GUY CARPENTER

An update from
The COVID-19 Task Force

March 24, 2020

COVID-19: A Macroeconomic Perspective

The COVID-19 pandemic is, first and foremost, a public health emergency, and our thoughts are with all those affected. The virus has spread to virtually every corner of the globe and is no longer containable. This has prompted governments to impose quarantines, travel restrictions and a variety of other measures in an attempt to minimize risks.

In today's highly connected and globalized world, these risk mitigation actions have caused a major shock to the global economy. Figure 1 outlines a range of recent estimates from five firms (Citibank, Goldman Sachs, Moody's, Morgan Stanley and Standard & Poor's (S&P) of the predicted impacts to major economies from the pandemic. While China's economy is expected to see positive growth overall this year, it will still experience a significant slowdown compared to recent performance. Given the level of disruption in Europe, most of the firms expect the Eurozone's economy to contract significantly. Most of them also predict that the United States will experience neutral to negative growth in 2020, especially as gross domestic product (GDP) forecasts had already been tempered by trade war concerns and moderated expectations.

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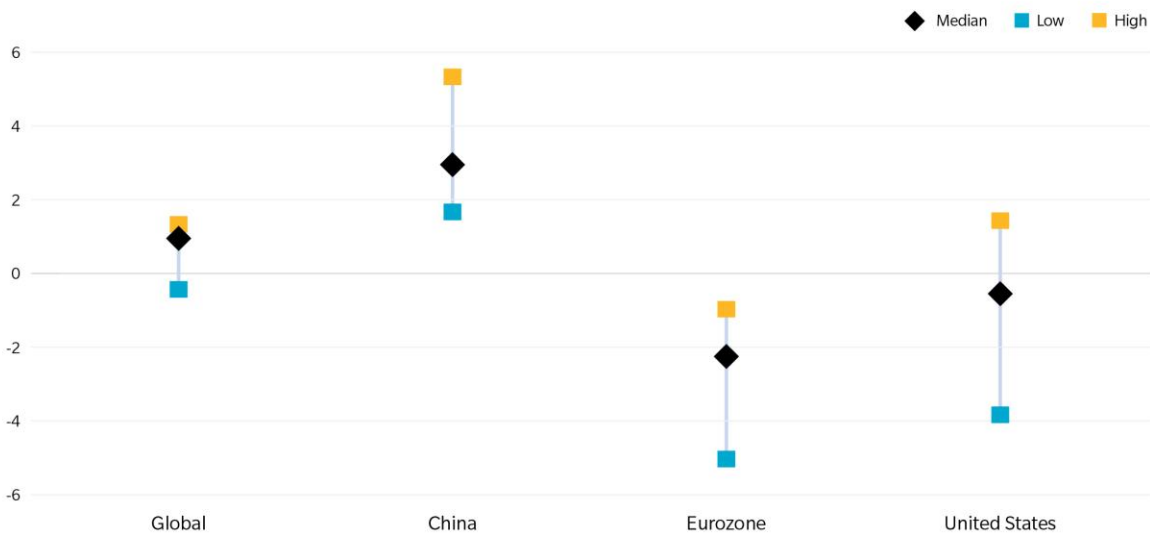
Figure 1. **2020 GDP Growth Expectations by Region – Percentage**

