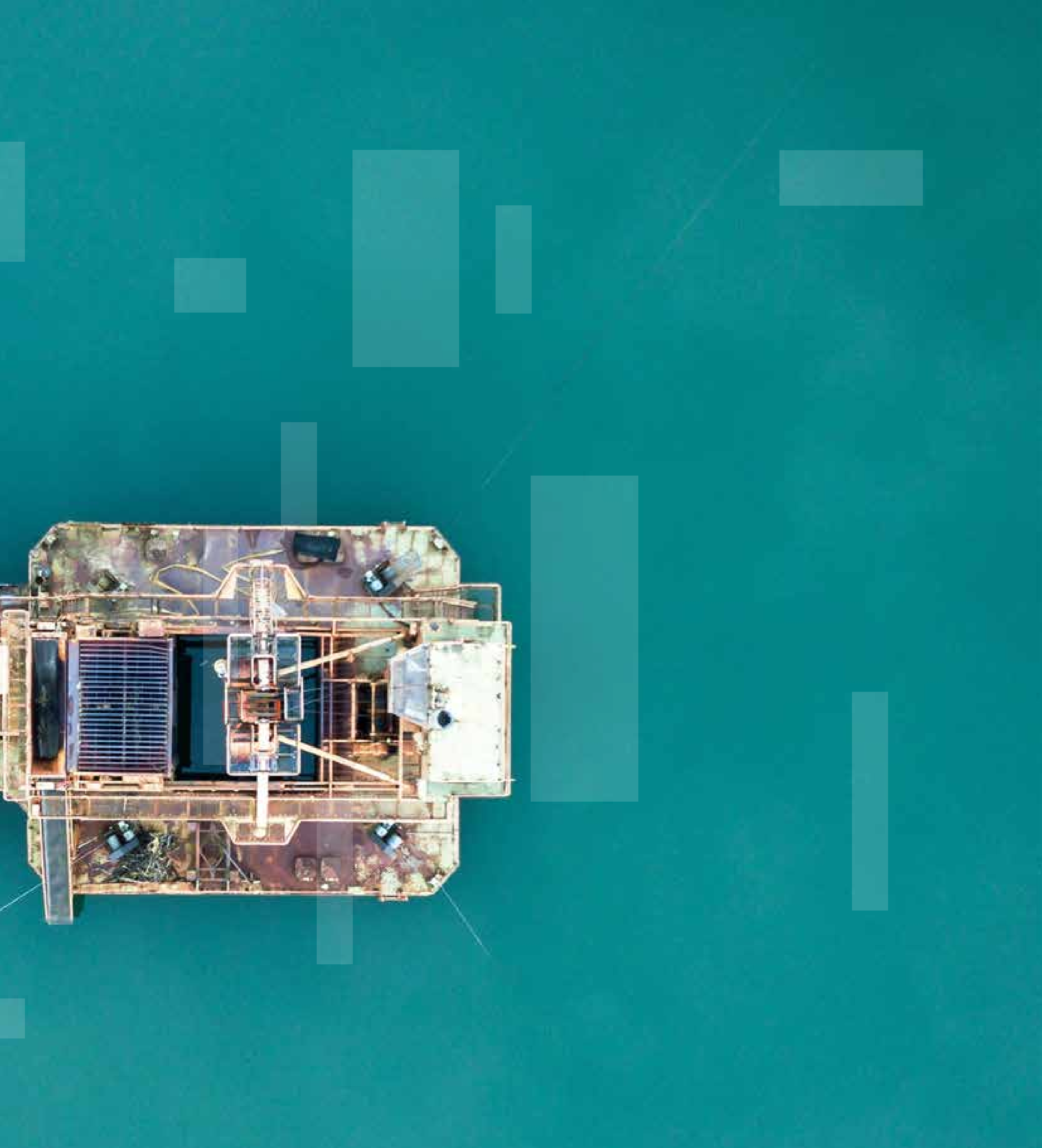
In our Energy Market Review released in April of this year, we explained why energy insurance buyers should do what they can to adjust to change in the insurance markets. We explained why the long period of gentle market softening had come to an end and discussed the options open to the buyer to mitigate the effect of the changes that we had seen in the market during the last 12 months. We explained that while conditions in the Energy insurance markets were hardening, that did not in itself mean that we were in a truly hard market, as was the case for example following 9/11 in 2001, but the upswing in rating levels was now a reality and buyers had to become accustomed to the fundamental change in market dynamics.

Six months on, we must report that the hardening process in both the Upstream and Downstream markets has intensified – albeit not at the same pace. With insurers around the world taking advantage of the momentum achieved during the early part of the year, the clear majority are falling into line and focusing on profitability rather than premium income.

So why are buyers having to face what we can perhaps call the “turning of the screw”? What are the factors that are driving this process and what can be done to mitigate its worst effects?

Taking each market in turn, we will examine the issues of underwriting capacity, losses, rating levels and the outlook for January 1 2020, thereby hopefully providing readers with an accurate assessment of what might be expected during the next few months.

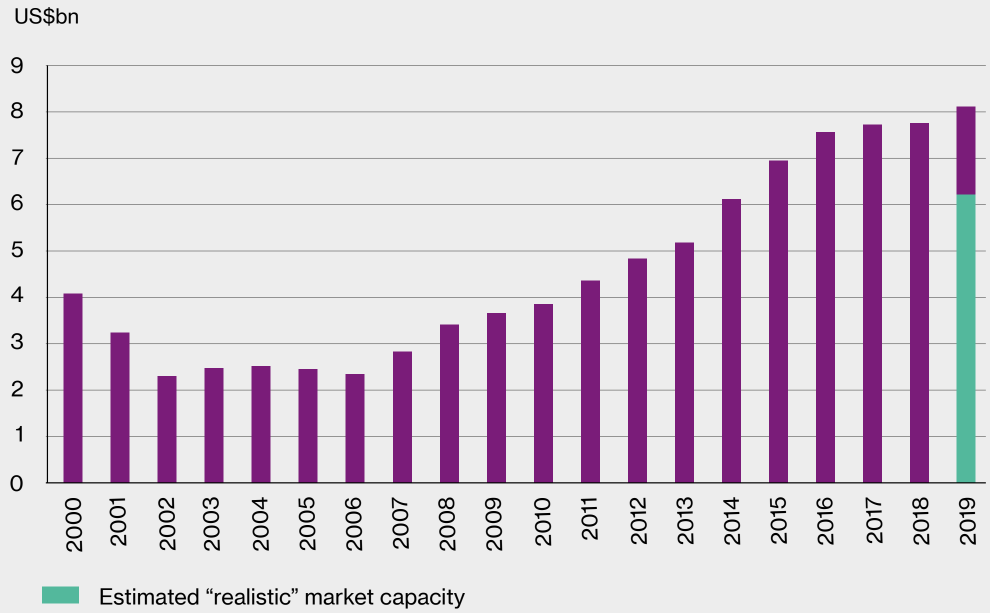




Upstream

Upstream - a profitable portfolio, but under pressure nevertheless

Fig 1 – Upstream Operating insurer capacities 2000-2019 (excluding Gulf of Mexico Windstorm)



