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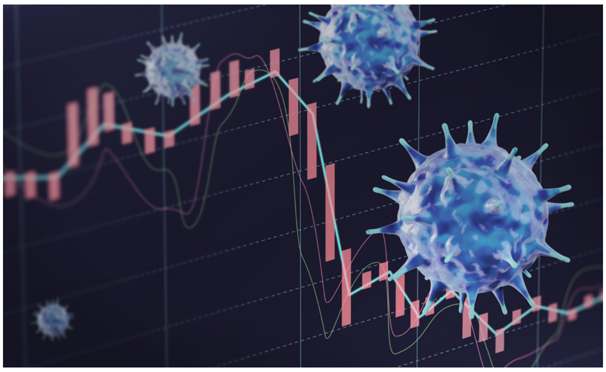
COVID-19 and Insurable Risk Appetite: Altering Philosophies in Uncertain Times

The global economy finds itself in a state of uncertainty in the face of the novel coronavirus (COVID-19), with S&P Global now forecasting a global recession this year.[1] In the past two months, we have seen the evolution of an oil price war between Saudi Arabia and Russia,[2] the S&P 500 index of US companies evidence a maximum peak to trough variance of 33.9%,[3] and Chinese industrial production drop by 13.5%[4] – all collectively highlighting the breadth of the outbreak's impact. Combining these macroeconomic factors with the fact that in the UK 45% of businesses reported lower than expected turnovers[5] (likely through a distinct lack of consumer expenditure) means that many organisations are very likely entering a period of severely restricted free cash flows.

In such uncertain times, organisations may face an unenviable set of conflicting factors: Risk appetite is reducing, but the need to control external costs is vital — all whilst a transitioning insurance market introduces unfamiliar volatility into any cost-benefit analysis. In this dynamic risk environment, how can organisations equip themselves to make the most capital-efficient use of insurance?



Risk Appetite and Risk Retention

With weakened/weakening cash flows in the short-to medium-term, many organisations will likely experience a reduction in their appetite to retain insurable risk within their organisation. Managing any avoidable volatility to the profit and loss account or balance sheet becomes less sustainable during these uncertain times. Ground-up (zero deductible) insurance coverage therefore becomes the preference — providing full risk transfer of unwanted loss volatility. In the past, this may have resulted in one of two things:

1. Organisations approaching renewal reverting to ground-up insurance purchasing.
2. Organisations outside of their renewal cycle "buying-down" their existing deductibles/excesses, in order to effectively benefit from ground-up coverage.

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[1] S&P Global.
[2] Forbes.
[3] 19 February 2020 (3,386.15) to 23 March 2020 (2,237.40).
[4] National Beureau of Statistics for China.
[5] Office for National Satistics.

The Impact of a Transitioning Insurance Market

Both of the options above may well have been viable while insurance was a relatively cheap source of capital — but with the market for a large number of classes of insurance now rapidly transitioning to a period of higher premiums and reduced capacity, this may no longer make economic sense.

It is a matter of priorities. Some organisations may be happy to pay higher external insurance premiums (and be financially capable of doing so) to transfer as much volatility out of their business as possible.

For other organisations, the lure of lower premiums in exchange for higher levels of risk retention may continue to be an attractive option — perhaps buoyed by confidence in their own business resilience, continuity planning, and crisis management response. The important point for those making this assessment is to know what the organisation's priorities now are.

If organisations need (or choose) to maintain higher deductibles /excesses in order to maintain affordable levels of premium, they need to determine the optimal balance of risk retention and risk transfer.

Insurance Programme Optimisation Through Risk Analytics

Through risk analytics — and more specifically, a stochastic modelling approach — organisations can obtain visibility on the potential loss volatility for a class of insurance risk within the forthcoming policy period (i.e. what a 1 in 10-year loss would look like, a 1 in 50-year loss, and so on). This in turn allows them to determine the value delivered through existing and alternative insurance coverages in exchange for their insurance premiums.

Such outputs can also be used to challenge insurer pricing, which will have been devised on a similar basis.

Having overlaid the risk model with premium indications from the insurance market — and with knowledge of the potential cost of differing retentions — organisations are in a better position to take decisions about their insurance programme. They can be confident that they have reflected their updated risk appetite, as well as revised premiums, when balancing risk retention and transfer costs. Documenting this analytical process also provides a governance trail to evidence and analyse these decisions.

Summary: What Can Organisations Do to Respond?

Organisations can manage the impacts of the COVID-19 crisis and beyond through an analytically informed review of their risk financing strategy. We broadly categorise such a review into three phases:

PHASE 1 **Managing the Crisis** — Track and assess the financial impact of COVID-19 on your organisations' financial strength and performance (free cash flows and other key performance indicators), in the context of your existing insurance spend and levels of retained losses.

PHASE 2 **Responding to the Impacts** — Reassess the "go-forward" risk financing strategy based on a redefined level of insurable risk appetite, in the context of experienced and forecast losses during this period (both in direct relation to COVID-19 and otherwise).

PHASE 3 **Maximising Recovery** — Deploy stochastic loss modelling and insurance efficiency methodologies to identify the financially optimal balance of risk retention and risk transfer, in the context of a redefined risk appetite and a transitioning insurance market.

Taking these steps can help organisations assess the financial impact of COVID-19, ensuring that the risk financing strategy is "fit for purpose", and the optimal balance of risk retention and transfer is deployed.

For more information on any of the solutions outlined in this document, please contact a colleague below, visit our COVID-19 resource centre, or speak to your usual Marsh representative.

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