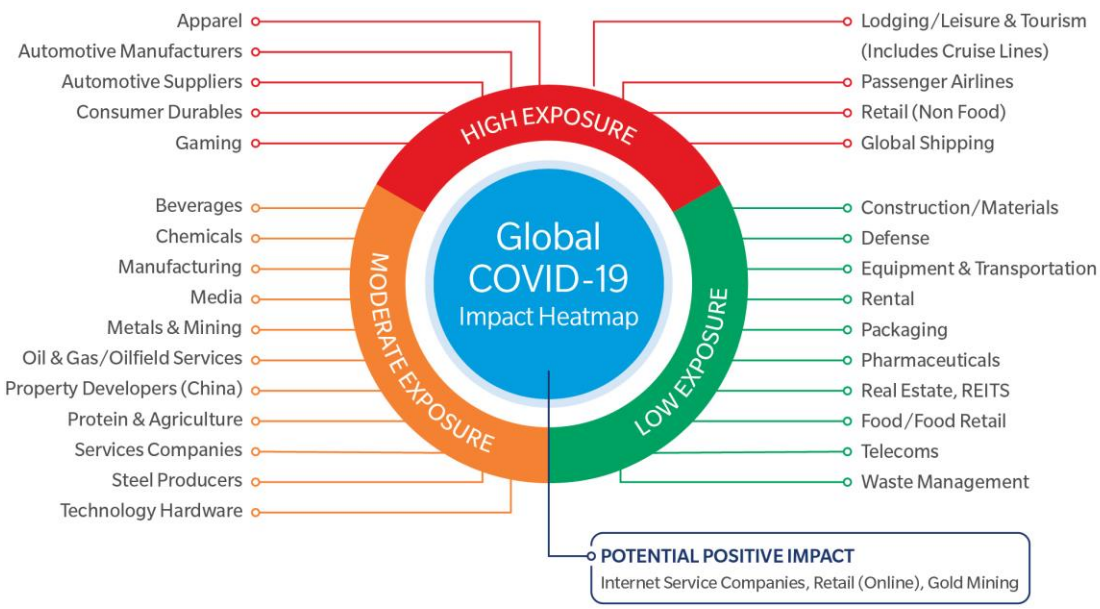


As of 3/20/2020 *Source: Current estimates from Citibank, Goldman Sachs, Moody's, Morgan Stanley, S&P*

The full economic impact of the COVID-19 outbreak is currently unknown and will take some time to materialize. The nature of the response to the outbreak (a combination of extraordinary containment and financial assistance policies) initially raised hopes that most advanced economies would follow a V-shaped trajectory – a sharp downturn, followed by a rapid rebound. Given the scale and scope of social distancing and business closures, things look less clear-cut today. Much will depend on the duration of the drop in economic activity and the extent of any structural damage.

This week, the Organization for Economic Co-operation and Development warned that the economic shock from the COVID-19 outbreak was already bigger than the attacks of September 11, 2001 or the 2008 financial crisis. It also commented on a recent prediction that the pandemic would result in global growth halving to 1.5 percent, saying it was already too optimistic and that it was "wishful thinking" that countries would bounce back quickly. It is clear that no geography, corporate sector or business will emerge from the crisis unscathed, although, as Figure 2 shows, certain sectors, for example, travel, will be impacted more than others.

