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Speakers

Andrew D'Arcy, Head of International P&C, Gen Re

Mike O'Dea, Chief Financial Officer, Gen Re

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Getting to grips with the financials of a (re)insurance company

Learning objectives:

Gain an understanding of the balance sheet of a (re)insurance company focusing on investment and reserves

Appreciate how the focus of reporting requirements can differ for shareholders, rating agencies and regulators and how companies assess the impact of external factors

Learn how external economic factors influence wider underwriting strategy and approach with particular emphasis on the current environment

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Agenda

- Composition of Financial Statements
- The Balance Sheet
  - Investments
  - Reserves
  - Other Items
  - Notes to the Accounts
- What Stakeholders look for
  - Regulators and Solvency
  - Rating Agencies
- Current economic conditions and their impact on the Balance Sheet

Composition of Financial Statements

- Directors' Report
  - Overview of results, financial position, business developments
  - Statutory information, e.g. directors, registered office
- Balance Sheet
  - Assets and Liabilities
- Profit & Loss Account / Income Statements
  - Revenues = premiums, investment income, investment gains/losses
  - Expenses = claims, commissions, operating expenses, foreign exchange, taxes
- Statement of Cash Flows
- Change in Shareholders' Equity (or net worth of the Company)
- Notes to the Accounts
  - More detail and analysis of major balances in the B/S and P&L
- Other Disclosures
  - Corporate Social Responsibility Report

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The Balance Sheet

What's on the Balance Sheet

Assets	**Liabilities**
Investments and Cash	Reserves
Premiums receivable	Unearned premiums
Reinsurance recoverables	Insurance balances payable
Prepaid reinsurance premiums	Accrued expenses
Accrued investment income	Tax balances
Goodwill	**Shareholders' Equity**
Fixed assets	Share Capital
	Retained earnings
	Other reserves

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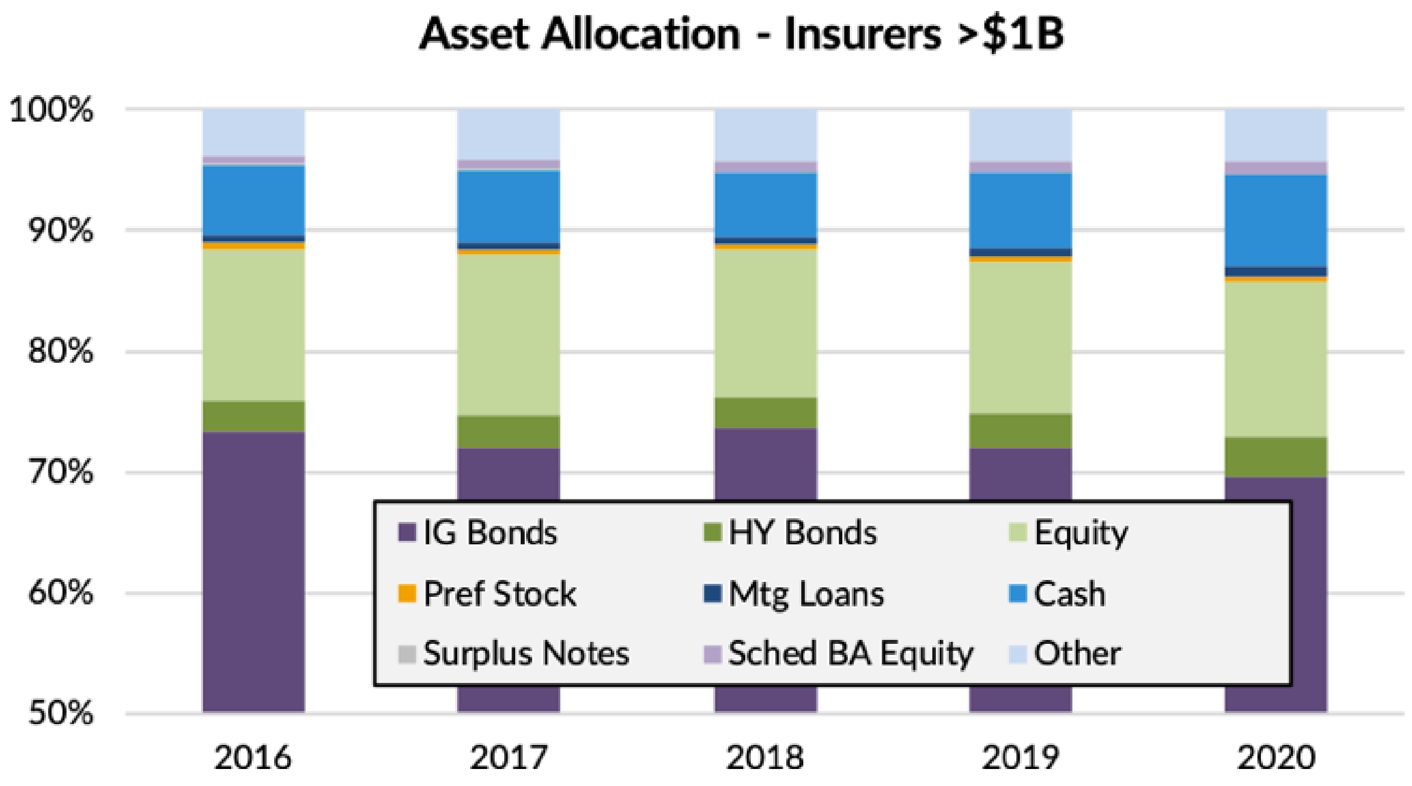
Investments and Cash

