GUY CARPENTER

COVID-19
An Unprecedented Event

MARSH & McLENNAN COMPANIES

COVID-19: AN UNPRECEDENTED EVENT

Crises are often (mis)characterized as "unprecedented" but the word is entirely appropriate to describe the societal and economic fallout from the COVID-19 pandemic. As we outlined in our initial report last month, the global economy has suffered a major shock after governments worldwide imposed social distancing, business closures and travel restrictions in an effort to control the virus.

A global recession is now inevitable, even if its scale and depth remain unclear at this time. Economic activity has never before been shut down in this manner, and there are real concerns over whether countries can prevent second or third waves of infections as economies are reopened. This is a highly fluid and potentially protracted event that could see further, unsynchronized responses by governments to any future COVID-19 outbreaks.

Predicting how governments and societies may react to various situations is difficult and potentially unpalatable (e.g., civil unrest and/or rising geopolitical tensions), but carriers can prepare for all eventualities and build financial resilience by challenging assumptions and conducting robust scenario stress testing.

Rebound or Depression?

Economists' opinions about how events will play out from here are even more divided than usual, with some forecasting a rapid recovery after a brief, but sharp downturn, while others are warning of sustained economic paralysis. On the one hand, Ben Bernanke, former Chair of the Federal Reserve, said recently that the economic impact from COVID-19 would be more akin "to a major snowstorm or natural disaster than it is to a classic 1930s-style depression." On the other, renowned economist, Nouriel Roubini (aka Dr. Doom), has warned that "the risk of a new Great Depression, worse than the original – a Greater Depression – is rising by the day."

Much will depend on the trajectory of infection rates as lockdown measures are relaxed. Governments are paying for a lack of preparation and planning. One view economists can agree upon is the impending global economic downturn because of COVID-19. With GDP contracting, new unemployment filings at record highs, oil trading at record lows, political attempts to redraw insurance contract wordings and questions around reopening the economy, it is premature to take comfort in the recent stock market rebound.

Rebound

V-Shaped Rapid Recovery

The economic impact from COVID-19 will be more akin "to a major snowstorm or natural disaster than it is to a classic 1930s-style depression."

Ben Bernanke, former Chair of the Federal Reserve

or

Depression

I-Shaped Economic Paralysis

"The risk of a new Great Depression, worse than the original – a Greater Depression – is rising by the day."