The decade closes out with official Upstream capacity still at theoretical record levels. However, there has been a small drop in realistic capacity available during the year – a sign of things to come?

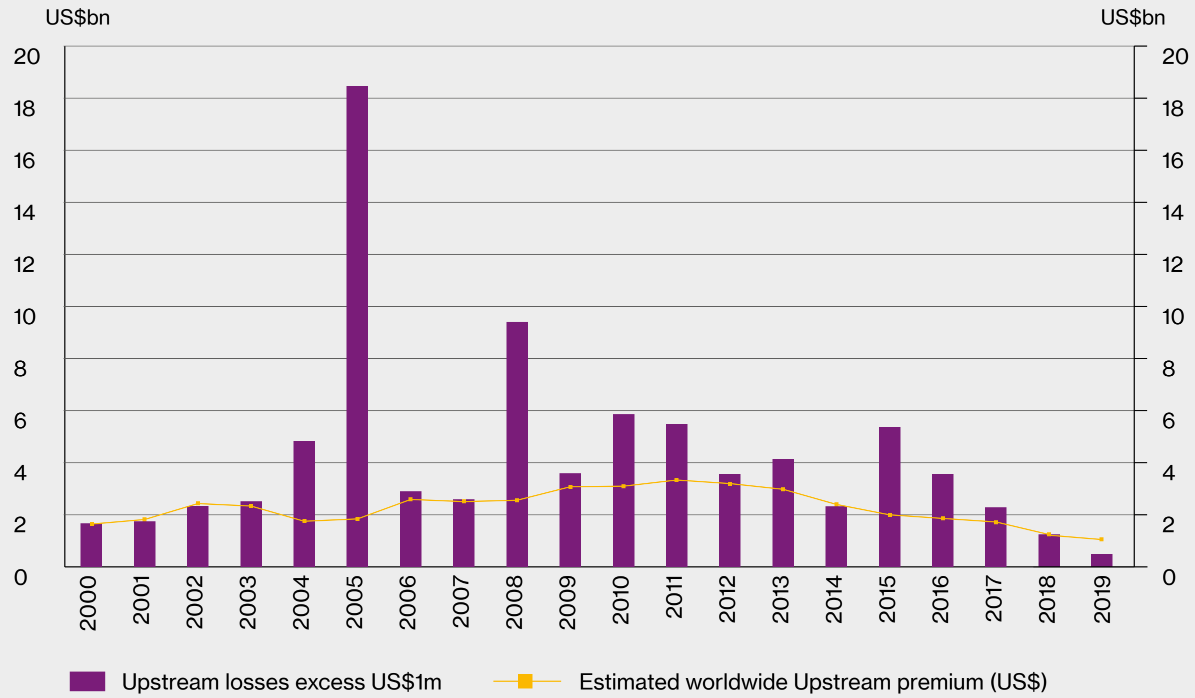
Source: Willis Towers Watson as at October 7 2019

On the face of it, the Upstream Energy portfolio continues to offer record levels of underwriting capacity to buyers. Our chart shows that over US$8 billion of theoretical capacity is available globally – still a record level.

Realistic capacity down to US$6.25 billion

However, this simple statistic masks several key developments in this market. To begin with, the maximum realistic capacity – i.e. not what the insurers theoretically offer on paper but what is actually achievable by brokers in practice – has now declined since April, from US$6.5 billion six months ago to US$6.25 billion today. Although this is only a small reduction, it's indicative of the mood in the market; the main reason for scaling back is that the availably of excess of loss facultative reinsurance has been decreasing and so costs have been increasing. So with current rating levels on excess programmes no longer matching the costs of reinsurance protection, this has prompted the direct market to scale back their lines on most major excess placements and prompting insurers to invest in more profitable areas of the programme. Indeed, most are now much more reluctant to put out their full underwriting line for any programme.

Fig 2 – WELD Upstream Energy losses 2000–2019 (excess of US$1m) versus estimated Upstream premium income



The benign Upstream loss record continues. It's still possible that a major offshore Gulf of Mexico windstorm loss in 2019 may give insurers the excuse to push for an acceleration of the hardening process.

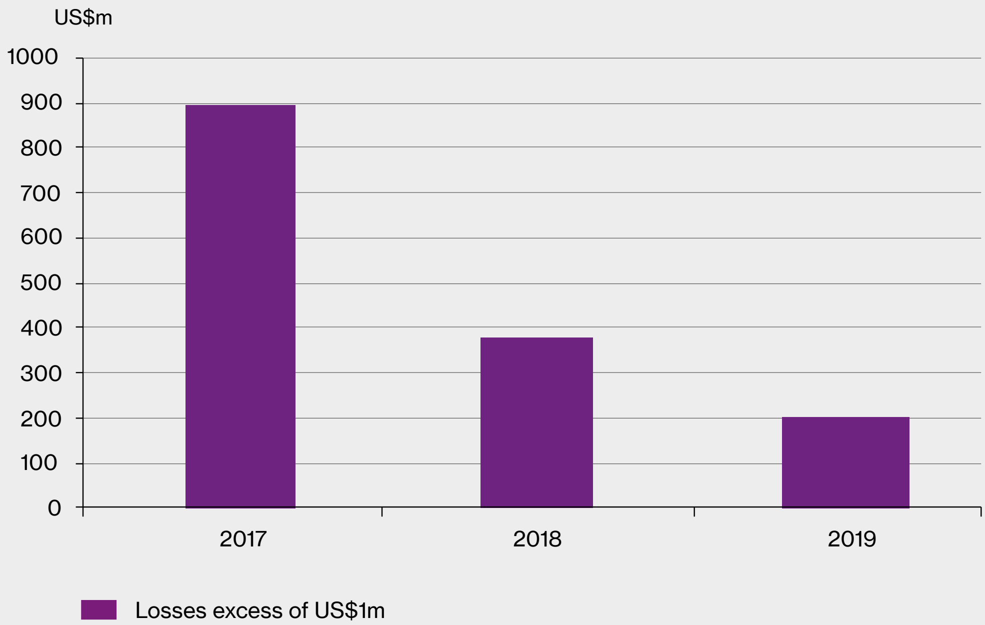
Source: WTW/WTW Energy Loss Database as of October 7 2019 (figures include both insured and uninsured losses)