- Prudent Person Principle and Policyholder Protection
- Investment strategy, portfolio management and risk return equation
  - Asset classes – bonds vs equities vs other categories
  - Credit quality and Duration
  - Liquidity
  - Currency
- Consideration of “matching” assets and liabilities – currency and duration
- Tendency towards bonds, relatively high quality and shorter durations
  - Protection for policyholders and management of volatility in results
- Impact on strategy from climate change considerations

Composition of Investment Portfolios



Source: *S&P Global Market Intelligence. Data as of 31 December 2020*

Other investments include deposits with banks and investments in renewable energies, physical gold and forestry.

Source: *Munich Re Group Annual Report 2021*

Reserves

- Known reported losses and **I**ncurred **B**ut **N**ot **R**eported losses (IBNR)
- Valuation is difficult, subject to many factors and a wide range of outcomes
  - Extensive use of historical data to determined loss development patterns
  - Overlaid with sometimes significant assumptions about the future
- Property considerations
  - Reserving for known cats – loss modelling output, repair and replacement costs, impact of supply chain constraints, greener (more expensive) technology
- Casualty considerations
  - Loss reporting patterns
  - Factors affecting ultimate loss costs – social and economic inflation, new exposures (PFAS), legal reform, 4^{th} party liability

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Other items

- Goodwill – value of “intangible” assets (not available to meet claims)
- Reinsurance recoverables – compared to reserves, i.e. how reliant is a company on their reinsurance and/or retrocession programmes
- Look at reserves and see what assets will be needed to meet future liabilities
  - Investments and Cash
  - Reinsurance Recoverables

Notes to the Accounts

- Investments and Cash
  - Asset categories
  - Unrealised gains and losses
  - Intercompany transactions
- Reinsurance recoverables
  - Relationship to reserves
- Reserves
  - Lines of business
  - “Known” case reserves vs “Unknown” IBNR
  - Sensitivity of assumptions
- Contingent Liabilities, .e.g. litigation

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Other Stakeholders

Regulators and Rating Agencies

Regulators and the Solvency Capital Requirement

- Regulators use SCR to monitor financial strength and inform their assessment and monitoring of companies
- SCR is based on capital charge factors applied to balance sheet items
  - Regulator prescribed = “standard formula” vs “internal model”
  - Factors driven by the underlying nature of the assets and liabilities
- Solvency II is based on the accounting principle of fair value
  - Investments are reported at their market value
  - Reserves are reported at the **N**et **P**resent **V**alue after applying discount rates (what companies expect to achieve as their investment return), which makes valuation sensitive to the interest rate environment

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Rating Agencies

- Regulatory solvency requirements focus on a company's ability to survive a large shock and protect policyholders, without necessarily having to trade forward
- In our competitive market place, that is not sufficient to persuade clients to do business, as they focus on companies' financial credit ratings
- Rating agencies are sometimes referred to as the "de facto regulators"
- Their approach goes beyond purely the current balance sheet and their financial analysis is much deeper
- AM Best Capital Adequacy Ratio (BCAR)

  https://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=197686

  - Balance Sheet Strength
  - Operating Performance
  - Business Profile
  - Enterprise Risk Management

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Current Economic Environment

Current economic conditions

- UK inflation hits 40-year record, highest in G7 – *Reuters, 22 June*
- U.S. Economy Shrank Worse-Than-Expected 1.6% Last Quarter As Recession Fears Grow – *Forbes, 29 June*
- Early 2022 sees record number of cost and supply chain profit warnings as companies face 'crisis as normal' – *EY, 3 May*
- Average UK pay rises stall at 4% – less than half the inflation rate – *The Guardian, 21 June*
- War, nuclear threat, terrorism, ...