Nouriel Roubini, renowned economist, aka Dr. Doom

Monetary and Fiscal Interventions

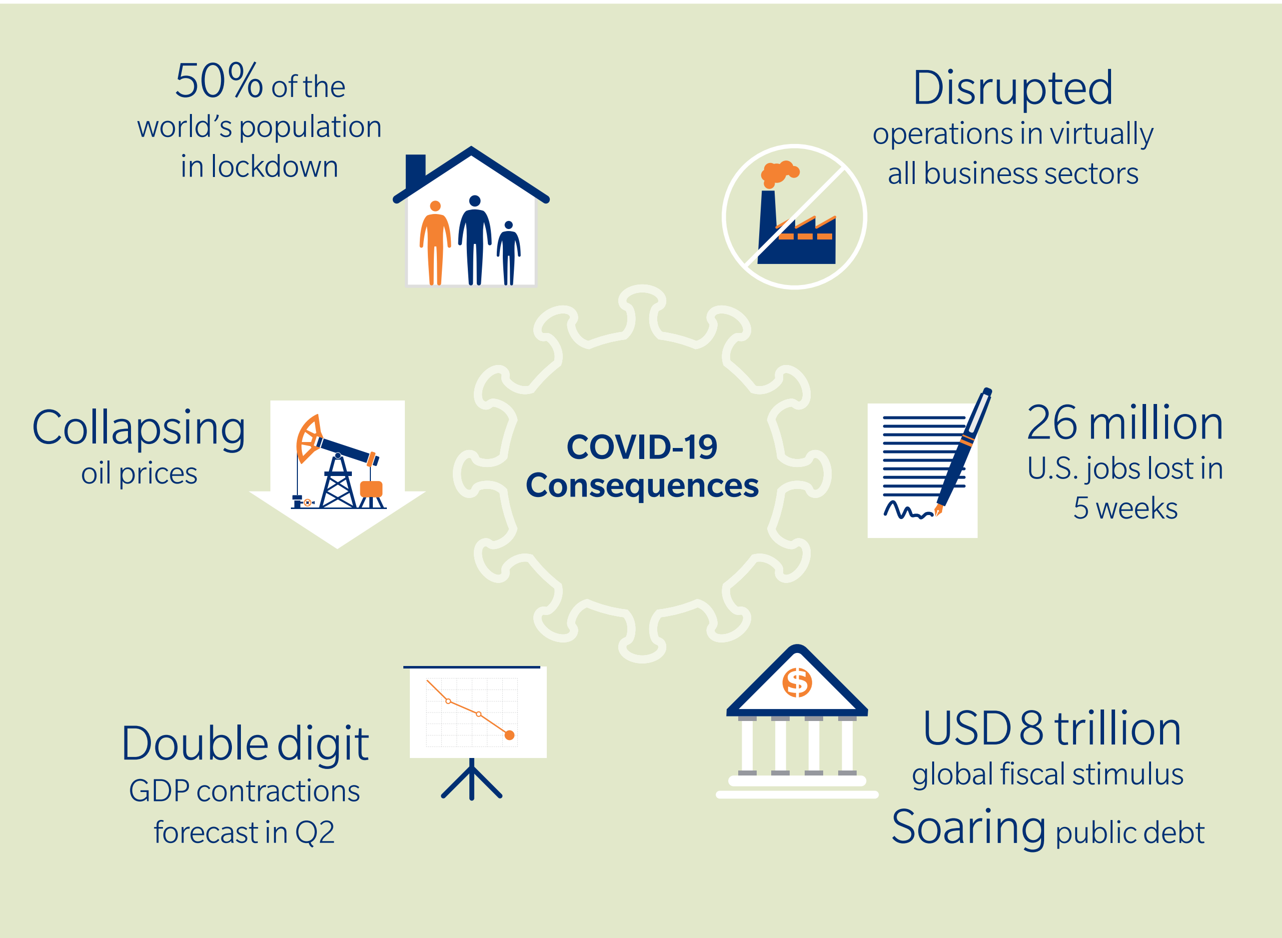
Rapid interventions by governments and central banks worldwide have been instrumental in stabilizing markets and supporting economies, for now at least. Figure 1 provides a visualization of how this coordinated policy response, which combines huge quantities of fiscal stimulus with major monetary policy actions, has helped to support households and businesses through the great lockdown while also providing acceptable levels of liquidity in financial markets and the broader economy. Regulatory and supervisory actions have also been important in shoring up economies by encouraging financial institutions to continue to lend and invest.

Efforts to mitigate the impacts of what is a known (pandemic) risk have created "black swan" consequences. The cost of being unprepared is massive. No geography, corporate sector or business will emerge from the crisis unscathed, although those with the foresight to stress test scenarios and maintain appropriate liquidity for all eventualities are likely to prosper.

FIGURE 1: FISCAL AND MONETARY RESPONSES TO SUPPORT ECONOMIES

Fiscal response on both sides of the Atlantic has been massive, in the order of 6–10+% of GDP	• Worker protection and support, such as improved/ extended unemployment • Credit support for business, especially SMEs, through direct grants and subsidized credit • Targeted support to specific industries (e.g., airlines)
Central bank actions are exceeding those from the financial crisis	• Central banks have taken many programs from the financial crisis off the shelf • Significant intervention to support liquidity and credit formation • ...in the face of interest rates that are already near or below zero
Banks remain central to effective transmission of monetary and fiscal policy	• In the financial crisis, banks were the problem, now they need to be part of the solution • While in better shape than 2007, some systems are fitter than others...

