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2020 – The Perfect Storm for Forthcoming Negative Rating Pressure

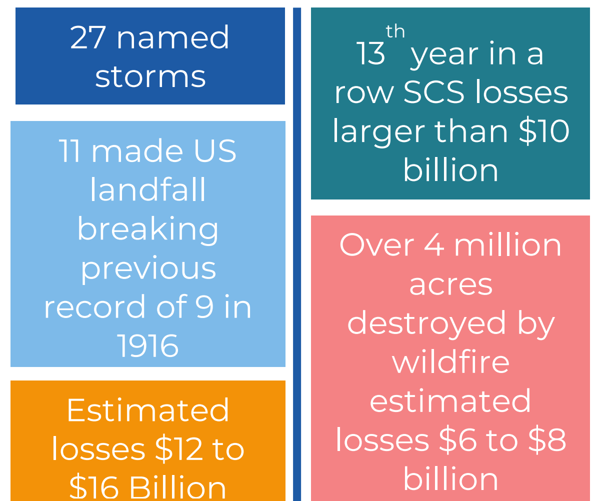
The insurance industry is facing a multitude of events at once in 2020, a "perfect storm" of disasters both natural and manmade.

- Wildfires and hurricanes were above average in 2020;
- The financial markets are pressuring the asset side of the equation putting more stress on solvency and asset liability matching;
- COVID-19 is threatening another shut down that already has many contested BI claims from the first round of shutdowns;
- Unintended cyber exposure has yet to rear its face;
- Civil unrest has the potential to surpass the 1992 LA riots in terms of insured losses; and
- We still have a polarized election upcoming that can wreak further havoc on both the financial market and the civil unrest front.

As we move closer to the end of the year the rating agencies are going to keep a closer eye on risk adjusted capital and stress testing of the aforementioned scenarios on actual 3Q2020 results, forecasted 2020, and 2021 financials. Companies with outsized exposure to these expanding natural and manmade events could receive negative outlooks and downgrades, which could ensue from one or all of three forms: capital shortfalls, increased volatility in current/future operating performance, and unresponsive ERM capabilities. These concepts will be examined along with how companies should be prepared to combat these challenges in the near term.

Natural Disasters

This year was forecasted to be an above average storm season with 16 storms and 4 major storms forming with higher than normal landfall probability, according to the Colorado State University April forecast. Year to date we have had 27 named storms. Hurricane Zeta will be the 11th landfalling storm in the U.S., which broke a century's old record set in 1916 of nine. On a preliminary basis, insured loss damage is estimated between $12 billion and $16 billion.



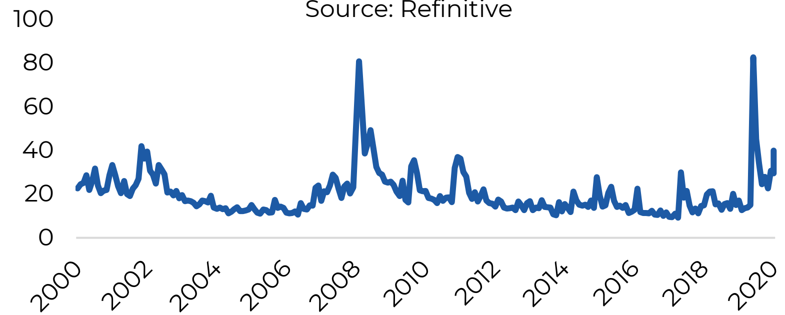
Severe convective storms (SCS) have also become a peak peril for insurers in 2020. Losses are still developing; however, through the end of September there were 25 industry loss events totaling $27 billion, ranking second behind the active year of 2011 in terms of total loss. 2020 is the 13th year in a row where SCS losses have been more than $10 billion, putting insurers modeling of these storms and reinsurance aggregate limits to the test.

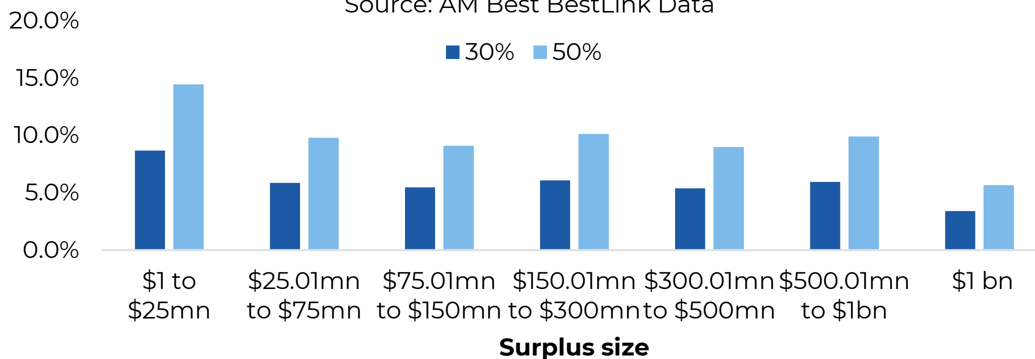
Coupled with hurricane and SCS, wildfire losses are devastating California. The California Department of Forestry and Fire Protection recently reported that wildfires destroyed more than four million acres in 2020. The previous record was 1.9 million in 2018. Fire loss estimates so far have topped $6-$8 billion.

