



# Bouncing Back From A Bad Year

THE LENGTH OF TIME IT TAKES A COMPANY TO RECOVER FROM A BAD YEAR DEPENDS ON THE CIRCUMSTANCES. BUT NAMIC AND GUY CARPENTER'S SCENARIO TESTING CAN HELP COMPANIES BETTER UNDERSTAND THEIR TIMELINES.

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Insurers exist to help make their policyholders whole once a loss has occurred. Consequently, it's a crucial question for insurers to know how long it would take for them to bounce back from potential loss scenarios. Given the expected trend of surplus growth for each company and their relative exposure to different scenario, the amount of time for recovery will vary.

To answer this question – and explore many other facets of scenario testing in the context of a full capital economic model – Guy Carpenter has partnered with the National Association of Mutual Insurance Companies to undertake a capital modeling study for NAMIC members.

These capital models use each company's own historical financial data, including underwriting experience, reserve development, line-of-business distribution, and asset allocation.

Complementing each company's unique experience, we layer independent economic scenarios for the baseline and Mercer's view of stressed economic scenarios.

In the baseline scenario, we see mutuals growing their surpluses by 8 percent pre-policyholder dividend, compared to 13 percent pre-shareholder dividend return for stock insurance companies. Return on surplus is driven by attritional underwriting profitability, reserve development, catastrophe losses during the year, and investment income and asset (un)realized gains.

Company characteristics of size, region, and business focus show persistent trends in expected return. For example, companies focused on commercial property are expected to make 11 percent return on surplus. By comparison, smaller companies that write less than \$20 million in premiums are expected to make 4 percent of surplus, a substantially lower

return relative to the increased risk in the marketplace.

The first scenario we considered was weather, as we updated our loss expectations to match recently observed losses. As such, this scenario is a shifting of the catastrophe curve to arrive at a new normal in weather losses. The stress equated to a 32 percent increase across the entire distribution of weather losses. On average, the baseline modeling suggests the industry would expect 4.8 percent of loss relative to surplus from weather claims. The scenario would create an additional 1.4 percent drain that can most often be handled in a company's earnings.

For the more extreme events, reinsurance solutions were more likely to mitigate the impact. We did not figure in any additional reinsurance costs; however, repeatedly recovering losses at this level will inevitably drive up the cost of that tail protection. Deeper review would suggest any one-year-average increase is survivable for all companies under this scenario; the real risk is accretive losses year after year that slowly eat away at policyholder surplus and pricing suitability. We have seen individual companies experience much larger catastrophe loss levels in recent years, which is in line with the stress in the tail. As such, it creates increased importance of a solid reinsurance process for the tail events.

Personal lines companies have the most exposure to this scenario, falling behind by two and a half months to plan because of increased weather losses. Commercial lines companies are least exposed and would only be behind plan by about half a month.


The stagflation scenario reflects an economically stressed environment of increased interest rates resulting in higher payout costs and increased reserve adjustments. It also includes a slowdown in the economy, reflecting shrinking premiums varying by line and more than 20 percent loss of equity valuations.

Compared to the weather scenario, stagflation presents a much longer-lasting impact. This scenario would take a minimum of two years for a mutual company to get back to one year of baseline performance. On average, mutuals would need two years and four months to return to one year of baseline performance. Companies that write less than \$20 million in premiums would take the longest to recover from stagflation – nearly three years and three months to be exact.