- Impact on investment portfolios from high inflation, volatility in financial markets
- Assumptions underlying reserve calculations to estimate future costs of claims

External economic factors and underwriting strategy

Agenda

- Introduction & Context
- Underwriting appetite in the context of:
  - Inflation: the big one
    - What can we expect and for how long?
    - What lines of business are most impacted?
    - How do we manage our portfolio?
  - Supply chain disruption:
    - Business interruption loss amplification
    - Demand surge amplification
    - Line of business strategy
  - Geopolitical risk
  - General economic environment

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Introduction & Context

- We live in “interesting” times…
- Our industry is already not in particularly good health….
  - McKinsey Global insurance report 2022: *Half of insurers are not making their cost of capital and half are trading below book value*
- ….And now the precision with which we can price and underwrite risk has rarely been more questionable….
  - Predicting inflation, supply chain resilience, political stability, economic growth and the impact of climate change, simultaneously and with their inherent correlations is extraordinarily difficult
- ….Leading to volatile market dynamics:
  - A pivot to Casualty lines as Property Cat risk becomes too volatile/loss making… But is this simply the most visible area of concern?
  - Reserves under increasing pressure from inflation.. But when will this move pricing?
  - Rates plateauing in many lines… In spite of increased risk and uncertainty
  - Greater focus on Ts & Cs to try to limit exposure… But this is also less pronounced now.
  - Fixed cost inflation putting pressure on expense ratios… Is this driving a “top line” focus?

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Inflation

- Let’s start with inflation
  - What kind? Supply (cost push) or demand (price pull)? CPI, Wage, Construction…?
  - What will the policy response be?
  - How long will it last?
  - What do we do about valuations?
  - *How do I manage a portfolio in this environment?*