Figure 2. **COVID-19 Impact by Sector**



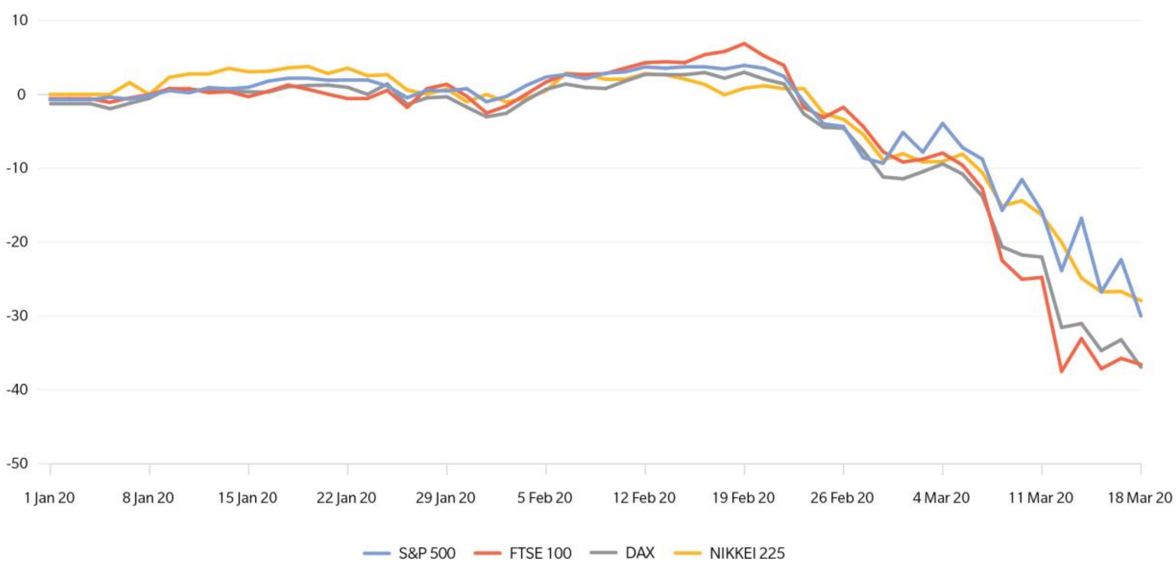
Source: Moody's

Financial Markets

The response of financial markets to these developments can be summed up in one word: volatile. Equity markets have fallen to levels not seen since the global financial crisis (or even further back in some instances) and credit spreads have widened materially, while emergency interventions by central banks have contributed to a collapse in sovereign bond yields.

Figure 3 illustrates that major equity markets around the world have declined by between 30 percent and 35 percent (approximately) since the turn of the year. This type of sell-off has little historical precedent: only three years in recent memory (1987, 2001 and 2008) had comparable movements and none in such a short period of time (of one month). This reflects the seriousness of the current situation: prospects for financial markets and the broader economy are now inexorably tied to how soon the virus can be brought under control and lives/businesses can return to normal.

Figure 3. **Major Equity Markets' Performance in 2020 YTD – Percentage**



As of 3/20/2020 *Source: Bloomberg data, Guy Carpenter*

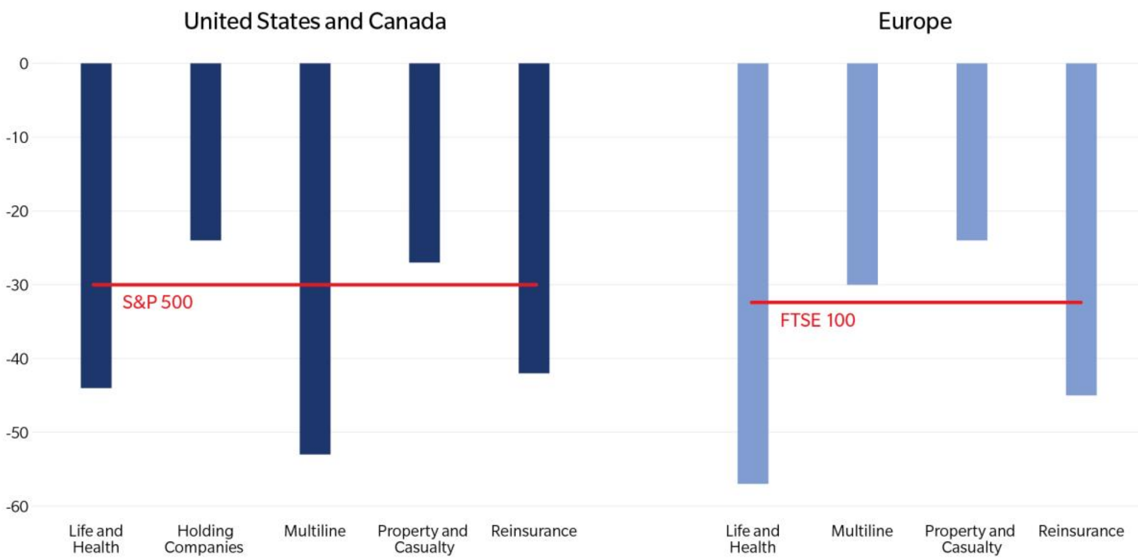
Reinsurance Resilience

In times of economic distress, (re)insurance is typically considered by investors to be a defensive sector. This view is well merited: it has less exposure to economic cycles than other industries and has a strong track record in navigating macroeconomic and capital crises.

