MOODY'S ANALYTICS

Economic Scenario Generators: Usage and Trends in the P&C Industry

CAS Annual Meeting – Minneapolis, November 3-6, 2013

LOIC GRANDCHAMP

November 4, 2013

What is an ESG? What can you use it for?

1. Introduction
2. Usage & Trends

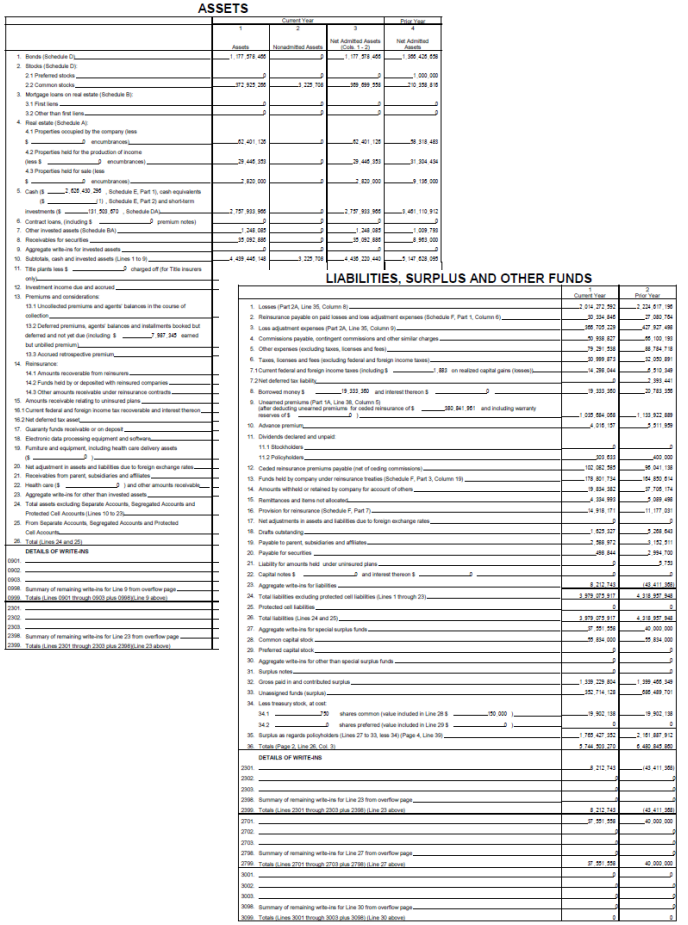
1

Introduction to ESG

Economic scenario generators – Why?

What are the sources of market and economic risks for P&C insurers?

- Interest rates
  - Government bonds (incl. inflation-linked bonds)
  - Municipal bonds
  - Mortgage-backed securities
- Credit
  - Corporate bonds
  - Reinsurance counterparties
- Currency
- Price inflators
  - CPI / Wage inflation
  - Specific claims exposures: medical, construction, auto
- Equity & property markets
- Correlations / dependencies



ASSETS

	Current Year 1 Assets	2 Nonadmitted Assets	3 Net Admitted Assets (Cols. 1 - 2)	Prior Year 4 Net Admitted Assets
1. Bonds (Schedule D)	1,177,579,485	0	1,177,579,485	1,066,426,659
2. Stocks (Schedule D):				
2.1 Preferred stocks	0	0	0	1,000,000
2.2 Common stocks	972,925,286	3,229,706	969,695,580	910,358,916
3. Mortgage loans on real estate (Schedule B):				
3.1 First liens	0	0	0	0
3.2 Other than first liens	0	0	0	0
4. Real estate (Schedule A):				
4.1 Properties occupied by the company (less $ 0 encumbrances)	62,401,128	0	62,401,128	58,518,483
4.2 Properties held for the production of income (less $ 0 encumbrances)	39,445,353	0	39,445,353	31,304,434
4.3 Properties held for sale (less $ 0 encumbrances)	2,820,000	0	2,820,000	9,195,000
5. Cash ($ 2,626,430,295, Schedule E, Part 1), cash equivalents ($ 0, Schedule E, Part 2) and short-term investments ($ 191,503,870, Schedule DA)	2,797,933,965	0	2,797,933,965	3,461,119,912
6. Contract loans, (including $ 0 premium notes)	0	0	0	0
7. Other invested assets (Schedule BA)	1,348,085	0	1,348,085	1,009,780
8. Receivables for securities	35,092,880	0	35,092,880	8,983,000
9. Aggregate write-ins for invested assets	0	0	0	0
10. Subtotals, cash and invested assets (Lines 1 to 9)	6,489,445,148	3,229,706	6,486,220,440	5,147,926,095
11. Title plants less $ 0 charged off (for Title insurers only)				
12. Investment income due and accrued				
13. Premiums and considerations:				
13.1 Uncollected premiums and agents' balances in the course of collection				
13.2 Deferred premiums, agents' balances and installments booked but deferred and not yet due (including $ 7,987,345 earned but unbilled premium)				
13.3 Accrued retrospective premium				
14. Reinsurance:				
14.1 Amounts recoverable from reinsurers				
14.2 Funds held by or deposited with reinsured companies				
14.3 Other amounts receivable under reinsurance contracts				
15. Amounts receivable relating to uninsured plans				
16.1 Current federal and foreign income tax recoverable and interest thereon				
16.2 Net deferred tax asset				
17. Guaranty funds receivable or on deposit				
18. Electronic data processing equipment and software				
19. Furniture and equipment, including health care delivery assets ($ 0)				
20. Net adjustment in assets and liabilities due to foreign exchange rates				
21. Receivables from parent, subsidiaries and affiliates				
22. Health care ($ 0) and other amounts receivable				
23. Aggregate write-ins for other than invested assets				
24. Total assets excluding Separate Accounts, Segregated Accounts and Protected Cell Accounts (Lines 10 to 23)				
25. From Separate Accounts, Segregated Accounts and Protected Cell Accounts				
26. Total (Lines 24 and 25)				
DETAILS OF WRITE-INS				
0901.				
0902.				
0903.				
0998. Summary of remaining write-ins for Line 9 from overflow page				
0999. Totals (Lines 0901 through 0903 plus 0998)(Line 9 above)				
2301.				
2302.				
2303.				
2398. Summary of remaining write-ins for Line 23 from overflow page				
2399. Totals (Lines 2301 through 2303 plus 2398)(Line 23 above)				