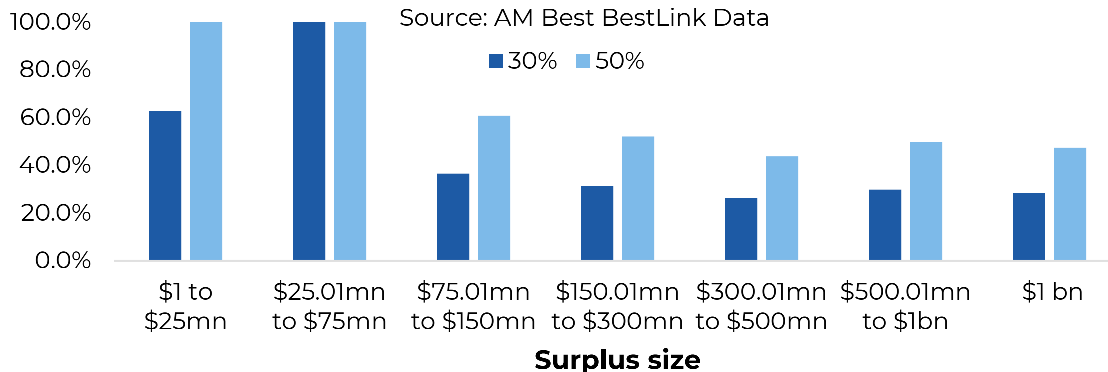
Companies that have outsized exposure to these natural disasters may be the most vulnerable to negative ratings pressure in the next six to twelve months.

Further Financial Market Volatility

The equity markets are treading through the waters of extreme volatility and companies with high common stock leverage are seeing their balance sheets tested. The VIX (volatility index) has not seen this level of volatility since the 2008 credit crisis peaking at 80.86 on November 20, 2008. This year the VIX made a new all-time high of 82.69 on March 16, 2020 and has recently been holding steady above 25 over the past month. In analyzing statutory data and stress testing companies for 30% and 50% common stock declines (as of 2Q2020), companies with larger balance sheets fare better even if the equity exposure is higher than average. The median surplus declines ranged from 3% to as high as 14%. Companies that had above average unaffiliated common stock exposure had maximum declines in surplus from 25% to as high as 100%, depleting all of the company's surplus and rendering them insolvent. Companies with surplus (as of 2Q2020) in the range of $1 million to $25 million and $25.01 million to $75 million had the biggest surplus declines and were the most exposed to insolvency. This stress testing was only performed on the asset side of the balance sheet. Increasing losses from natural and manmade disasters would put more pressure on risk adjusted capital if the reinsurance in place does not adequately address the frequency and severity of events contemplated in scenario testing. .







Unintended Exposure - Cyber

At the same time, companies may experience increased losses from cyber exposures. The stay at home workforce has exploded, pushing VPN and video meeting apps to their limits. This opens the door to more cyber exposure than ever before. Ransomware attacks are on the rise globally. The FBI has reported that the number of cyber-attack complaints they receive has increased over 350% from pre-coronavirus levels. Hospital systems are not only battling COVID-19, but also cyber-attacks causing ambulance diversions and networks being taken offline for days. The Department of Homeland Security's Cybersecurity and Infrastructure Security Agency is concerned that degraded and/or delayed patient care from cyber related events could lead to loss of life. School districts are also being targeted with threats of private information being publicized unless a ransom is paid.

Cyber risk could be the second leg of the COVID-19 pandemic, generating losses that no one expected. The same exclusions or sub limits written into policy contract language have the possibility of being exposed to the same state and federal intervention as the current pandemic exclusions on business interruption policies. Insurance companies may be at risk for another exposure not considered in their pricing models

COVID-19 Shutdown Part 2 & Increased Civil Unrest

Just as the curve flattened for many states into the summer months, cases are increasing across the globe. The threat of another shutdown looms and will once again test the limits of premium financing and rebates forcing insurance companies to reforecast the rest of 2020 and into what may be a slow start to 2021.