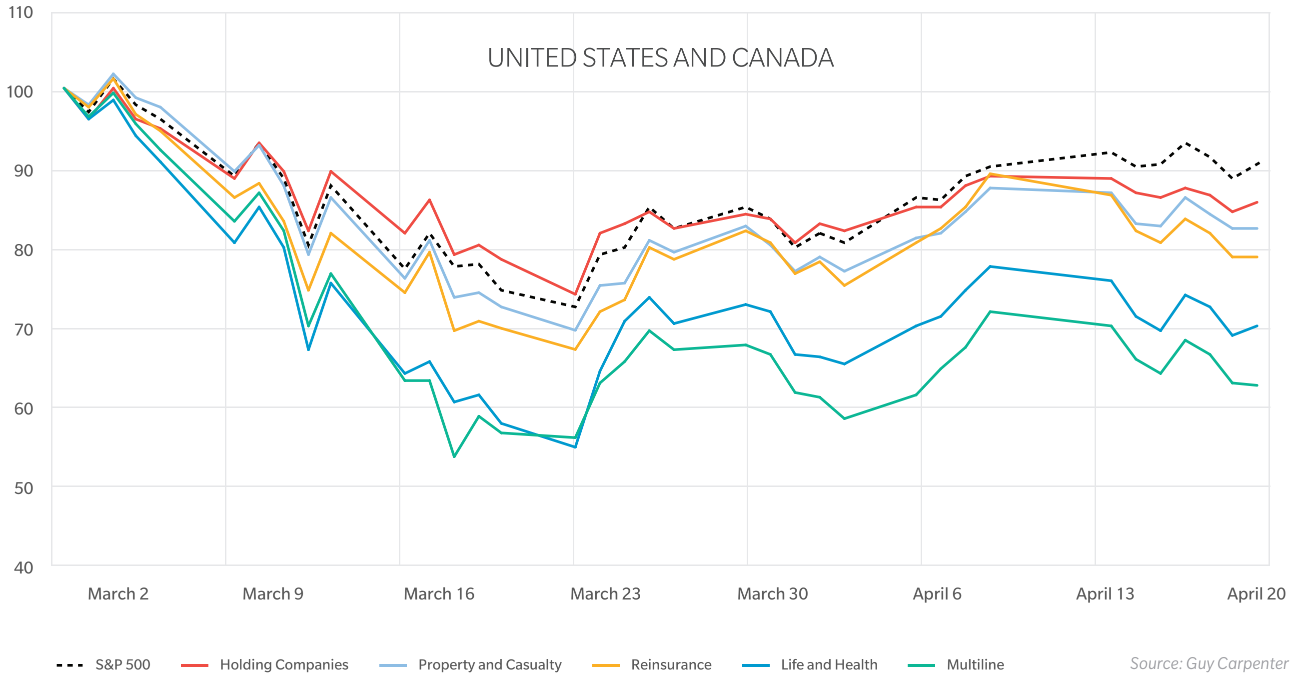
Source: Oliver Wyman



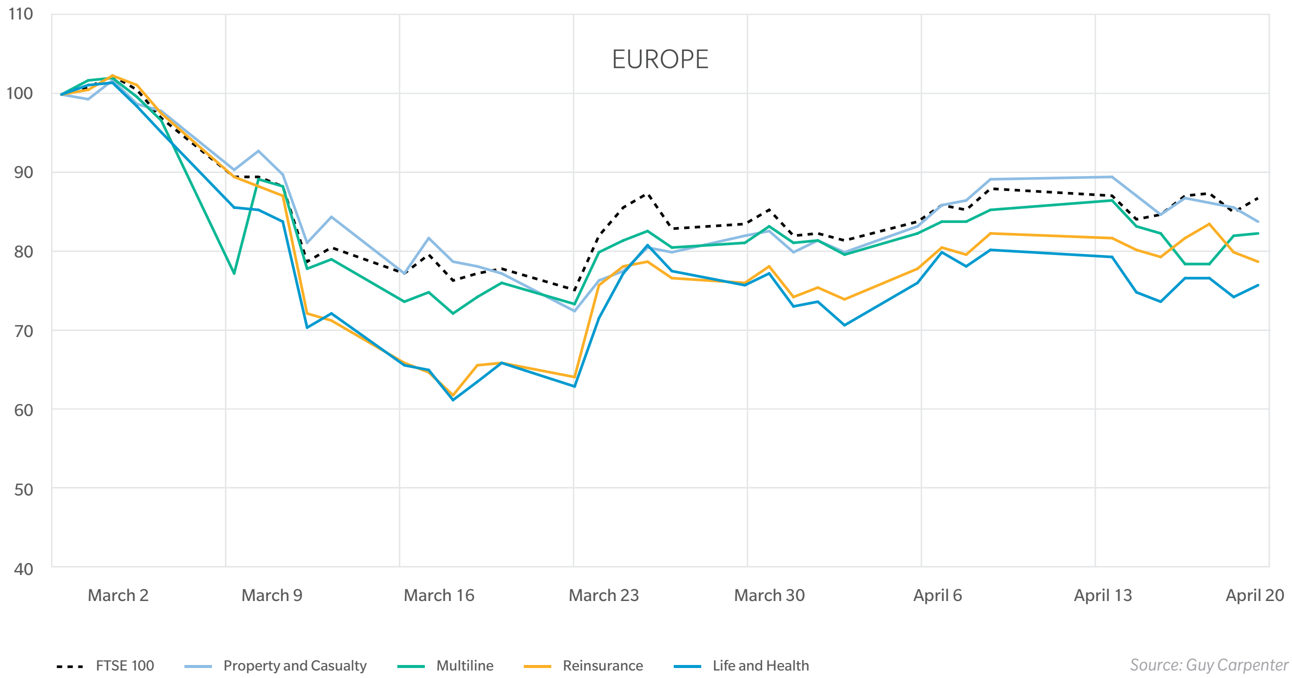
Market Performance

This is especially true of (re)insurance carriers, who will play a crucial role in supporting communities and businesses through these uncertain times. The sector's traditional defensive characteristics notwithstanding (i.e. less exposure to economic cycles than most industries and a strong track record in navigating macroeconomic and capital crises), most (re)insurance segments have underperformed both the S&P 500 and FTSE 100 since the onset of the crisis (see Figure 2).

FIGURE 2: PERFORMANCE OF (RE)INSURANCE SUBSECTORS VS. S&P 500 AND FTSE 100 – MARCH 2020 TO YTD



Source: Guy Carpenter



Source: Guy Carpenter

At least five important insights and trends can be gleaned from this analysis:

1. Some of the performance disparity between (re)insurance and the S&P 500 and FTSE 100 has more to do to with other (outperforming) sectors within the indices than the (re)insurance sector itself. U.S. techs, for example, have played an important role in shoring up the S&P 500 so far and the performance of the (re)insurance sector is comparable to (or better than) other financial sectors.

2. Each (re)insurance segment within the United States and Europe are now broadly in line with one another. Multiline is the clear exception, where it continues to lag in the United States. Much of this discrepancy comes down to size: the European Multiline segment is made up of 45 companies, with a total market capitalization of nearly USD 500 billion. The U.S. segment is a much smaller (11 companies), with a market capitalization of just USD 65 billion.

3. Figure 3 shows how credit spreads in the United States have widened since the onset of the crisis, although they remain below levels reached during the financial crisis in 2008/09. As the largest class of investors in high-grade fixed income securities, (re)insurers are particularly exposed to rapid interest rate movements. With high-grade government and corporate bonds experiencing major sell-offs, this threatens to impair balance sheets and capital for certain carriers.

4. Persistent investor concerns about underwriting may also be hindering the performance of the (re)insurance sector, particularly at a time when it is coming under close scrutiny from governments and regulators (more on this later).

5. The reinsurance segment in both the United States and Europe has recovered strongly from its nadir in mid-March, reflecting its resilience and robust capitalization, along with its strong track record for innovation during times of stress.

FIGURE 3: YTD MOODY'S Baa CORPORATE BOND YIELD RELATIVE TO YIELD ON 10-YEAR TREASURY

Source: U.S. Federal Reserve Bank of St. Louis, Guy Carpenter

Challenged Landscape

The COVID-19 pandemic clearly presents significant challenges to insurers and reinsurers. After years of relative stability brought about by strong capitalization, the landscape for the sector has undeniably changed and become more difficult.