LIABILITIES, SURPLUS AND OTHER FUNDS

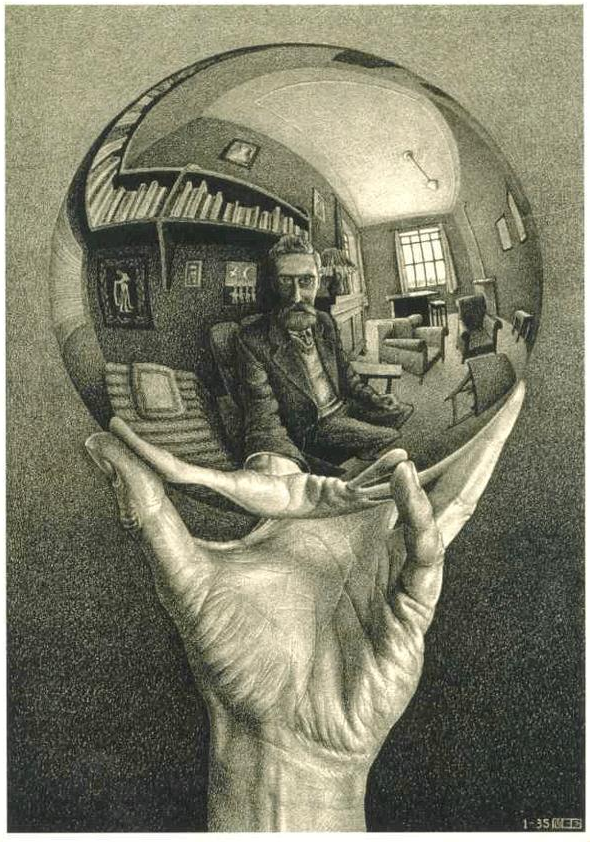
	Current Year 1	Prior Year 2
1. Losses (Part 2A, Line 35, Column 8)	2,014,272,762	2,224,517,196
2. Reinsurance payable on paid losses and loss adjustment expenses (Schedule F, Part 1, Column 6)	36,334,646	27,080,764
3. Loss adjustment expenses (Part 2A, Line 35, Column 9)	388,705,229	427,927,486
4. Commissions payable, contingent commissions and other similar charges	76,938,827	66,100,193
5. Other expenses (excluding taxes, licenses and fees)	79,291,538	68,794,718
6. Taxes, licenses and fees (excluding federal and foreign income taxes)	36,999,873	32,050,891
7.1 Current federal and foreign income taxes (including $ 7,883 on realized capital gains (losses))	14,286,044	8,510,348
7.2 Net deferred tax liability	0	3,993,441
8. Borrowed money $ 19,333,350 and interest thereon $ 0	19,333,350	20,793,356
9. Unearned premiums (Part 1A, Line 36, Column 5) (after deducting unearned premiums for ceded reinsurance of $ 380,841,961 and including warranty reserves of $ 0)	1,085,584,056	1,133,922,889
10. Advance premium	4,016,157	5,511,959
11. Dividends declared and unpaid:		
11.1 Stockholders	0	0
11.2 Policyholders	300,000	400,000
12. Ceded reinsurance premiums payable (net of ceding commissions)	102,562,595	96,041,138
13. Funds held by company under reinsurance treaties (Schedule F, Part 3, Column 19)	178,801,734	164,850,614
14. Amounts withheld or retained by company for account of others	19,894,362	27,708,174
15. Remittances and items not allocated	4,394,999	3,089,496
16. Provision for reinsurance (Schedule F, Part 7)	14,918,171	11,177,031
17. Net adjustments in assets and liabilities due to foreign exchange rates	0	0
18. Drafts outstanding	1,625,227	5,269,540
19. Payable to parent, subsidiaries and affiliates	2,566,972	3,152,511
20. Payable for securities	488,844	2,994,700
21. Liability for amounts held under uninsured plans	0	0
22. Capital notes $ 0 and interest thereon $ 0	0	0
23. Aggregate write-ins for liabilities	8,212,743	(43,411,358)
24. Total liabilities excluding protected cell liabilities (Lines 1 through 23)	3,979,073,917	4,218,957,948
25. Protected cell liabilities	0	0
26. Total liabilities (Lines 24 and 25)	3,979,073,917	4,218,957,948
27. Aggregate write-ins for special surplus funds	37,551,556	40,000,000
28. Common capital stock	55,934,000	55,934,000
29. Preferred capital stock	0	0
30. Aggregate write-ins for other than special surplus funds	0	0
31. Surplus notes	0	0
32. Gross paid in and contributed surplus	1,339,229,804	1,399,466,349
33. Unassigned funds (surplus)	352,714,128	598,489,701
34. Less treasury stock, at cost:		
34.1 750 shares common (value included in Line 28 $ 750,000)	19,902,138	19,902,138
34.2 0 shares preferred (value included in Line 29 $ 0)	0	0
35. Surplus as regards policyholders (Lines 27 to 33, less 34) (Page 4, Line 39)	1,765,427,352	2,181,987,912
36. Totals (Page 2, Line 26, Col. 3)	5,744,501,270	6,400,945,860
DETAILS OF WRITE-INS		
2301.	8,212,743	(43,411,358)
2302.	0	0
2303.	0	0
2398. Summary of remaining write-ins for Line 23 from overflow page	0	0
2399. Totals (Lines 2301 through 2303 plus 2398)(Line 23 above)	8,212,743	(43,411,358)
2701.	37,551,556	40,000,000
2702.	0	0
2703.	0	0
2798. Summary of remaining write-ins for Line 27 from overflow page	0	0
2799. Totals (Lines 2701 through 2703 plus 2798)(Line 27 above)	37,551,556	40,000,000
3001.	0	0
3002.	0	0
3003.	0	0
3098. Summary of remaining write-ins for Line 30 from overflow page	0	0
3099. Totals (Lines 3001 through 3003 plus 3098)(Line 30 above)	0	0