A continuing benign loss record - but premium pool is still in decline

This chart shows all Upstream losses recorded by our database during the last 19 years, together with our own estimates of global Upstream premium income for the corresponding period. It can be seen that since 2015 the market has been experiencing an increasingly benign overall loss record, with 2019 set to outperform even 2018 in terms of overall loss quantum.

Despite these encouraging signs in terms of losses, the worry for insurers is that global Upstream premium income levels are still on the decline. By extrapolating statistics available from Lloyd's, we estimate that there is now less than US$1.25 billion of premium globally for the Upstream sector – compared to US$2.5 billion only five years ago. So while the overall loss record continues to be benign, and the portfolio remains a profitable one, without reversing this premium income trend the market's future as a viable concern will continue to be an uncertain one.

Fig 3 – Offshore Construction losses reported to date, 2017-19



Source: Willis Towers Watson Energy Loss Database as at October 7 2019

Offshore Construction bucks the trend

One area of the portfolio that is certainly not in profitable territory is Offshore Construction. Our Energy Loss Database statistics of Offshore Construction, particularly for 2017 (see Figure 3 above) now present grim viewing for those Upstream insurers who are attempting to augment their premium income by investing more in this sector. It is not that the sector has suffered a run of catastrophic losses; quite to the contrary, none of these losses have been in excess of US$100 million and in normal circumstances would be accepted as part of an average Upstream loss run.

As a result, there has recently been a retrenchment in this market, particularly in the case of projects featuring significant subsea exposures.

Atlantic Windstorm rates set to increase further

Despite the absence of a major hurricane hit on upstream infrastructure in the Gulf of Mexico this year, rating levels for any Atlantic Windstorm exposures are set to increase following the destruction wrought by hurricane Dorian in September. As we have often pointed out, this class is written separately by a subset of the Upstream market and capacity has been relatively limited for the last 11 years following hurricane Ike in 2008. There can be no doubt that as rating levels for Atlantic Windstorm cover increase following Dorian, the specialist Upstream Wind market will take the opportunity to follow suit – regardless of whether they have actually suffered a loss or not.

US E&P portfolio continues to be kept under scrutiny

As we pointed out in our April Review, attritional losses emanating from the US E&P sector have had a significant negative impact on this part of the Upstream portfolio. Insurers remain in a determined mood to ensure that rating levels are adjusted upwards to redress these losses.

Placing process taking longer

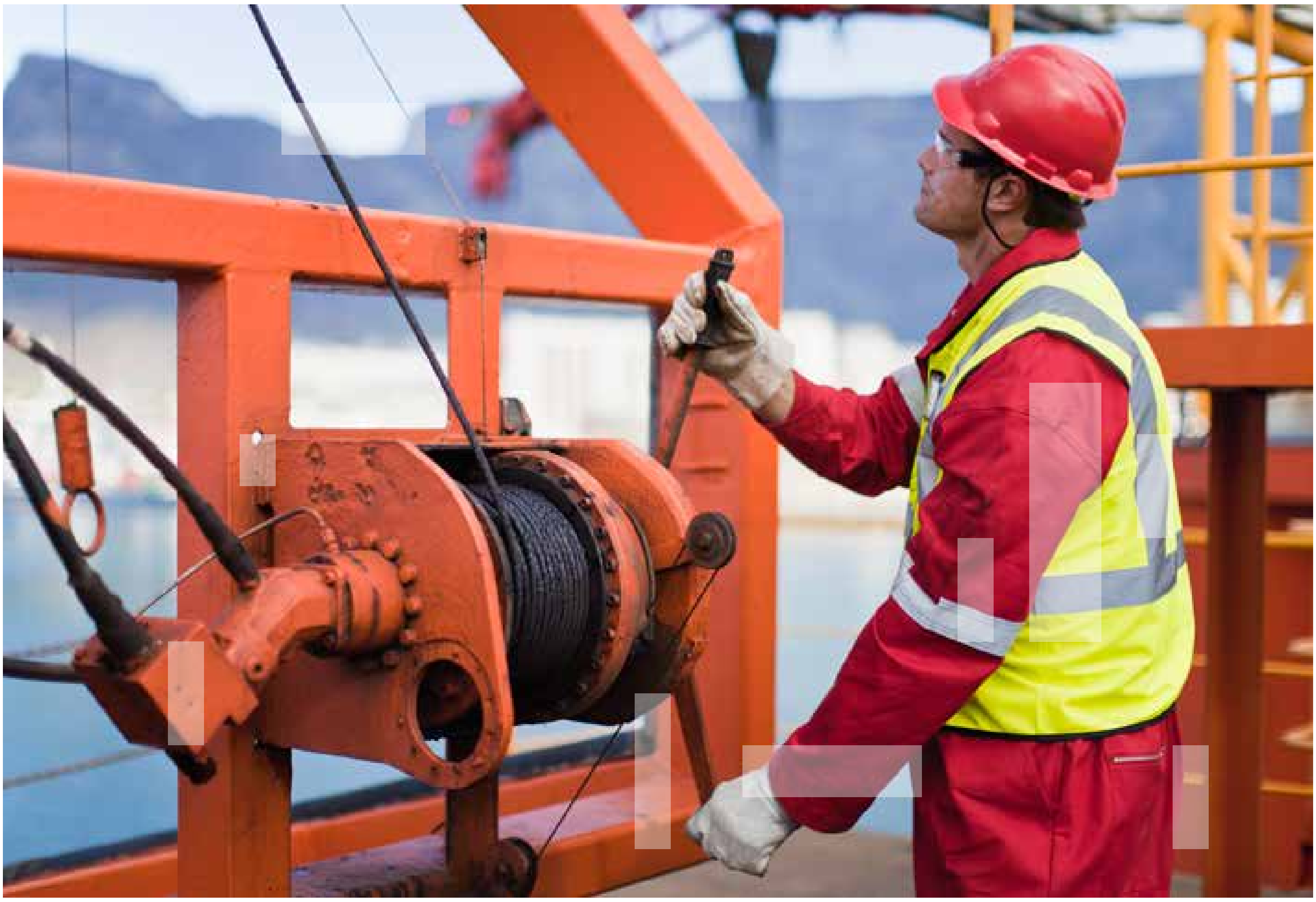
As realistic capacity levels begin to tighten, the placing process is taking longer. Underwriters are still under scrutiny by Lloyd's Performance Management Directorate and their own management and so leaders now have the determination and confidence to hold out for what they want. And as some following markets decide to withdraw from some of the less attractively priced programmes, the process of completing programmes is taking longer, even if they are placed eventually.