The fundamentals of (re)insurance nevertheless remain strong, and opportunities are available in this environment for (well-capitalized) carriers to offer new solutions and grow into challenged lines. Pricing was already on the increase in stressed areas prior to the COVID-19 crisis, and the key drivers behind these rate increases – including shifting views (and appetites) of risk, higher loss cost trends and deteriorating loss experience – are being exacerbated by the pandemic.

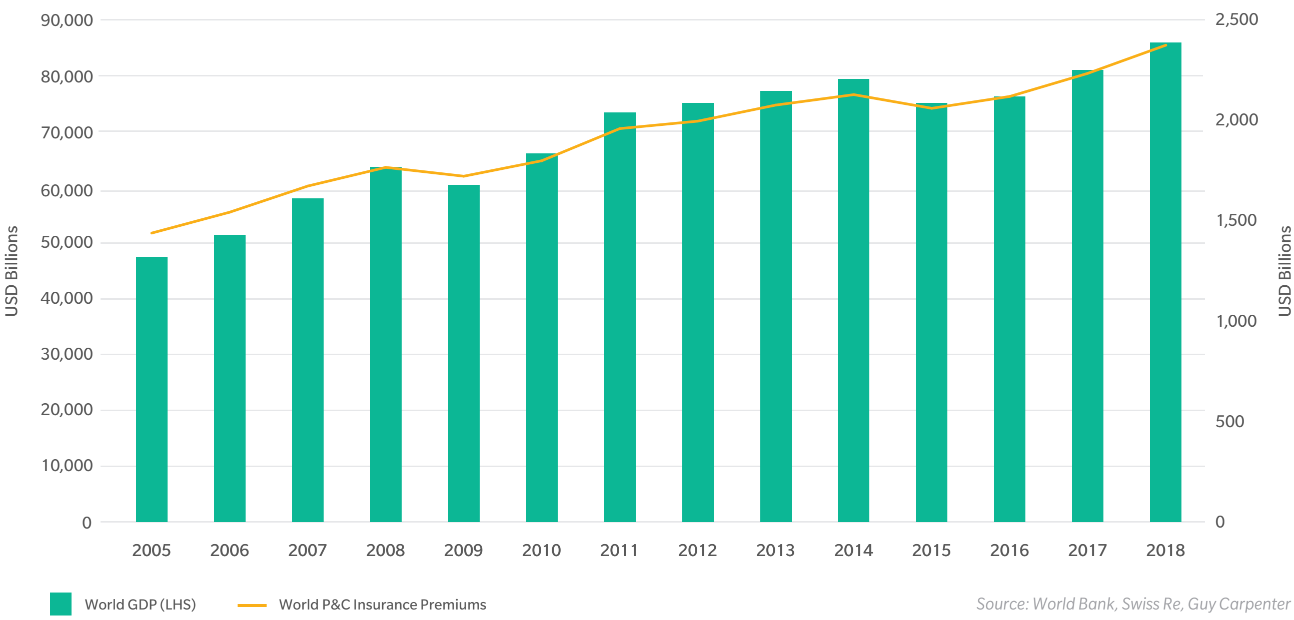
Figure 4 illustrates how all these multiple, competing factors are altering the operating environment for property and casualty (P&C) carriers, with pressure on the asset side of balance sheets coinciding with multiline underwriting losses and a potential decline in demand.

Capital positions have become more strained at a time when access to capital has reduced and costs of capital have risen. Equally important, a fall back into recession is likely to hinder insurers' top-line growth. Figure 5 shows the clear correlation between world gross domestic product (GDP) and global P&C insurance premiums. With most advanced economies expected to see double-digit GDP contractions in the second quarter of 2020 (and even for the full year), insurance premium levels look set to fall in the near-term. This has implications for reinsurance premium volumes too, although pressure on cedents' balance sheets is likely to support demand in the near-term, at least.