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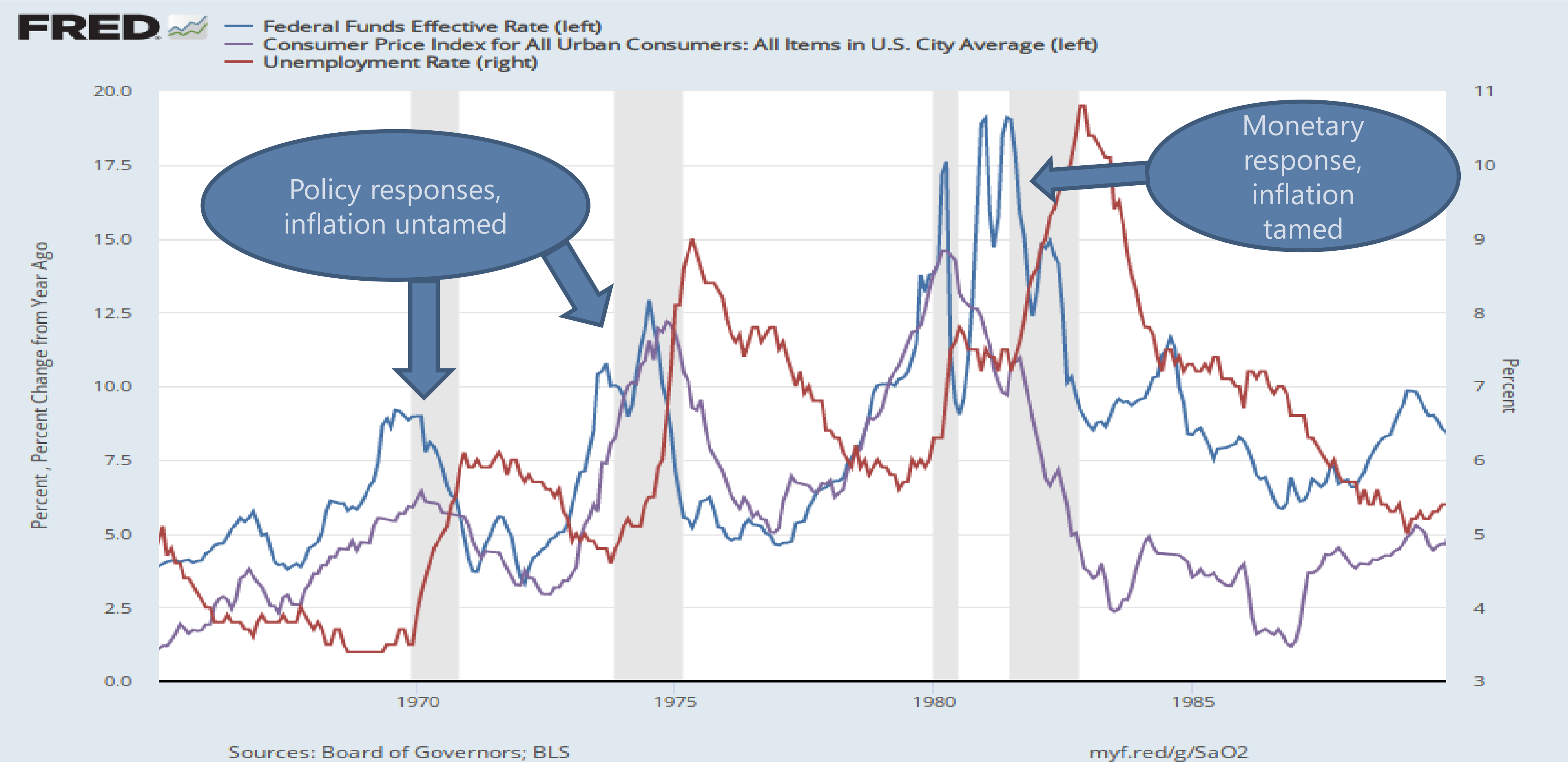
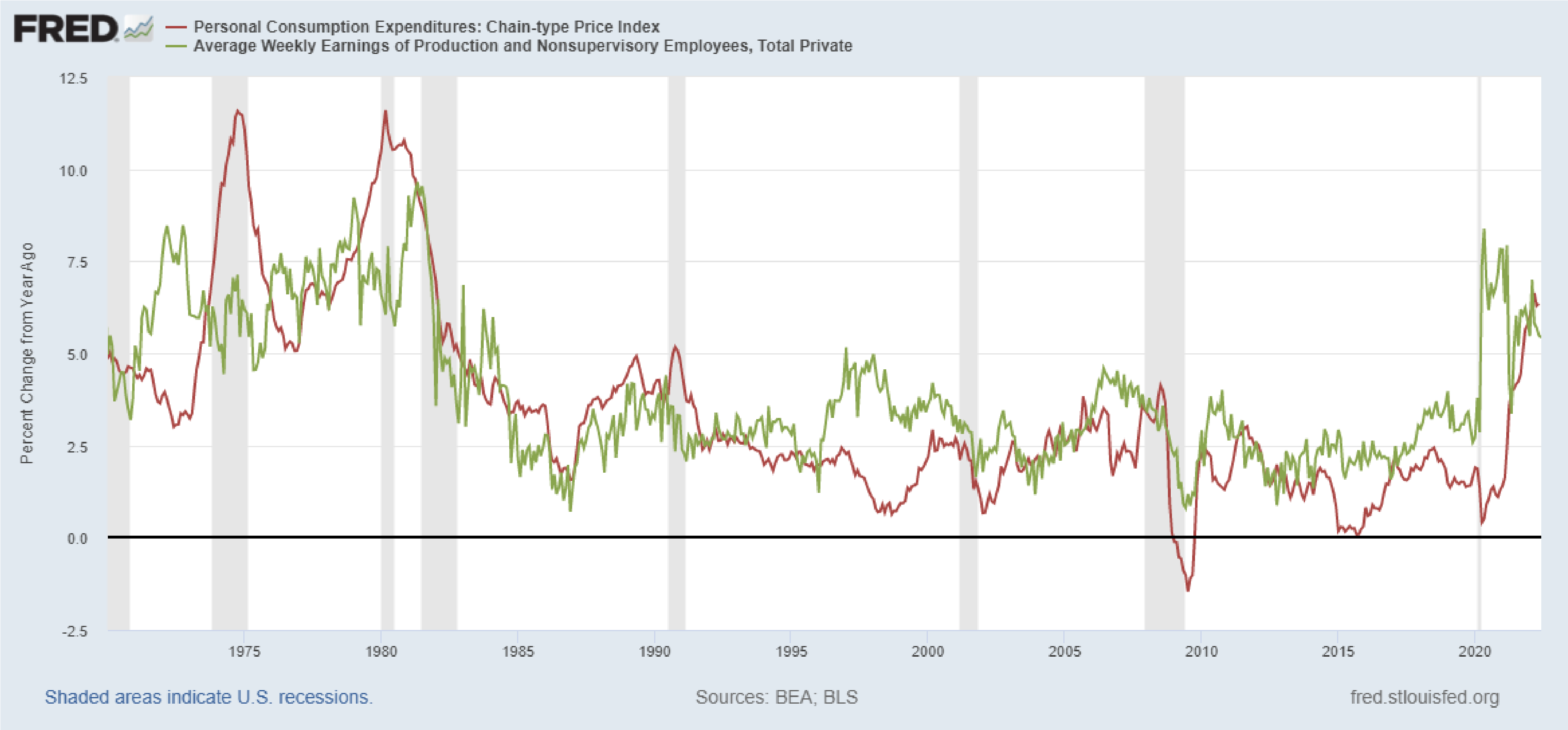
Inflation: What kind of response and for how long?



