COVID-19: Standard & Poor's Outlook

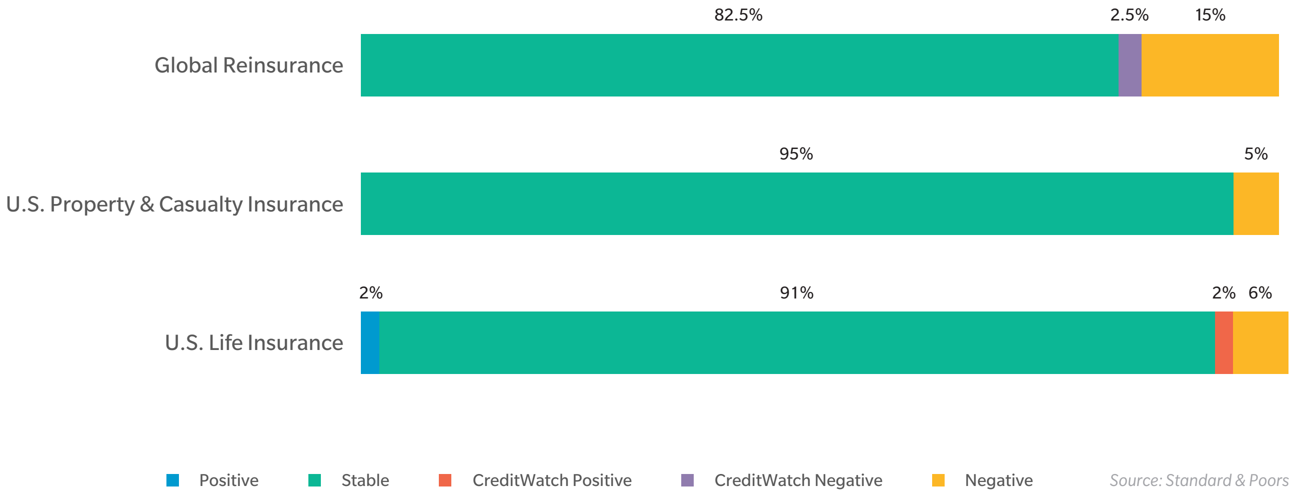
Expectation of Earnings Event

Standard & Poor's (S&P) has taken a measured approach in response to the COVID-19 pandemic. In the early stages of the pandemic, their focus was on the asset side of the balance sheet. In recent months, as the capital markets have rebounded and the prospects for a quick economic rebound have receded, their focus has increasingly shifted to looking at the prospects for growth.

As a result, thus far, ratings of companies with existing weaknesses have been impacted. Circumstances are now worse for companies that entered this period already under pressure. Fortunately, the reinsurance industry entered 2020 from a position of strength with strong capitalization and pricing tailwinds and the majority of insurers and reinsurers have demonstrated they possess an underlying resilience.

Right now, rating agencies are working under the expectation that the pandemic will be an earnings event. If it evolves into a capital event (greater than 10 percent of policyholders' surplus impacted), the rating pressures would increase. Significant uncertainty around the shape of the recovery remains. Companies with strong capital and liquidity, efficient expense structures and effective tail protection are best positioned for the next several quarters.

FIGURE 1: STANDARD & POORS CREDIT OUTLOOK; MAY 2020



Source: Standard & Poors

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Global Reinsurance Sector Outlook Turns Negative

S&P recently changed its outlook for the global reinsurance sector to negative from stable, as it anticipates a number of negative rating actions and increasingly difficult business conditions for the sector over the next 12 months. S&P assigned a stable outlook to over 80 percent of global reinsurers and projects that reinsurers will not meet their cost of capital in 2020 for a third year in a row due to COVID-19 insured losses and lower investment returns. Event cancellation, mortgage, trade credit, and directors and officers/errors and omissions are perceived as the lines most sensitive to COVID 19 losses.

The majority of S&P's rating downgrades and negative outlook changes for reinsurers were in reaction to earnings performance despite their strong capital positions. Specifically, those companies are not performing at their rating level, and/or are underperforming their peers at that rating level.

Additional factors impacting S&P's negative outlook for the global reinsurance sector:

- Forecasts of above-normal activity during this year's Atlantic basin hurricane season.
- Constrained alternative and third party capital and retrocession capacity.
- Reduced capital cushions; while capitalization remains robust, it is below historical levels due to the confluence of:
  - Financial market volatility
  - Active catastrophe years in 2017-2018 and the resulting loss creep
  - Lower loss reserve releases due to adverse trends in certain casualty lines.
- Industry consolidation, which could see a pause, though secular trends remain in place.

Alternative Capital: A Flight to Quality

Alternative capital availability constraints have further heightened amid COVID-19 developments. Capital providers have been reeling from prior catastrophe losses and recent market volatility on their portfolios. Trapped capital was estimated to stand at USD 20 billion at the start of 2020 and COVID-19 would trap additional capital. Investors are now shifting to well-established sponsors or managers with better track records as they seek higher returns.

Alternative capital remains an integral part of the reinsurance sector, and S&P believes it will grow once the issues are resolved.

Offsetting factors for S&P's change in outlook include:

- A hardening reinsurance pricing environment with momentum that continues to gain strength through 2020.
- Stable life reinsurance earnings.