More centralisation of underwriting authority

In this business climate, regional offices are keen to keep in step with central office underwriting strategies. There is now more communication between London and regional hubs, and although here is often a degree of time lag between what is offered in other regions and terms quoted in London, there is no doubt that most regional insurers are now following suit and fuelling the gently hardening process.

Impact of other areas of heavy industry portfolio

Finally, we should mention the impact of other areas of the Property and Casualty (P&C) portfolio that is also contributing to the gently hardening process. As we mentioned in our April Energy Market Review, the long term negative underwriting results for Downstream, Hull, Aviation and Construction mean that additional pressure is being put on Upstream as the one area of the overall P&C portfolio that is still making a profit to hold the line and edge rating levels upwards in line with overall management strategies.



Rates continue to move upwards

For all these reasons, despite the inherent profitability of the sector, rating levels continue to rise as we detect a more determined mood in the market, particularly from the leaders. For the most eagerly sought programmes, these rises are currently being kept to a minimum – on average, as little as 2.5% for operator business and perhaps 5% for contractor business. However, the majority of the Upstream portfolio is now expecting rises in the region of 5-7.5%, especially for programmes which require the participation of most of the market. As usual, the extent of the increase will naturally depend on the usual factors: loyalty, premium volume, loss record and quality of the underwriting submission.

However, for Offshore Construction, North American E&P and loss affected programmes, the news is less encouraging; in these areas we are seeing a much stronger rating upswing.

A view from Singapore

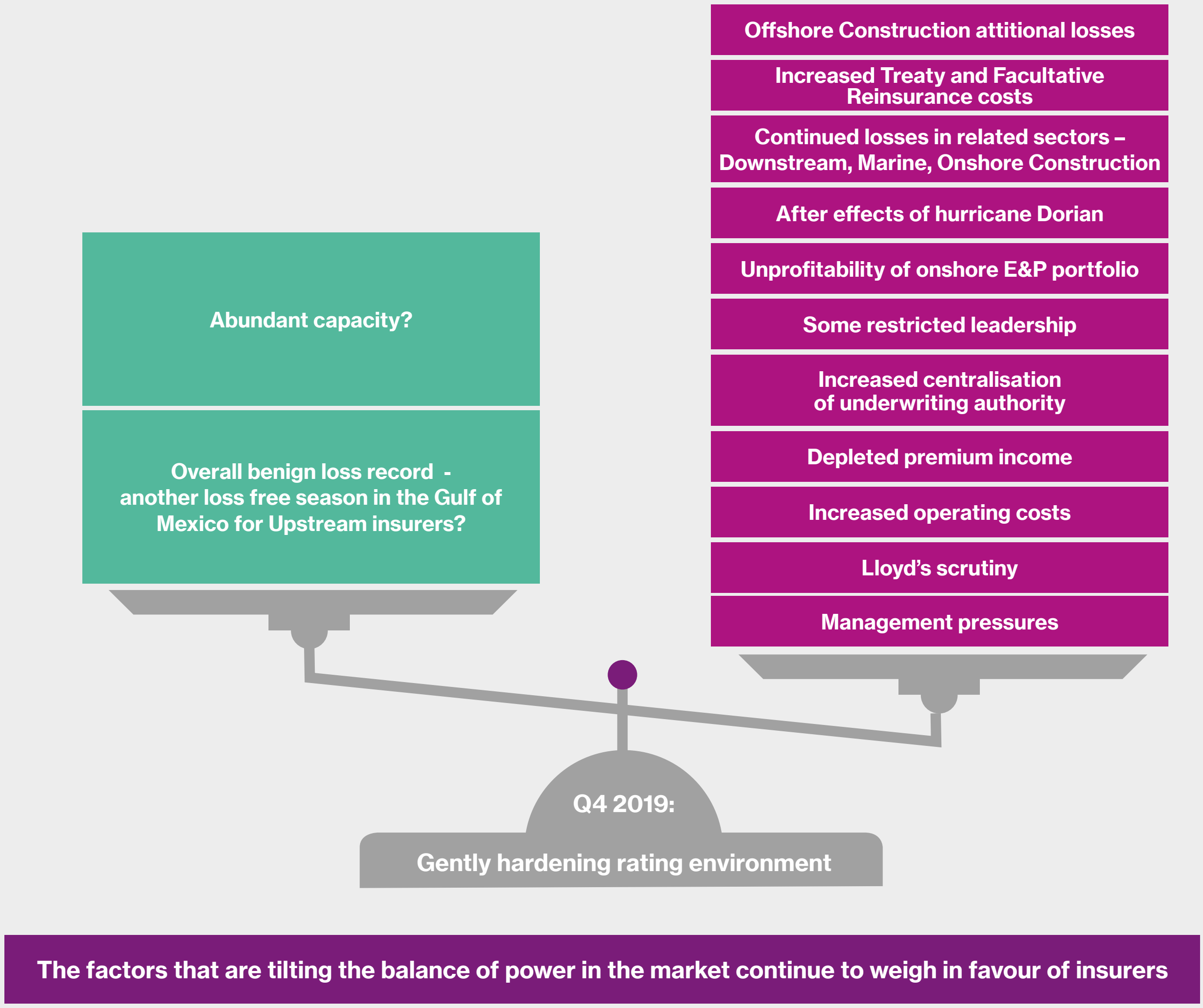
The start of the third quarter showed a more stable Upstream market in Singapore, especially in relation to operational account renewals, which were flat to 5% for programmes with good loss records. However, things changed very quickly towards the end of Q3, with minimum increases of 5% to 7.5% for the same type of programmes. The quick shift in rates could be justified through a combination of increased offshore construction and drilling activity, which is now generating much needed premium for this class of business, and the confidence that insurers now have that they can retain business even when they charge rate increases.

