

Inflation risk

Interview with Hans-Joachim Guenther, Chief Underwriting Officer and Head of Endurance Reinsurance, Europe and Asia and Jeffrey Dollinger, Chief Actuary, Endurance Worldwide Reinsurance

Why is inflation of concern in the current economic environment?



HJG: Government lending in many countries is creating massive deficits to resist the worldwide recession and these deficits increase the likelihood of high inflation. This is of concern to insurers

as inflation can significantly increase claim costs, especially for long tail casualty lines or even engineering coverage. While insurers may also see nominal increases in premiums based on sales, payrolls, etc. and can even revise their market terms for the current underwriting year, these don't offset the inflationary impact on reserves from previous underwriting years.

JD: Inflation causes deficiencies in reserves from past years but also hurts the asset values of insurers who invest in bonds with long maturities, because long-term debt is sensitive to high inflation and may need to be written down in value. Duration matching of assets and liabilities does not protect insurers against this additional inflation risk, because for an insurer writing long tail liability business this strategy would entail investing a portion of the portfolio in long duration bonds.

HJG: When talking about inflation, you also hear from time to time the argument that high inflation is going to be offset by a high interest rate environment which should mitigate inflationary burdens. Although this premise isn't incorrect, interest rate developments always respond to inflation with a time delay, i.e. real inflation is going to grow in high inflation environments.

How does inflation impact ceding companies?

HJG: Insurers may need to adjust not only their current reserving levels, but also recognize that for long tail risks in casualty lines, inflation can impact prior year reserves. Typically, ceding companies may need to reevaluate reserves going back as many as ten, twenty or even more underwriting years and adjust

these reserves to account for inflation expectations. You only need to consider those lines of business with significant bodily injury exposure, such as motor or decennial liability covers.

There is also a significant risk that insurers will not price new business adequately as the industry relies on historical loss experience that doesn't always appropriately predict future loss trends. Given uncertainty and the divergent views in the market, even if an insurer could accurately predict inflation, competitive pressures would likely prevent them from realizing adequate rates.

How can ceding companies address these impacts?



JD: From an investment perspective, insurers can manage their asset portfolio to a short duration to manage inflation risk. Cedants with longer term debt can invest in inflation

indexed bonds, such as Treasury Inflation-Protected Securities (TIPS) and I-Bonds issued by the US Treasury or other kinds of floating rate notes, as well as asset classes whose underlying investment exposures are related to tangible assets whose value tends to keep better pace with inflation than other investments.

Cedants may also wish to consider the high degree of correlation across accident years and work with their reinsurance partners who understand inflation risk to develop appropriate reinsurance strategies. Appropriate structures can be tailored to provide both inflation protections for the ceding company, such as risk sharing, and adequate pricing to the reinsurer for the ceded risks.

How are anticipated inflation increases impacting the current rate environment?

HJG: Reinsurers may well need to increase rates in anticipation of inflationary increases in claims. However, with inflation expectations varying across reinsurers,

ceding companies will likely see wider ranges in pricing. In this type of market, it becomes especially critical to partner with a knowledgeable reinsurer that can differentiate between real claims movements and inflation effects. Insurers may also see greater use of sliding scale terms or other price adjustment methodologies to address inflation risks beyond those covered by indexation clauses.

Don't indexation clauses cover inflation risk?

JD: To some extent, but not all costs are covered by indexation clauses. For example, increases in the cost and utilization of at-home and other types of medical care have greatly outpaced inflation indices commonly used for workers compensation, motor liability and other liability lines reinsurance treaties. These costs can drive up claim costs, particularly for motor liability, where they account for over 50% of the costs of serious bodily injury claims in most major countries.

Does inflation have a greater impact on insurers or reinsurers?

HJG: Despite indexation clauses, the leveraged effect of loss trends under excess of loss treaties causes reinsurers to assume proportionately more inflation risk than insurers. A simple example of a fully indexed layer might help to understand this effect: if an unlimited excess of loss program with a €1 million attachment point is impacted by a €4 million gross loss, the reinsurer would need to pay out €3 million. But were there to be 50% inflation over a period of time prior to payment, the gross loss would increase to €6 million; an indexed retention would increase to only €1.5 million resulting in a loss of €4.5 million to the reinsurer. In this example, the economic impact to the reinsurer increased by €1.5 million while the cedant's retention only increased by €0.5 million.

Is the impact expected to be more severe in certain markets?

HJG: Overall, because inflation tends to be a global phenomena, geographic diversification does not mitigate inflation risk. Moreover, inflation risk is greater where claim payments are pushed further into the future due to certain specific regulatory and legal requirements of some countries. For example, the Court Act in the UK encourages periodic payout of claims rather than lump sum payments and in France it is common for motor liability claims to be eventually reopened. In fact, it is widely believed that the Fifth European Union Motor Insurance Directive will increase bodily injury exposure in some countries as the limits for motor liability are harmonized across the Continent.