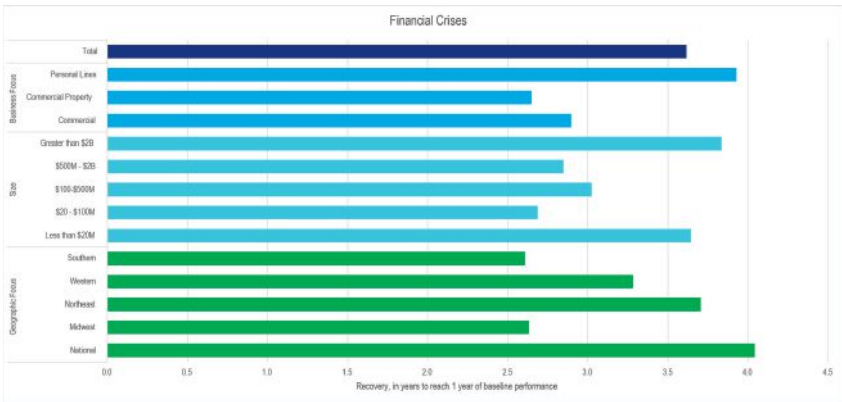
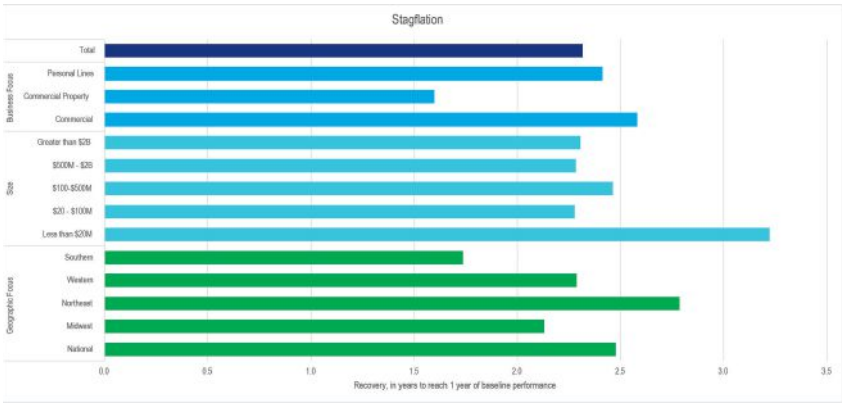
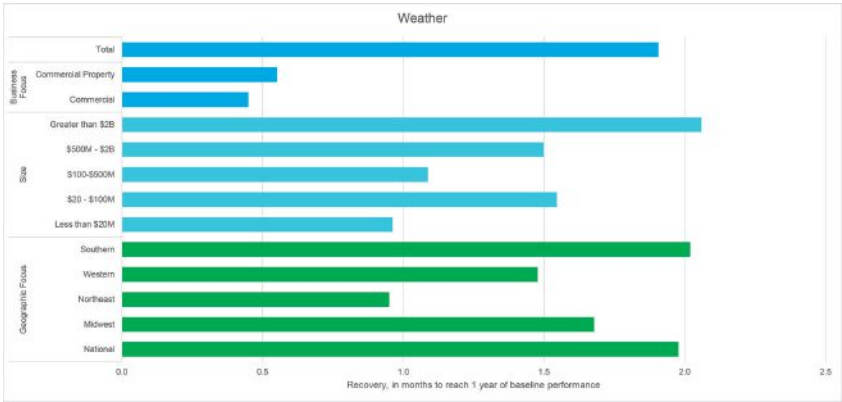
The financial crises scenario reflects the largest risk to mutuals. This reflects a liquidity crisis in the United States that causes a 42 percent drop in equities paired with a slight shrinking of premium.

A company's asset allocation and exposure and asset leverage are driving factors in this scenario. It would take a minimum of two years for a mutual company to get back to one year of baseline performance. On average, mutuals would need three years and seven months to get back to baseline. National companies would take the longest to recover at more than four years.

We have highlighted one takeaway available from scenario testing, but different circumstances apply depending on a company's premium size and geographic and business focus. Awareness of how these scenarios could potentially affect an insurer is a key element of risk management and governance for insurance leaders in preparing for future risks and ensuring long-term resilience.

While the future is uncertain and mutuals are in the business of risk, setting expectations and strong risk management are important for all insurance company leaders. Studies that look for trends in exposure characteristics can help prepare management for the unknown and help consider action points in advance. 

# The Scenarios



Scan the QR code to request your customized risk report.