Stable outlook triggers:

- S&P will revise the global reinsurance sector's outlook to stable if it believes that reinsurers' underwriting and risk selection are disciplined and supported by hardening pricing such that their returns can meet their costs of capital on a sustainable basis.
- The sector will not be considered for an upgrade until 2021 at the earliest, given the myriad developments related to COVID-19 that are expected to arise over the next few quarters.

U.S. Property & Casualty Insurance Sector Outlook Remains Stable

As the COVID-19 pandemic continues and its impacts across insurance and reinsurance markets become increasingly clear, S&P is maintaining its stable outlook for the U.S. property & casualty (P&C) insurance market and it assigned a stable outlook to 95 percent of P&C insurers. Thus far, the only ratings action S&P has taken is to revise the outlooks from positive to stable for certain insurers. Most importantly, the sector was highly capitalized as it entered the COVID-19 crisis and it maintains a robust capital buffer following asset stress tests.

Additional factors impacting S&P's stable outlook for the U.S. P&C sector:

- Pricing increases will likely be uneven as insurers pushing for rate increases on personal lines and small- to medium-sized enterprise accounts are likely to encounter difficulties because those sectors are already struggling economically. However, insurers are still pushing rate increases on larger accounts, particularly within excess and surplus lines, as they look to meet return hurdles that have been depressed after years of pricing inadequacy.
- COVID-19 claims in the U.S. P&C primary market are being characterized differently than catastrophe events largely because of the length of time for COVID-19-related claims to manifest, as the pandemic is seen as a longer-tail event.
- Despite the global reach and anticipated costs of COVID-19, S&P expects its effects to be medium in scale and considers it more of an earnings event than a capital event, when it gauges the impact to only the U.S. P&C market.
- Doubts about the sustainability of continued reserve releases.

Negative outlook triggers:

Given the sector's capital buffer, S&P believes it would take a "perfect storm" scenario to trigger a negative outlook change. A combination of the following events would have to occur for the sector's outlook to change:

- A sizeable catastrophe event (or multiple events)
- A spike in inflation
- "Silent" coverages that could materially change risk perception
- Higher-than-expected corporate bond downgrades or defaults; greater equity market volatility.

U.S. Life Insurance Sector Outlook Remains Stable

S&P also maintains a stable outlook for the U.S. life insurance sector, and assigned a stable outlook to over 90 percent of life insurers. The rating agency views asset risk as the most significant and immediate concern for the sector, over other factors relating to equity market volatility, near-zero interest rates and increased mortality risk.

Additional factors impacting S&P's stable outlook for the U.S. life insurance sector:

- The effectiveness of hedging programs. Despite the declining equity market, hedging programs are working and insurers have been adjusting their playbooks for some time to suit this low-interest rate environment.
- Relatively low reported losses from pandemic following stress tests.

Negative outlook triggers:

- Higher-than-expected corporate bond downgrades or defaults.
- Substantial reserve increases, which could occur due to persistently near-zero or declining interest rates. Long-duration targeted improvements may accelerate recognition of these impacts.
- Higher-than-anticipated losses due to hedge breakage from equity market volatility.
- Significant increases in mortality over the next few weeks or months.

Stress Testing

S&P continues to refresh its asset stress test, which reflects real-time insights on rating migration and default risk. The reinsurance, P&C and life teams all conducted asset stress tests as the markets were starting to show dislocation in late February, as well as in mid-March, when the equity market was close to its recent low point.

Generally, S&P derives its assumptions from internal research conducted on ratings transitions and stresses observed during previous financial crises. The asset stress tests show that the sector's capital buffers remain resilient, with 86 percent of companies still at a strong, very strong or excellent level after the stress test. S&P also compares the assumptions in its stress test against the capital adequacy calculations contained in its capital models.

For its part, A.M. Best elected to triage the (re)insurance industry using a simple, easy-to-model solvency test across all ratings issued globally, and despite limitations on the level of information available on insurance companies, A.M. Best uses a very high-level test to measure a one-scenario impact on the industry. Like S&P, A.M. Best responded in a measured way to COVID-19, and only changed its outlook on the life and annuity sector to negative.

GUY CARPENTER

How Can Guy Carpenter Help?

While there are early signs of a stock market recovery in the United States, it is too early to declare victory. There is significant uncertainty around the timing and shape of the recovery. In times as challenging as these, companies need to demonstrate their capital strength, liquidity management, earnings prospects and risk management to the rating agencies.

Guy Carpenter is well equipped to work with companies to address the ratings-related repercussions of the COVID-19 pandemic. From advising on how to structure capital needs to running stress test exercises to measure the impact to carriers' capital and liquidity under several difficult scenarios, we are here to help companies position themselves positively in the view of rating agencies, during and after the current pandemic

Engage and No Surprises

How can you effectively deal with rating agencies?

- Understand the ratings methodology; very transparent criteria allows you to understand the rating drivers.
- Be forward looking; help your ratings analyst understand your business and financial prospects over the next two years. Be candid.
- What is your "Credit Story?" Develop a clear narrative of your competitive position, risk tolerance and management. What are your capital and earnings prospects?

And above all,

- Be predictable; it is never a good idea to surprise your analyst. Sharing bad news and a plan to address the problem helps to build your credibility; poor reputation will follow you!

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