Notwithstanding the above, as in London specialist areas within Upstream such as Offshore Construction and fracking have attracted significant rate increases, with many placements failing to achieve 100% support. We are now seeing a hitherto unprecedented trend of multinational oil company captives declining participation on a construction risk if deemed to be too cheap. As a result, these two areas have attracted increases of 100% from the original terms quoted in comparison to the final terms achieved to complete 100% of the placement. Buyers are not hesitating to switch broker and/or lead insurer where their quoted terms did not achieve 100% support. Indeed, three major construction projects in the region have recently been placed at almost double the quoted tender rates.

This is not the first time that the Offshore Construction market has hardened in this manner, and we seem to be seeing a repeat of 1998 when the market hardened quickly as a result of capital withdrawal. This time round, it's more about sentiment and market discipline, combined with a number of market withdrawals and consolidation.

Looking at Q4 2019, we anticipate rises in the region of +7.5% to +10% for operational risks. The trend for Offshore Construction is expected to continue to rise, especially for stand-alone subsea projects.

Fig 4 – Recent pressures on the Upstream underwriting environment, October 2019



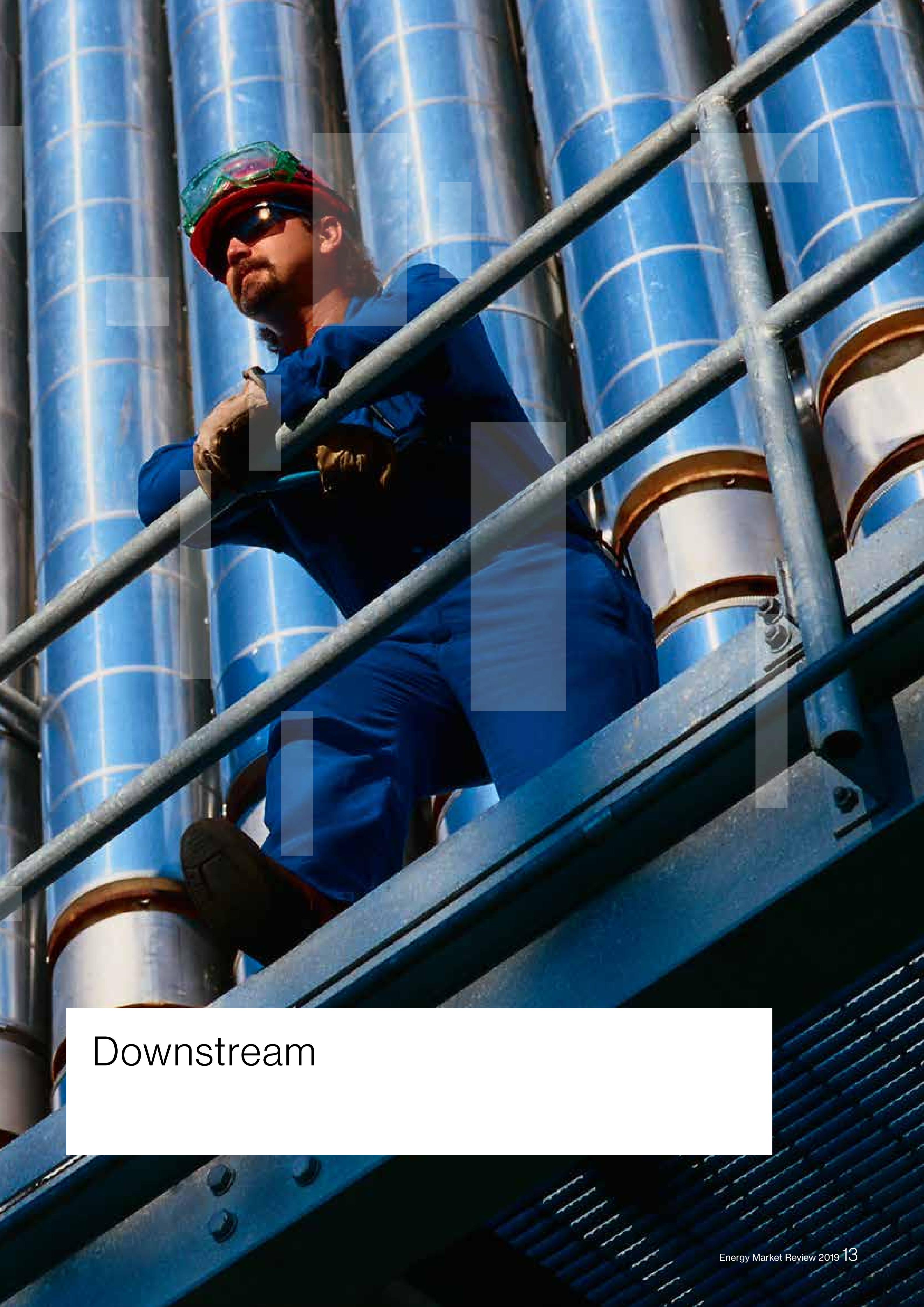
Source: Willis Towers Watson

The outlook for January 1 2020

Figure 4 above shows how the balance of power in the Upstream market is continuing to shift in favour of the insurer. On the one hand, capacity remains abundant in historical terms, while it would appear that the market has once again avoided a major Gulf of Mexico windstorm loss.

But on the other hand, the picture has now become a little more challenging as further negative "blocks" are added to the ones that we identified back in April. If we now take into consideration the impact of recent Offshore Construction losses, together with the possible tightening of conditions in the reinsurance market (both Treaty and Fac), we can see that the scales are pointing ever more strongly towards a market hardening.

