

Climate change could drive reinsurance volume, but softening a more immediate threat: Morningstar

While climate change could drive reinsurance volume in the long-term, softening of the market is more important in the medium-term, Morningstar analysts have highlighted in a recent report.

The re/insurance industry is facing increasing losses as global temperatures continue to increase, a direct consequence of climate change. While the frequency of large-loss events may have stabilised, their severity continues to rise.

According to the recently published Morningstar Equity Research, this trend should, in theory, increase long-term demand for insurance and reinsurance coverage, narrowing the protection gap and supporting top-line growth for reinsurers.

However, the research suggests that "the market is operating at overcapacity, and that is the more important driver in the medium term."

The notoriously cyclical property-casualty sector has



enjoyed a favourable period with strong pricing since 2021. This was a response to periods of low capacity, where high demand led to a surge in prices and increased returns on equity.

This, in turn, has historically attracted new capital, which drives prices and profitability down. The recent cycle, however, was blurred catastrophe bonds, which can take up to two years to settle.

Morningstar believes that the market peaked last year, but the full impact on reinsurers

profits may not be realised for another year or two, after which profits are likely to stagnate and fall.

Global warming, fuelled by rising greenhouse gas emissions from fossil fuels, has led to a consistent increase in the Earth's average surface temperature.

This has been linked to a rise in droughts, rising sea levels, and, critically, more severe storms with heavier rain and stronger winds. While the resulting increase in economic losses from catastrophes

should, in theory, fuel long-term growth for property-casualty reinsurance, capital has not yet been outstripped by these losses, leading to the current market shift.

According to Morningstar, the reinsurance market is showing signs of turning. Analysts explained: "The largest 10 reinsurance companies hold a combined market share of 69.4%, translating to a 586.3 Herfindahl-Hirschman Index, which reflects an unconcentrated industry that we believe is indicative of low barriers to entry. Following the financial crisis, the reinsurance cycle stayed hard, as industry capital remained constrained until around 2013.

"At this point, we think the attractive returns on offer had enticed enough capital that a negative impact on pricing began to take effect as capacity began to swell. And as global catastrophe losses began to decline, market softening was free to run."

Hurricanes Harvey, Irma, and Maria in 2017, in Morningstar's opinion, marked the bottom of the soft cycle. Due to

the long settlement cycle of catastrophe bonds, the market did not fully harden for another two years.

The significant loss year of 2021, which included Hurricane Ida and other major events, then accelerated the strengthening of the market. However, with alternative capital now at record levels, pressure on pricing has resumed.

Morningstar anticipates that the softening of the market is the most pressing issue for the medium term.

Some have suggested that reinsurance cycles are becoming longer, yet Morningstar analysts believe that reinsurance has recently experienced "a prolonged, yet gradually hardening, market in the early years."

"That firming then accelerated. While the market softened for four years between 2014 and 2017, it began to harden between 2018 and 2020, gently. It wasn't until the heavy natural catastrophe year of 2021 that the real strengthening of the market started to take effect.

The firm market we are now leaving has been in effect for seven years. Alternative capital has reached record levels, and losses from the Los Angeles wildfires have not offset the fall," the firm explained.

The full impact on earnings will likely be felt over the next two to three years as premiums run off. Lower interest rates, resulting from a softening of inflation, are also likely to lead to lower investment and reinvestment yields.

This combination of declining prices and investment returns is expected to cause a plateauing of reinsurer earnings within the next four years.

"We think investors can already see this at some reinsurance firms. Price improvements began to slow around two years ago for Hannover, but this year its risk-adjusted price changes turned negative. Given the current pricing trend, we anticipate prices may move through their long-term adequacy around January 2026," Morningstar analysts concluded.