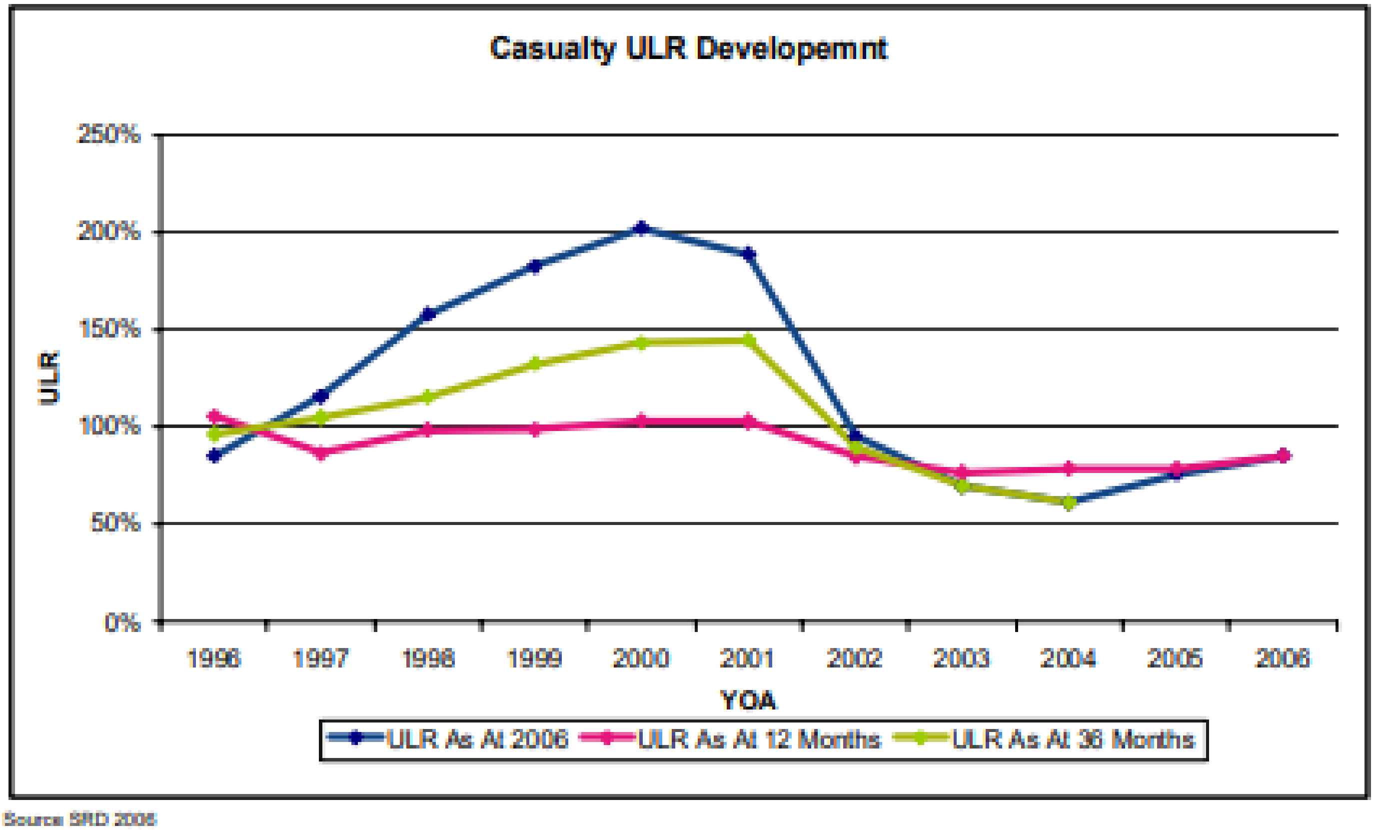
- Experience of most central banks is that interest rates must rise sharply to tame inflation. Historically this has been followed by economic distress, or at least raised unemployment. This is unlikely to be resolved in the very short term

Inflation: Ok, but CPI doesn't impact long tail, right?