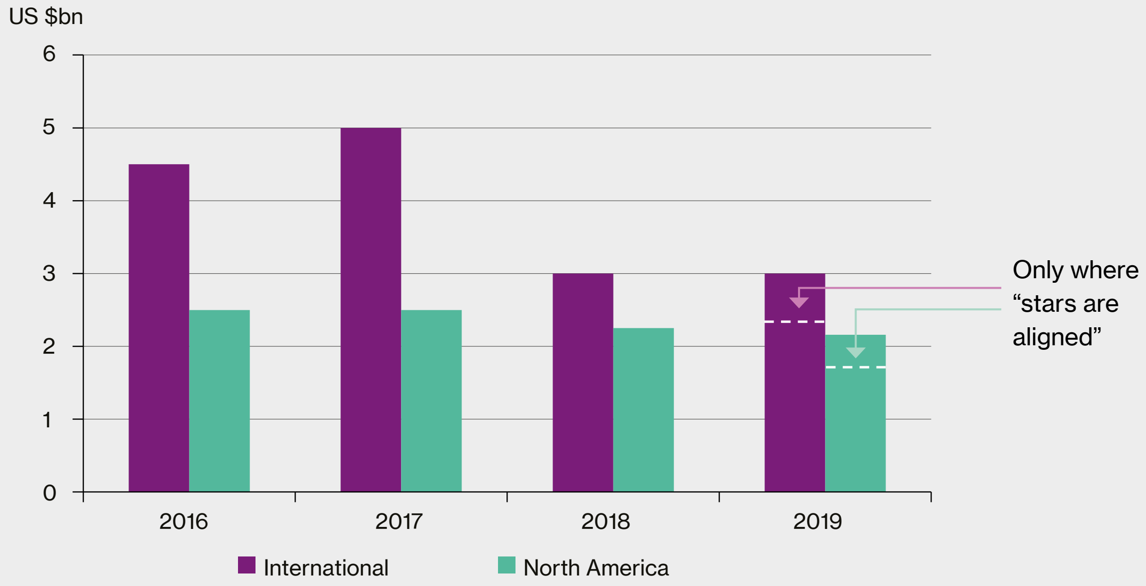
Navigating an optimum route through this less certain market environment will take a measure of long-term planning for all Upstream Energy insurance buyers, regardless of size and buying power. At the January 1 renewal season, it will be interesting to see which strategies pay the most dividend as the market begins to tighten the screw.



Downstream

Downstream – retrenchment and retreat as supply ebbs away

Fig 1 – Realistic maximum Downstream market capacity levels, 2016-19



Source: Willis Towers Watson as at October 7 2019

Realistic capacity decreases for all but the choicest business

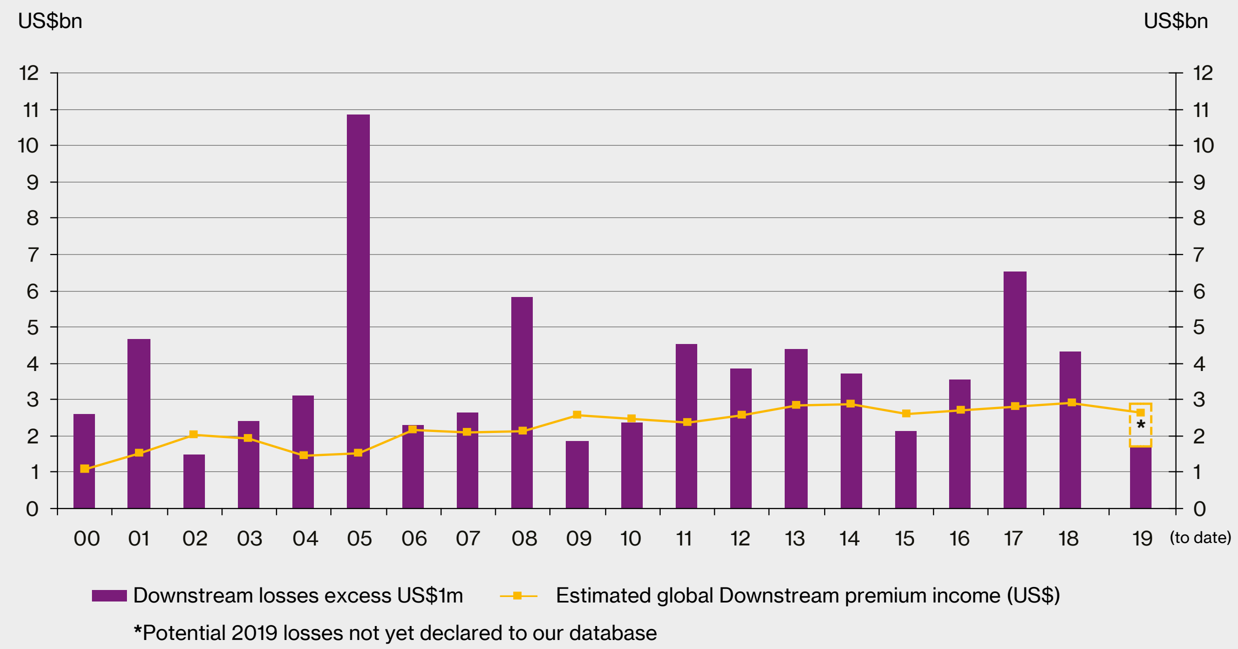
In our April 2019 Review we stated that the total theoretical global capacity for Downstream risks had shown a decrease this year for the first time since 2002. This is itself provided a strong illustration of the changing climate in the Downstream insurance market and accounted for the significant upswing in rating levels that we had begun to experience earlier in the year.

However, until recently we were confident that the maximum realistic capacity levels achievable in the market remained at 2018 levels, and that was also reflected in our April review. Six months further on, we must report that the continuing apprehension in the market to put out maximum lines for almost every type of business has meant that we can no longer be quite so confident in asserting this. It's certainly true that where the "stars are aligned" – the right client, asset, geography, coverage, premium volume, track record and underwriting information – it may still be possible to access the full realistic capacity. However, for most Downstream business a more realistic figure is approximately 80% of what we were advising in April, i.e. US$2.4 billion for International business and US$1.75 billion for North American risks. This is particularly the case for refining and/or loss-impacted programmes, without captive and/or other facility and/or local market support.