For example, despite confronting an unprecedented multi-risk loss following the attacks of September 11, 2001, and a severe economic downturn following the event, the sector was able to recapitalize successfully and trade through. In addition, it is important to remember that the reinsurance sector emerged relatively unscathed from the global financial crisis of 2008. At a time of considerable economic turmoil and deep distress in the banking system, the capital base of the reinsurance sector remained solid and liquid throughout.

This is not to say the sector will be unaffected by the current crisis – far from it. Indeed, the fact that certain segments of the insurance sector (including reinsurance) have underperformed the S&P 500 and FTSE 100 (as seen in Figure 4) points, in part, to investors' concern about balance sheet impacts and future earnings growth. Concerns about underwriting may also have contributed to the sell-off, particularly at a time of claims inflation and an active plaintiffs' bar, but current expectations point to manageable losses for risks that are covered explicitly by policies.

Figure 4. **YTD Performance of (Re)insurance Subsectors vs S&P 500 and FTSE 100 – Percentage**

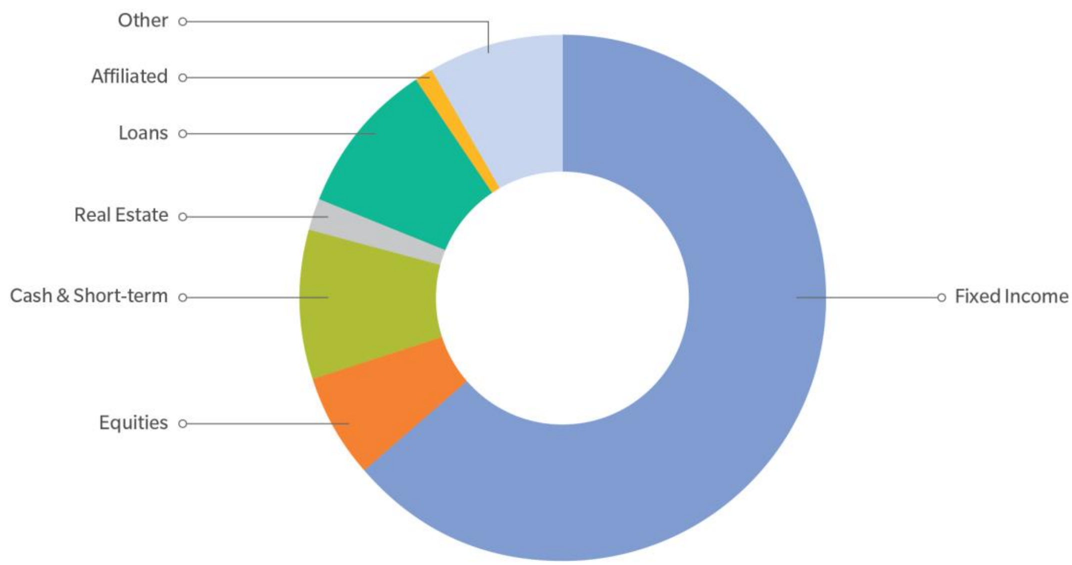


As of 3/20/2020 *Source: Guy Carpenter*

Ultimately, financial market volatility (and the resulting economic downturn) from COVID-19 is expected to have a greater impact on (re)insurance companies than any spike in claims. Lower interest rates, wider credit spreads and an equity crash will clearly hit carriers' assets and, perhaps more importantly, reduce access to capital. A fall back into recession will also hinder growth opportunities, given the long-standing correlation between economic output and premium growth.

It is nevertheless important to point out that most reinsurers' investment portfolios are invested conservatively, with a predominance of (high-grade) fixed income securities and low equity gearings (see Figure 5). While investment returns are likely to drop to new lows, such conservative allocations are likely to insulate reinsurers from significant investment portfolio risks.