- True, social inflation may be a more material driver of some lines. But wage inflation is a driver of BI and other liability claims in many jurisdictions
- Not a perfect relationship, but wouldn't bet that wage inflation won't track prices to some extent

The "reserving cycle" tends to reduce visibility of long tail issues

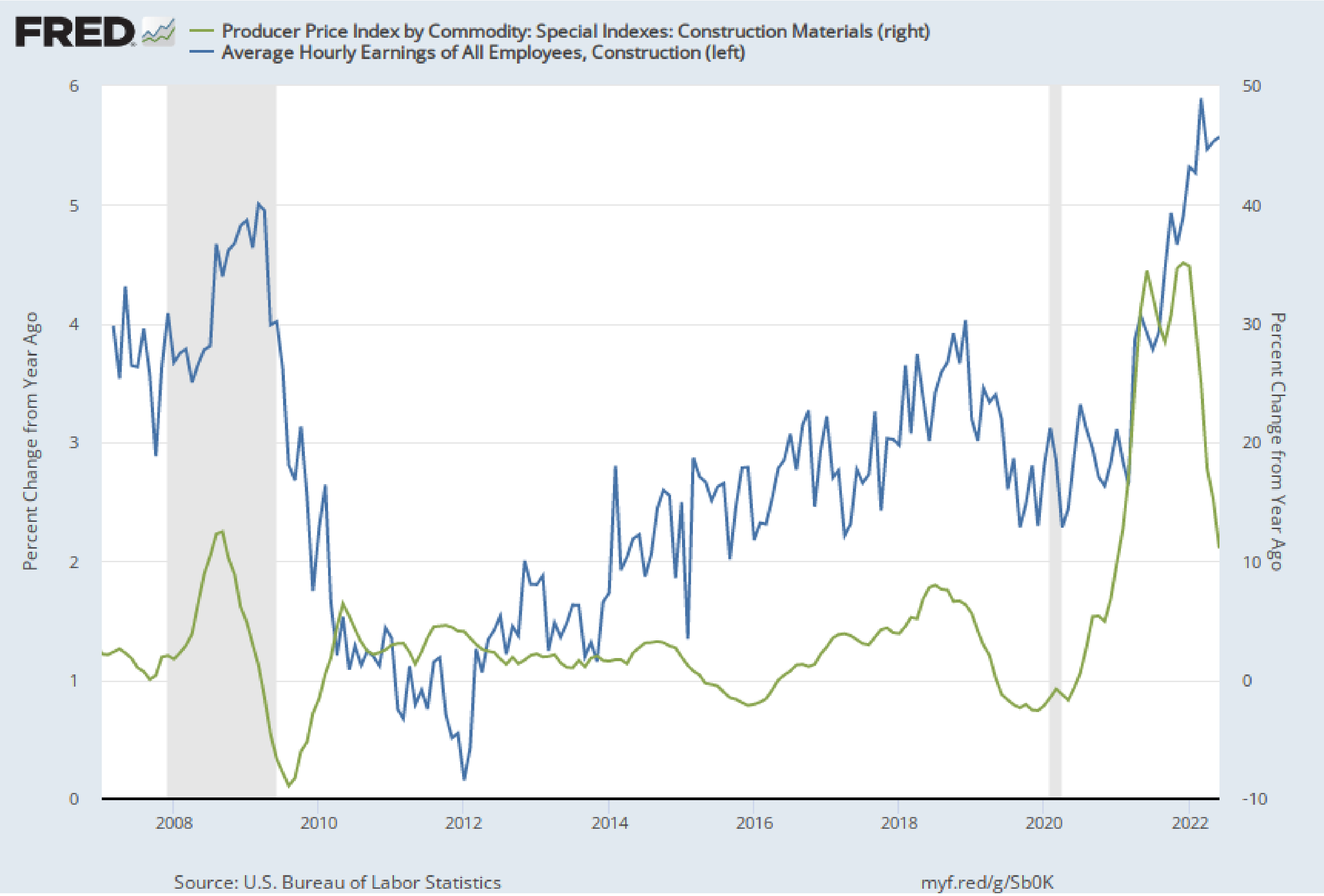


Source: Lloyd's of London presentation to GIRO, 2006

The Actuarial Profession
making financial sense of the future

- Bad years tend to get worse, and we are slow to recognise a bad year
  - ➔This impacts behaviour and pricing until experience emerges some years later

So long tail business may suffer. What about short tail?