Placement process taking longer

As we move further into 2019, achieving even these capacity levels is becoming increasingly challenging. It is taking much longer to finalise large placements, especially as insurers are increasingly unwilling to compress their dollar capacity into smaller placement limits. And for refining business in particular, following underwriters are under instruction not to take as large a percentage share as the leader, unless further losses bring them under further pressure from their management.

Fig 2 – WELD Downstream losses 2000 – 2019 (excess of US$1m) versus estimated global Downstream premium income



Source: Willis Towers Watson/WTW Energy Loss Database as October 8 2019 (figures include both insured and uninsured losses)

Meanwhile Lloyd's has refused to grant more capacity to the Downstream portfolio. This has resulted in more Lloyd's carriers using their company stamp (and buying cheaper facultative reinsurance from regional reinsurers).

Losses continue to plague the market

Our Energy Loss Database shows that for the last four years the Downstream market has been beset by losses hitherto unheard of without the contribution of a major windstorm (such as Katrina, Rita and Wilma in 2005 and Ike in 2008). While 2017 has proved to be truly catastrophic, 2018 continued to be characterized by an unprecedented level of major North American refinery and chemical losses, where the Physical Damage element of the loss is covered by the mutual Oil Insurance Limited, but the Business Interruption element is not.

Final loss total for 2019 can only increase

Any hopes that Downstream insurers might have had that 2019 would prove to be a turning point has been thwarted; instead our database shows over US$1.5 billion of losses set against a total premium volume of approximately US$2.7 billion. Given that we understand that there is a major North American loss currently reserved in our database for approximately US$500 million that might easily escalate further before final adjustment, and allowing for the fact that final annual loss figures do not usually materialise until at least 6 months into the next year, we feel justified in suggesting that final losses may reach as much as US$3 billion by the time the figures are completely mature.

Reinsurance market capacity withdrawal

The Downstream situation has been compounded by the withdrawal of capacity from the Reinsurance market and the increased retentions that the direct market has had to assume as a result. Where once a US$400 million loss would enable an insurer to recover a large proportion from its reinsurance policies, it seems that this is no longer the case; such a loss is now considered as attritional by the market as in most cases any reinsurance recovery is likely to be minimal at best.

Lloyd's syndicates premium income targets already met

We are also finding that the facultative reinsurance market, on which so many Downstream insurers have relied on for so long to support their existing market share, has either withdrawn from this class or made it increasingly difficult to access. This situation has been compounded by the fact most Lloyd's syndicates writing Downstream business have essentially already met their premium income targets for this class of business in 2019. This means that they are already unavailable to fill in the gaps on any reinsurance programme that is no longer complete because of withdrawals and/or scaling back by existing insurers – unless the price is highly attractive. This in turn is likely to increase the pressure on the hardening dynamic still further in the months ahead.

Result: direct insurers more exposed to attritional losses

So with increased reinsurance retentions, Downstream insurers are now more exposed to losses than ever before; in the meantime, fresh losses reported in Q3 included major incidents in the Middle East, USA & North Africa within the US$100m-400m range – just the kind of losses that are having a disproportionate impact as they are now generally below most insurers' retention levels. What's more, the impact over the last few weeks of hurricane Dorian and the Saudi drone attack have done little to ease the determined mood in the market.

Rating levels increase further as market apprehension mounts

All the hallmarks of a hardening insurance market – decreased capacity, more expensive reinsurance costs, a continuing poor loss record - are therefore in place, so it is not perhaps surprising that we have to report an acceleration of the hardening process as we move closer to 2020.

In London, double digit rating increases are now standard, while for refining clients, closer to 30% is often the starting point. Much higher percentage rises are being imposed loss impacted programmes; at the same time, line sizes are being trimmed, resulting in less placements being over-signed.

Centralisation of underwriting authority increases

It's true that some global discrepancies remain, so brokers need to identify areas of the global market that remain the most competitive. But as in the Upstream market, we are continuing to find that underwriting authority is becoming more centralised, with London/central hubs now tending to have the final say. Moreover, even those underwriters charged with a more centralised role are increasingly reluctant to be the first quote terms, preferring instead to wait to see what terms others are quoting before revealing their own position.

The challenge of accessing fresh capacity

Brokers are therefore currently being faced with the challenge of seeking out optimum terms form a market that is increasingly reluctant to offer anything to buyers which would bring them into conflict, either with their own management or with their colleagues in the market. No wonder fresh competition is hard to find, given the extent to which so many underwriters seem to constantly be looking over their shoulder, so aware of the scrutiny by others.

So the option of exploring other leadership options at renewal, often an effective tool to bring existing leaders into line during a soft market, is now proving to be much more difficult. Most insurers will now insist on reviewing the previous year's terms in full – even if they were new to the programme and looking at the risk for the first time.

Little concession for reduced limit or increased retentions

Another option that is theoretically available to buyers in the face of disappointing terms from the market is to either buy less programme limit or increase the programme retention - sometimes even a combination of the two. In this way, existing insurance budgets can be maintained in the face of a hardening insurance market environment.

However, even this strategy is now not proving so easy to follow as in previous underwriting eras as individual underwriters do everything they can to increase their premium pool in the face of their ongoing losses. We have recently come across a new stipulation from several leaders which states that the terms offered for a particular programme are dependent on the full terms being accepted by the buyer – in other words, that little or no reduction in premium would be allowable either in the event of an increased retention of decreased programme limit. While this kind of stipulation is not as yet widespread across the market, the very fact of their existence is of significant concern to buyers and their brokers, and it will require all the market knowledge and skill that the broker has to ensure that the effects of such stipulations remain as limited as possible.

A view from the USA

In the United States, many of the biggest composite insurers are proving to be tough markets. As we move into Q4, these insurers are starting the renewal conversation around 15-25% rate rises, with no market seeming to agree to anything much less than 20%. As in London, renewals are taking more time and going down to the wire. Natural catastrophe risk in particular is being scrutinized more closely, as in London is sometimes being limited via deductible and limit. Meanwhile the notion of "re-underwriting everything" is gaining some traction with the following market, with many insurers "right sizing" their lines – in other words, reducing their share. With top line growth out of fashion, all of these factors are contributing to the hardening process.

