VIEWPOINT

Risk selection is critical to a sustainable financial institutions market

The market's low-frequency, high-severity risk profile, together with the lack of homogeneous data, is creating a highly challenging environment for underwriters

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A fragile and hazardous environment faces insurance clients in the financial lines sector as 2021 unfolds amid a hardening market, a global pandemic and an uncertain economic outlook.

Sophisticated financial sector companies must navigate an unprecedented landscape of diverse, unique and fast-shifting threats, perhaps most obviously exemplified by the exponential rise in cyber attacks affecting all sectors. Customer claims and regulatory investigations are also on the rise and, increasingly, individual directors and officers of firms are being held personally liable, leaving organisations and their executives vulnerable to a plethora of emerging risks. Risk is certainly up and, coupled with unpredictability, a continuing hard market is the overarching theme in the foreseeable future.

The commercial insurance market started firming in 2018 after nearly a decade-and-a-half of price reduction, only briefly interrupted by the global financial crisis. The arrival of Covid-19 in 2020 turned up the heat and the market changed gear from price correction to outright hardening. Portfolio rate increases of between 25% and 40% were recorded across the industry, with examples of underpriced individual risks facing a dramatic 300% to 500% adjustment. Axa XL's withdrawal from financial lines and directors' and officers' liability in London added to this.

The result of corrective pricing over the past three years would have succeeded in putting the market on a sounder footing had it not been for the impact of social inflation, reserve deficiencies and the Covid-driven amplification of economic uncertainty.

Inflation threat

After a decade of quantitative easing (QE) and the recent reopening of economies in the US and Europe after lockdowns, inflation is now the threat that could provoke a change in policy. It is worth underscoring the tight correlation in this class of business between economic shock and operational loss activity – stock market volatility, combined with an economic downturn, serve to expose crime losses and spur claims against this sector's institutions for financial loss and compensation.

QE and the low interest rate policy response that followed the financial crisis have had the effect of stimulating asset prices – stock markets are trading at an all-time high, with valuation multiples some economists feel bear all the hallmarks of a bubble. There are plenty of conflicting signs that are encouraging – for example, the pick-up in economic activity most starkly evidenced by recent estimates private equity companies have struck merger and acquisition deals worth more than $500bn in the first half of 2021 (the highest since records began in 1980). However, there remains concern if the policy response to rising inflation is to raise interest rates in markets that have grown used to them being at historic lows, fragile economies could go into shock and asset prices could crash.

For the short term, such drastic economic threats are likely to be held at bay, although the outlook is unclear. Another interesting trend is the gathering pace of the shift of global trade to the East, after centuries focused on Western interests. What might the world's changing economic centre of gravity mean for financial institutions and their risk exposure profiles?

How should underwriters respond to these fluid risk dynamics and complexities in general? The pace of rate change grabs attention, but the most important pricing metric is rate adequacy. The ability to price risk appropriately is a key determiner of success for an underwriter. In addition to price adjustments, carriers are certainly demonstrating more discipline, reducing both line size and concentration in layers written. For small and medium-sized enterprises and asset management business, only two years ago an insurer would need to write 100% of a primary $5m layer to be credible. Now, it is normal to see a lead line restricted to 50% or even 25%. Increased discipline and capacity constraints are leading to a renaissance of the subscription market.

At Mosaic, we believe by having a broad portfolio that avoids concentration, we are better able to withstand systemic exposures to any particular financial sector, economy, jurisdiction or regulator. Underwriting strategy must begin with a rational portfolio framework that governs the deployment of capacity before we begin the critical individual risk selection work within it.

Barrier to entry

The low-frequency, high-severity risk profile of this class of business, together with the lack of homogeneous data, creates a barrier to entry and means considered judgment is required to underwrite this portfolio successfully. Experience certainly helps refine critical thinking, so long as one is open-minded and prepared to absorb lessons. We have built a team around industry veterans at Mosaic; experts who bear the scars from the early 1990s, the dotcom bubble at the turn of the last century and the financial crisis. We have certainly been to school.

Risk selection and careful analysis of financial institutions is fundamental from our perspective – although a big challenge. Contract language, coverage attachment points, capacity deployment and premium decisions are all vital parts of the underwriting process, but differentiating potential clients by culture, operational risk, business model and financial strengths and weaknesses best determines the performance of an underwriting portfolio.

Syndication is another way to mitigate against unknowns, especially in the capricious environment surrounding financial institutions these days. We have created our company with a hybrid model to share exposure and make our offering more robust through market cycles; it combines our London syndicate with a global syndicated capital management structure, enhanced by an agile insurtech platform, essentially taking the Lloyd's subscription market virtual.

It is unusual but effective: by taking a share of risk for Mosaic 1609 and matching that with capital from third-party partners, we create syndicated blocks of capacity to distribute worldwide. In times of economic uncertainty, spreading cover in such a way offers more powerful portfolio protection, especially to address clients' operational risks in today's climate. ■

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