- Enormous and well publicised increase in construction material costs. Now wage inflation picking up also. What would demand surge look like?

Inflation: portfolio strategy

- We are (generally) writing annual policies. To a large extent, we don't care how long inflation lasts, why it is here or how it will be managed. Our horizon is often short.
  - Valuations are treated with care and inflation expectations are higher than current
  - Lower layers are particularly exposed in the short term. Gearing effect is higher for top layers, but price correction may occur before they are hit?
  - Average clauses and other protections are preferable and making a comeback in some markets
  - Avoiding risks that are most exposed to business interruption (or heavily sublimit it)
  - Multi-year is next to impossible. Care needed for engineering, etc.
- For long tail (liability), we are required to consider medium term inflation expectations:
  - Why should inflation be transitory? Has wage-price spiral already started?
  - Is there enough margin in this line for the (inflation) risk taken? Assuming 60% LR, 15% Brokerage, 10% internals… a 95% CR becomes 105% if inflation is 4% higher than expected for 4 years… Without gearing! Excess layers would suffer much, much more.
  - Jurisdictions with close link between claims settlement and average wage are very exposed.
- Portfolios should be overweight in less exposed lines– shorter tail or excl BI type exposure

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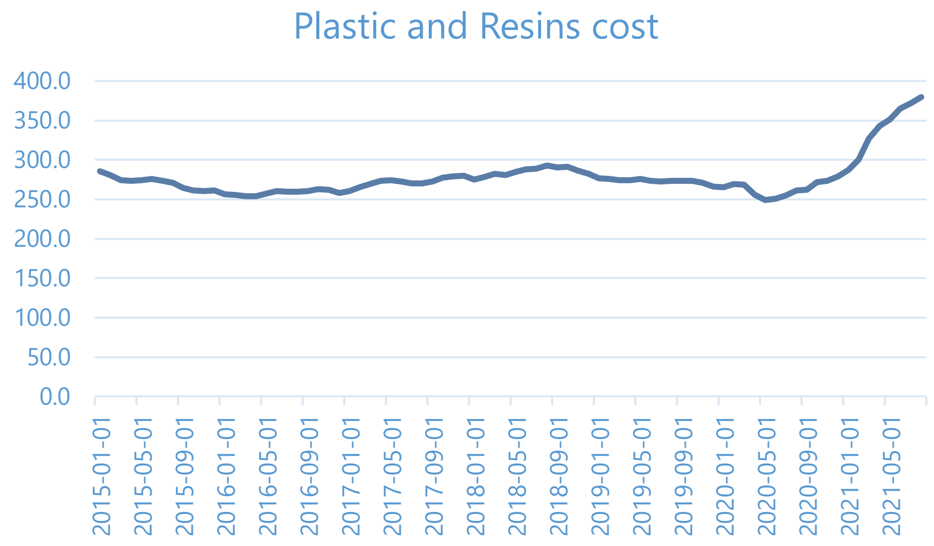
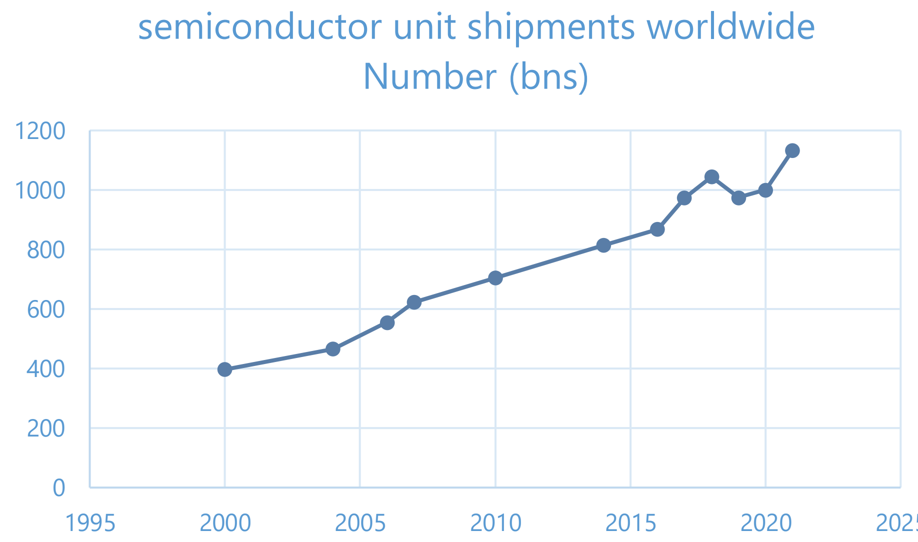
Supply chain disruption