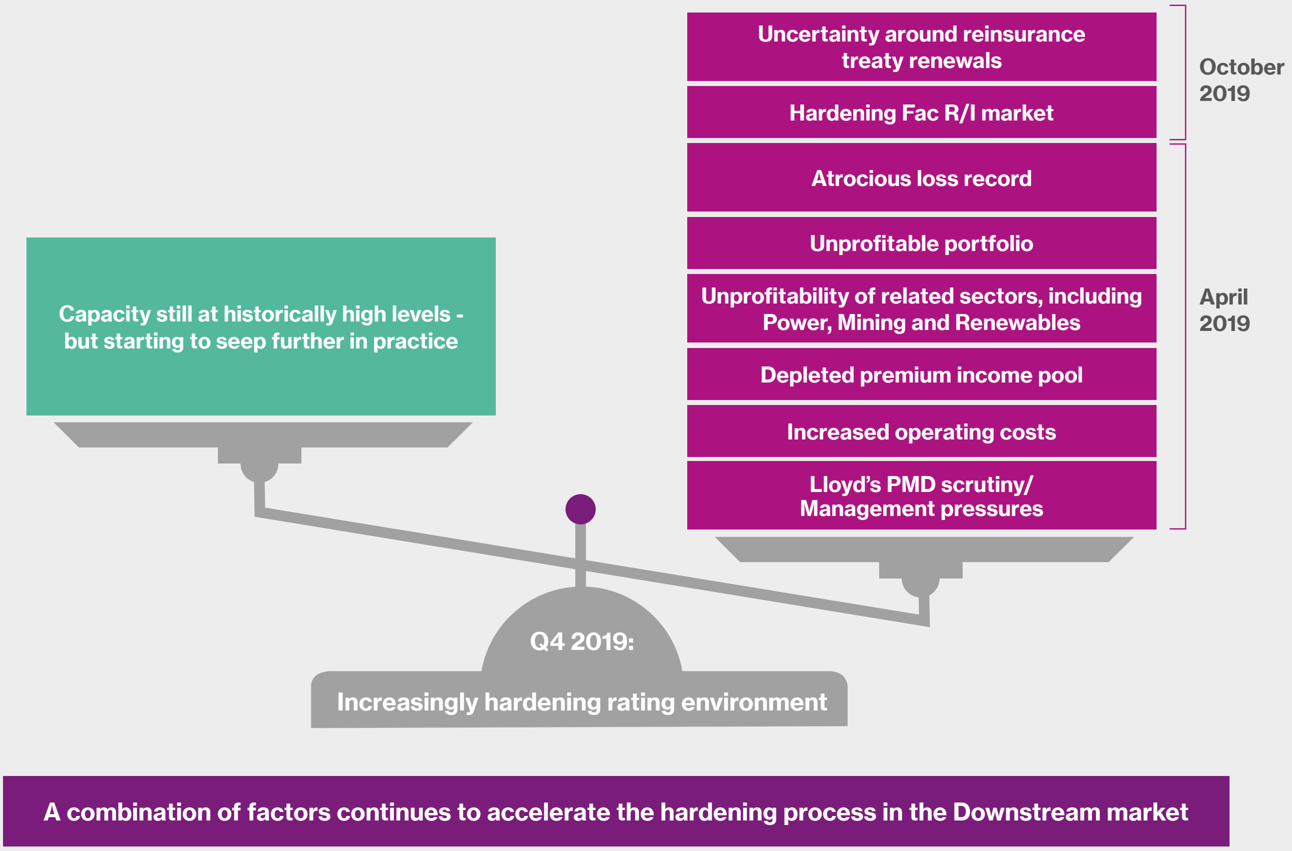
A view from Singapore

The Singapore market has now officially turned, as it has experienced three straight quarters of pure rate increases. Natural disasters and human error are the key contributors for these losses. Reinsurers are now scrutinizing contingent and incidental covers more closely where any heightening of the risk profile is being turned down. We anticipate this to be the theme for the rest of 2019, and if further losses get reported then these increases will get steeper. As for capacity, the rest of the year will see focus on continued bottom line growth, and therefore a very cautious deployment is on the cards. Consolidation and Mergers & Acquisitions within insurers/reinsurers will further restrict capacity for obvious reasons.

These difficult messages are being delivered to clients all across Asia who now look like they are not "surprised" anymore with the hardening of the market. The July 1 2019 renewals saw the most dramatic of changes, where one of the most competitive Asian territories, Korea, saw risk adjusted premiums. Rate increases on loss free business were circa 5-7.5%, and risks which carried losses saw increases anywhere between 10-15%. Mid-market programmes were the worst hit as the dollar increases were reluctantly accepted. Given our comments earlier regarding the increased centralisation of underwriting authority, it seems that local markets are no longer being able to appease clients and are looking at guidance from large international carriers. In summary, the upward rating drift will continue, and we are seeing consolidation of underwriting practices across the Asian market. Our recommendation is to ensure that risk surveys are promptly done before any renewals, and to allow as much time as possible for the renewal process to take place.

Following the July 1 renewal season Q3 saw increases of circa +15% for programmes with clean loss records, while as we look towards the end of the year we anticipate an increased hardening, with rises of +15% to +30% on clean programmes now anticipated.

Fig 3 – Downstream: an increasingly hard market



Source: Willis Towers Watson

The outlook for January 1 2020

Figure 3 above sums up the current situation in the market and shows graphically how the balance of power within the market continues to shift in the insurers' favour. Since our April 2019 Review two further critical factors have emerged that has accentuated the hardening process; the uncertainty around reinsurance treaty renewals, which is making leading insurers even more nervous about quoting new business, and the withdrawal of the facultative reinsurance market, which has put further pressure on brokers to replace gaps in programmes originally designed in the old soft market which are now coming under significant pressure as insurers scale back their lines and as the original facultative reinsurance market become increasingly difficult to access.

Leadership remains scarce, so "going early" with terms can create uncertainty, as this may well give following insurers enough leverage to enable the "tail to wag the dog." Moreover, OIL wrap programmes with a heavy emphasis on Business Interruption (BI) exposures are concerning some underwriters who can often view this as "anti-selecting" and who usually respond by loading BI rates.

It will only be by consulting widely with their broker that buyers can mitigate the worst effects of this hardening process. And as we have said so often in our Review, it is those buyers that have established long term strategic partnerships with key insurers who will be protected most in this increasingly challenging underwriting climate, as the market "turns the screw" in their quest for additional premium income and the nirvana of a profitable portfolio.

Editor: Robin Somerville

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