Figure 5. **Investment Mix for the Guy Carpenter Reinsurance Composite at YE2019**



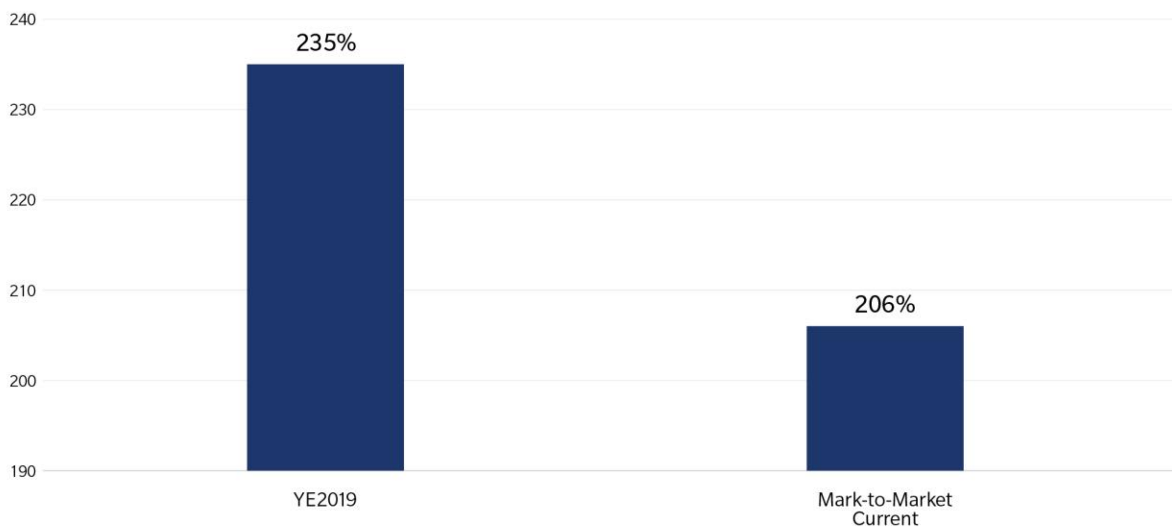
Source: Guy Carpenter

Strong Fundamentals

The fundamentals of reinsurance remain strong. Despite a period of unprecedented catastrophe losses in recent years, the sector continues to operate in an environment of plentiful capacity and abundant capital. Indeed, total reinsurance capital increased by USD 115 billion, or a third, between 2012 and the end of 2019, to reach USD 438 billion. This occurred despite record-breaking catastrophe losses of USD 300 billion in the last three years.

Reinsurers' capital and earnings will nevertheless have been hit in recent weeks by declining equity markets, falling interest rates and widening credit spreads. While it will be some time before the impact on capital can be quantified fully, Figure 6 shows that European reinsurers' weighted Solvency II/ Swiss Solvency Test ratio has fallen from 235 percent at the end of 2019 to 206 percent currently. Given the challenges, these are respectable outcomes, even if some ratios are towards the bottom of guidance levels. Reinsurers remain in reasonable shape overall.

Figure 6. **Solvency II Sensitivities of European Reinsurers – YE 2019 vs Mark-to-Market Current – Percentage**



As of 3/20/2020 *Source: Guy Carpenter*

Alternative Capital

The resilience of the reinsurance sector is being reinforced by strong liquidity in the alternative market, which is important given it makes up approximately one-fifth of total reinsurance sector capital. COVID-19 is expected to impact alternative capital differently from traditional markets:

- As discussed earlier, traditional reinsurance companies have taken a hit to their asset portfolios in the value of their equity holdings and credit spreads widening on their fixed income securities.
- Alternative capital structures are designed to minimize asset risk, with most catastrophe bonds investing in either treasury money market funds or International Bank for Reconstruction and Development/European Bank for Reconstruction and Development paper. This has helped to shore up their values. Even for collateralized reinsurance and sidecar transactions, the investment guidelines for assets are prescribed narrowly.
- On the liability side, contracts for catastrophe bonds are negotiated carefully to define the coverage precisely and avoid ambiguity. The effect of these protections has been evident in the secondary market trading of catastrophe bonds, where most of the outstanding securities, which do not have pandemic as a named peril, have been trading close to par. This could help attract further capital inflows into the catastrophe bond market in the near and medium term.