- Manifests most directly in business interruption loss
  - Business interruption is number 2 on the Allianz Risk Baromter for 2022 (having been number 1 risk in most years in the last 10). According to their 2020 report, BI can cost up to 45% more than the corresponding fire damage loss.
  - 61% of respondents to a McKinsey survey increased inventory of critical products. Many others have "Near shored" their supplier bases and production sites.
  - CBI should be seen as a deeply unattractive part of any portfolio. Even in a geopolitically and economically (more) stable world it was close to unpriceable.
  - Public utility extensions, given to some extent in most markets, are a particularly difficult CBI product to deploy, particularly with grids under pressure.
- Post event loss amplification is a major issue.
  - This was seen most clearly after Uri
  - Suggestion of supply chain issues causing construction and labour crunches in Australia post flood with material inflationary impact

Examples of supply chain disruption that can directly lead to loss amplification

- Plastics supply disruption may be reflected in sudden cost increases. This was seen in 2021 post Storm Uri in the US.
- Semi conductor shortages can be inferred from the sudden fall off in shipments in 2019 compared to the clear increasing trend in prior years.
- Deployed ship capacity through Shanghai decreased by 7.2% in Q2 2020





Sources: stlouisfed.org, Statista.com, UNCTAD.org

Supply chain disruption: Portfolio Strategy

- For shorter tail lines, we favour business that:
  - Has minimised BI as much as possible, sub limiting appropriately
  - Has wording that clearly considers the impact of inflation on BI. An annual revenue limit (for example) will be compressed if the daily lost revenue is much higher than predicted at point of underwriting
  - Is less exposed to industries with long and complex supply chains. SME domestic exposures may be more favourable.
  - Excludes or limits PU extensions given grid strain.
- Longer tail lines should generally be less impacted but given the focus on supply chain disruption in most industries, there may be heightened D&O exposure.
- Cat exposure is particularly susceptible to surprise loss amplification and lower layers are much less attractive (given relatively small losses are now attaching to many treaties).

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Geopolitical risk

- War, SRCC, PV exposures are particularly difficult now.
  - Marine & Offshore energy exposures frequently have write backs for War.
- Closely related to supply chain disruption and loss amplification. Increased input costs (energy, fertiliser, etc.,) arising from the war in Ukraine impacts the supply chains of certain industries
- Economic outlook is very poor in the short-medium term. Likely energy crunch during Winter 22/23 in Europe (and elsewhere) may lead to unrest, particularly given the reduced gas flow through Nordstream 1.
- Higher likelihood of cyber events? Poor occurrence definition to delineate "War" risks in the context of cyber. Financial lines (extortion in crime policies) also heavily exposed here.

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General economic outlook

- Given historical requirement to control inflation through higher interest rates, the typical impact on unemployment and asset values, as well as ongoing supply chain issues (energy), the economic outlook seems relatively bleak
  - Typically higher frequency claim environment
  - Typically higher incidence of fraud
  - Materially more exposure in financial lines classes (D&O and PI in particular) if/when asset prices suffer
  - Pressure on insurance spend/pricing ("Cost of living crisis could force consumers to cut back on insurance, FCA warns", FT July 22nd, 2022).
- Tighter product definitions, occurrence triggers, etc., allow us to manage risk without simply/only adjusting price.

Conclusion: “So what *can* we write?”

- We are in a very specific transition phase.
  - If inflation were embedded, even at an elevated level, we would be able to price for it
  - If economic growth was already faltering globally, we would be able to adjust for likely loss trends
  - If supply chains had recovered/adjusted to current geo politics, or clearly persisted in a “new normal” we would manage our BI exposure more effectively as a market.
- For now, we are not able to see stability in key assumptions. This is an additional layer of uncertainty for us to price for. But like all challenging markets, we can navigate it and the best underwriters will still be profitable
  - Underwriting strategy in this environment requires particularly strong discipline in price and terms
  - A well-diversified portfolio is critical
  - Most lines remain writable at the right terms and conditions, but (healthy, profitable) growth in excess of inflated rate is relatively unlikely.
  - Mistakes will be made in this environment which only become apparent in future years. Pure “follow” strategies are unlikely to work so well as risk selection is critical.

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Getting to grips with the financials of a (re)insurance company

What we have covered:

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Learn how external economic factors influence wider underwriting strategy and approach with particular emphasis on the current environment

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