FIGURE 4: IMPACTS OF COVID-19 ON P&C (RE)INSURANCE SECTOR

Source: Guy Carpenter

FIGURE 5: WORLD GDP VS. GLOBAL P&C INSURANCE PREMIUMS



Source: World Bank, Swiss Re, Guy Carpenter

Insurers will also sustain underwriting losses from the pandemic, even if it is not possible at this stage to understand the quantum fully. The fact that COVID-19 is the first systemic, pathogen-based loss to broadly impact the (re)insurance market compounds its complexity, meaning claims will inevitably manifest themselves differently compared to more conventional natural catastrophe events, and over a longer period of time.

Losses are emerging from areas such as event cancellation, trade credit, travel, business interruption and accident & health. While certain other lines of business, including personal and commercial auto, are benefiting from an immediate dip in claims due to the lockdowns – more than half of the world's population remains under some sort of confinement – loss experience and reserving look set to worsen for some classes in the longer term.

This has led to the usual situation where (mostly auto) premium rebates or discounts are being offered to some policyholders while regulators are simultaneously applying pressure in certain jurisdictions, Europe especially, for carriers to defer or suspend share buybacks and dividend payments to ensure they have the capital necessary to pay future claims. This is despite virtually all carriers in the region remaining within their targeted Solvency II ranges.

Governmental and regulatory pressure on carriers is already intense, and is only going to increase as further coverage gray areas emerge. Coverage disputes and litigation are inevitable in the coming months (or even years), given the complexity of the event. Business interruption coverage has taken center stage so far, but pandemic-related claim trends within liability lines will take shape as well. This is likely to result in asymmetrical losses by line, region and carrier over the next several quarters.

Pandemic Exclusions

Ultimately, risk carriers excluded pandemics from all-risk commercial property policies years ago because price adequacy to achieve an appropriate spread of risk would have precluded most companies from buying it. While some more specialist polices may include coverage for COVID-19 claims, the important point is respecting contracts.

As events move from theoretically defined scenarios to real world application, coverage interpretations become critical and actual coverage gaps may arise. Fundamentally, though, paid losses must follow contract terms in order to maintain a healthy marketplace. Any erosion of contract rights – whether by legislatures or by courts – is bad for the entire economic system.

The clear and decisive intervention by the Financial Conduct Authority in the United Kingdom, clarifying that most commercial policies in the country do not cover pandemics and carriers in this case have no obligation to pay out business interruption claims in relation to COVID-19, has provided much needed clarity and offers a sound template for other regulators to follow.

In the end, the financial market volatility, and the resulting economic downturn, associated with COVID-19 could well eclipse the aggregation of losses that emanate from exposures covered explicitly by policies. As we pointed out in our previous report, the (re)insurance sector's strong capital base at the onset of the crisis, along with carriers' conservative investment allocations – with a predominance of (high-grade) fixed income securities and low equity gearings – are likely to provide some insulation from the impacts associated with COVID-19.

Lloyd's of London has been one of the first out of the gate in attempting to quantify underwriting losses from COVID-19. CEO John Neal commented recently that losses associated with the virus could aggregate over time to a similar level as those from hurricanes Harvey, Irma and Maria in 2017. This would mean Lloyd's facing a COVID-19 underwriting loss of approximately GBP 4.5 billion – a material, but manageable loss for the market. The composition of COVID-19 losses would nevertheless likely be very different to that of a typical windstorm, spanning a wider range of lines of business and bringing considerable uncertainty.

Lloyd's is well placed to confront such a scenario. In response to financial market volatility, Lloyd's announced in mid-March that its central solvency capital requirement coverage ratio was 205 percent, which is a robust level. No update to the broader market-wide ratio was included in the announcement. Although this too is likely to have fallen, the decline will be mitigated somewhat by Lloyd's syndicates investment portfolios, which are considered conservative, and members' capital contributions.

(Re)Insurance Resilience

The (re)insurance sector is well-versed at navigating market-changing events, and while the impact of previous shock events such as Hurricane Andrew, the terrorist attacks of September 11, 2001 and Hurricane Katrina may have resulted in a loss of capital and reduced capacity in the short-term, the market responded to each occasion by innovating, working with governments and attracting more capital in the longer term.