Typical long-term providers of alternative capital are pensions, endowments and sovereign wealth funds. Multi-strategy hedge funds are also invested in the space on an opportunistic basis. As the pandemic has caused widespread dislocations in the financial markets, some of these multi-strategy investors have sold a portion of their catastrophe bond holdings to raise cash to invest in other opportunities outside the sector.

Dedicated insurance-linked securities (ILS) funds, meanwhile, are taking the opposite side of this trade and adding to their catastrophe bond portfolios. While the financial markets remain disrupted for the foreseeable future, Guy Carpenter expects ILS funds to be robust buyers in both the primary and secondary markets. It is notable that last week, one of the most volatile in financial markets history, catastrophe bond transactions priced for Allstate, Mitsui Sumitomo and American Integrity and new transactions were announced for State Farm and SCOR. This market clearly remains open and functional.

Rating Agencies' Response

Given the fluidity of the current situation, rating agencies have a lot to weigh up when assessing carriers' credit risk. Global insurers and reinsurers entered 2020 with a stable outlook from all the major rating agencies, due largely to strong capitalization levels and early signs of a firming market. Despite dwindling reserve releases, the agencies were comforted by the offsetting impacts that came from higher pricing.

Events have nevertheless moved on dramatically since the turn of the year. A.M. Best last week changed the outlook on the life and annuity sector to negative from stable in response to interest rate cuts and possible mortality implications on the sector. Fitch also responded this week by revising its outlooks for the global reinsurance and U.S. property and casualty insurance markets to negative. Fitch cited concern about the credit quality of reinsurers. It also acknowledged that reinsurers will be less impacted by the coronavirus pandemic than life and health insurers, emphasizing reinsurers' strong capital adequacy, robust risk management and solid business profiles.

These assessments align with Guy Carpenter's. We believe that rating changes are likely for insurers and reinsurers impacted indirectly by financial market fluctuations and that the range of actions will depend on how long the disruption lasts and the impact on equity and bond markets.

There are other rating agency considerations to bear in mind in the short-term, beyond rating changes. A.M. Best has announced a detailed approach to testing the operational readiness of companies' to respond to the fallout from the pandemic. The questionnaire focuses on operational impact, changes to forecasts, discussion of the lines most impacted and companies' own stress tests (please click **here** for more information). In addition, A.M. Best will also look at the impact of stress events on insurers' risk based capital positions.

Reinsurers face their challenges from a position of strength.

Carriers' ability to maintain appropriate liquidity to meet maturing debt obligations and claims will be crucial over the coming weeks and months. Central bank intervention last week to shore up liquidity was an important development that seems to be working in the short term, at least.

The prospect of higher corporate bond default rates is another area of concern. S&P has already increased its projected defaults to low double digits in the United States, and high single digits in Europe. Equities make up a relatively small part of invested assets (6 percent) of the Guy Carpenter Global Reinsurance Composite due to high capital charges under the Risk Based Capital Frameworks, globally. Similarly, the capital charge for below investment grade bonds are also high and thus represent a relatively low portion of invested assets. If the macroeconomic weakness continues for a sustained period of time, the performance of BBB/A bonds and real estate could also be adversely impacted. This would have a manageable, yet more severe impact on (re)insurers.

Ultimately, carriers with heavy concentrations in equity and below investment grade bonds relative to shareholders' equity should engage with the rating agencies to discuss their financial positions and manage their ratings. Carriers with relatively risky balance sheets should also be prepared to discuss their risk tolerance and management, liquidity, stress testing and risk based capital with the rating agencies. For life insurers, asset quality problems are exacerbated by the significant asset liability management challenges associated with low interest rates and minimum guarantees. Again, holding holistic discussions with the rating agencies is imperative for these companies.

Here To Help

Guy Carpenter is monitoring closely developments associated with COVID-19 outbreak and stands ready to help and support clients through this highly fluid and challenging period. This is the first in a series of briefings that seek to keep clients informed of the major macro developments and issues related to COVID-19.

Guy Carpenter exists to support clients at times of adversity so please reach out to your local representative with any questions or concerns you may have.

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