Civil unrest insured losses could top $1.5 billion in 2020

As the election nears, the U.S is entering a more divided and polarized election cycle. Talks from both sides about a contested election and transfer of power is already being discussed in the media and on the debate stage. Insurers have seen an increased frequency and severity in claims from civil unrest as businesses have been decimated in affected areas. The 1992 LA riots accumulated $775 million in insured loss which equates to approximately $1.4 billion inflation adjusted. 2020 civil unrest is in a range of $500 million to $900 million, and there are still pockets of unrest throughout the U.S. As tensions rise, insurers could see even more claims as protests during and for some time after the election is a concern. Depending on the duration and scope, insured losses from civil unrest could **top $1.5 billion**. Rated insurers should be able to show stress testing of this scenario if they have exposures.

Negative Ratings Pressure in the Near Term

All of the events that have already occurred, plus the potential for more large losses in 2020 and early 2021 will put capital adequacy of some insurers to the test. Companies with outsized exposure to these expanding natural and manmade events could see downward ratings pressure which could ensue from one or all of three forms: capital shortfalls, increased volatility in current/future operating performance, and unresponsive ERM capabilities.

3 Forms of Negative Ratings Pressure

1. Capital shortfalls
2. Current/future operating volatility
3. ERM capabilities questioned.

Capital Shortfalls

Balance sheet stress testing may reveal the need for capital under certain scenarios. Given the recent events of 2020, some of these stress test scenarios could become reality. If stress tests reveal a shortfall, then companies must have a credible plan of raising capital. Companies that have an established track record of raising capital in any form (surplus notes, debt, and equity) will be given more qualitative credit. Companies that do not have a track record may find it difficult to convince the rating agencies that they can raise the amount of capital needed to cover the shortfall at a reasonable cost of capital.

Companies that have access to capital from a parent company, holding company, or private equity backing will have a stronger qualitative assessment for the ability to raise capital. Access to capital is easier as interests are aligned for success, and the timeframe is short since accessing the financial markets is bypassed.

Smaller companies that do not have the aforementioned access to capital, but have access to "on demand" capital will also fare well in stressed scenarios. Credit facilities, or contingent capital facilities that are able to shore up the shortfall in stressed scenarios, are also easier to access with pre-determined costs and conditions. They also bypass the financial markets taking the unknowns out of the equation.

Current / Future Operating Performance Volatility

Many companies may have reported increased volatility in their operating performance metrics tracked by the rating agencies. If the volatility is outside of the normal bounds for the rating level this may affect the credibility of forecasted financials. Additionally, companies should be able to articulate their ability to achieve rate responsiveness to significant changes in their underlying costs, such as the recent increases in property catastrophe and/or excess casualty reinsurance.

Companies with January 1 and/or June 1 reinsurance renewals can show how prospective aggregate covers in the form of whole account stop losses could cap losses that would affect capital strength. Increased quota share for certain lines of affected business can also help reduce future volatility.

ERM Capabilities Questioned

Given these unprecedented times, insurance companies' Enterprise Risk Management (ERM) risk tolerances and policies are being tested. How companies prepare for these unknowns and how they handle them will be on the minds of boards, shareholders, regulators and the rating agencies. Each year insurance companies that are rated have to present their results and discuss their plans for the upcoming years during their annual rating review. This involves discussions on their ERM risk tolerances and stress testing of the balance sheet. Given these unprecedented times ERM is supposed to contemplate the unknown. Companies should show stress testing results for "pandemic" or a stress test that takes into account unknown large losses on both the asset and liability side of the balance sheet. A "nuclear" stress test that severely depresses the assets side, and increases the liability side should be a part of every company's ERM stress testing. Companies that have exceeded their risk tolerances with no warnings will have their ERM capabilities questioned.

Looking Forward

Rated companies should be prepared for another round of stress testing if a second wave of COVID-19 shutdowns occur. Be prepared to show aggressive stress testing with multiple events to capital in the most current financials (as of 3Q2020) and 2020 and 2021 projected plans. Contingency plans for capital raising, taking into account tighter credit markets and higher cost of capital, should be considered. Companies that may have material declines in risk adjusted capitalization will need to have a credible plan of how they will shore up the capital shortfall. If operating performance volatility is a concern then a concrete actionable plan to reduce the volatiliy going forward should be explained in detail. ERM risk appetite and tolerance statements if breached will come into quesiton. Companies should be prepared to respond with changes that are being made to show that ERM will protect the ongoing strategy . Companies that cannot answer these quesitons will have hard time convincing the rating agencies that their forward looking forecasts are aligned with their current rating.

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