Liquidity and access to capital are crucial to ensuring risk carriers can continue to provide cover following market-changing events. Reinsurance has been a reliable and efficient source of contingent capital to insurance companies through previous periods of uncertainty and its value proposition is stronger today than ever, especially as it is now one of the best-priced source of capital on offer to carriers.

Ensuring Insurability

The reinsurance market is well positioned to support insurers through this period of uncertainty. The sector's capital position remains strong and stable (even after the recent market volatility) and reinsurance is one of the most effective tools available to insurers in managing earnings volatility at this time.

COVID-19 does, however, raise serious questions about the insurability of pandemics, and other similar, systemic (non-physical) risks going forward. The sheer scale and indefinite times horizons associated with these types of risks are immense and likely beyond the financial capabilities of the insurance industry for tail events. Solutions can nevertheless be found if key stakeholders, including governments, policyholders, intermediaries and carriers, come together to develop a plan to implement mitigation strategies and a response mechanism for future pandemic events.

Public-Private Partnerships

Important progress has already been made on this front, with Marsh & McLennan Companies at the forefront of conversations to create forward-looking solutions. Ultimately, we see every viable, long-term solution requiring government participation. Given the loss potential associated with major global pandemics, the need for a public-private solution is clear. Indeed, the public-private partnership model is one that has worked particularly well to date for other risks that are capable of causing systemic economic shocks (such as terrorism).

The level of sophistication and expertise developed over decades in dealing with market-changing catastrophe events puts the (re)insurance sector in an unrivaled position to drive the agenda and strengthen economic resilience. Insurance continues to deliver significant value for communities and businesses around the world. It will play a crucial role in the coming weeks and months in helping societies and businesses get back up and function normally again by paying legitimate claims, assuming new risks and investing in real assets to rebuild economies and support corporate growth and government borrowing.

Reinsurance will be crucial in supporting insurers in these endeavors. It is currently an extremely efficient form of contingent capital when measured against debt, equity and cedents' own capital. By deploying reinsurance strategically, insurers can reduce capital requirements, improve solvency, minimize earnings volatility, selectively write more business and, ultimately, pursue profitable growth — important attributes in this highly uncertain environment.

Here to Help

Guy Carpenter has convened a COVID-19 Task Force to support clients through these extraordinary times. With much speculation about coverage disputes and litigation, and as reinsurers escalate efforts to introduce COVID-19-related exclusions or wording changes to contracts on upcoming renewals, the Task Force is coordinating responses in a thoughtful manner focused on the best outcome for our clients. Stress test exercises to measure the impact to carriers' capital and liquidity under several difficult scenarios is a key component of Guy Carpenter's offering. Preparation and resilience are going to be important areas of differentiation in this environment. We encourage you to get in touch with your local representative with any questions or concerns you may have.

> Given ongoing developments, Guy Carpenter has created "what if" scenarios to help clients respond to the impact of asset deterioration and underwriting challenges in a recessionary environment as well as the potential for increased catastrophe losses. By understanding these capital and volatility risks, Guy Carpenter can put solutions in place to help our clients prepare for tail events.

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About Guy Carpenter

Guy Carpenter & Company, LLC is a leading global risk and reinsurance specialist with more than 3,100 professionals in over 60 offices around the world. Guy Carpenter delivers a powerful combination of broking expertise, trusted strategic advisory services and industry-leading analytics to help clients adapt to emerging opportunities and achieve profitable growth. Guy Carpenter is a business of Marsh & McLennan (NYSE: MMC), the world's leading professional services firm in the areas of risk, strategy and people. The company's 76,000 colleagues advise clients in over 130 countries. With annual revenue of $17 billion, Marsh & McLennan helps clients navigate an increasingly dynamic and complex environment through four market-leading businesses including Marsh, Mercer and Oliver Wyman. For more information, visit www.guycarp.com and follow Guy Carpenter on LinkedIn and Twitter @GuyCarpenter.

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