Economic scenario generators – What?

ESG outputs

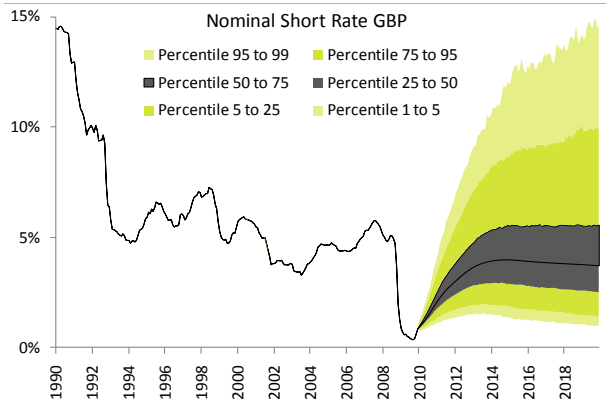
- An ESG produces forward-looking scenarios for multiple risk drivers
  - ESG provides a distribution of possible values for economic risk factors at future timesteps
  - Output is a time series of variables for each scenario (trial)
  - Economically coherent joint distributions of financial and economic factors attempting to capture the dynamics of financial markets – dependency, tail risk

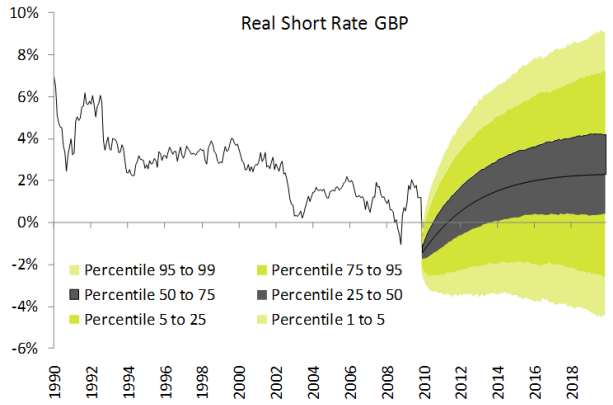
Trial	Time Step	Interest Rate	FX	…
1	0	0.20%	1.25	…
1	1	0.21%	1.19	…
1	2	0.25%	1.22	…
1	3	0.23%	1.30	…
2	0	0.20%	1.25	…
2	1	0.23%	1.33	…
2	2	0.21%	1.34	…
2	3	0.30%	1.27	…
3	0	0.20%	1.25	…
…	…	…	…	…

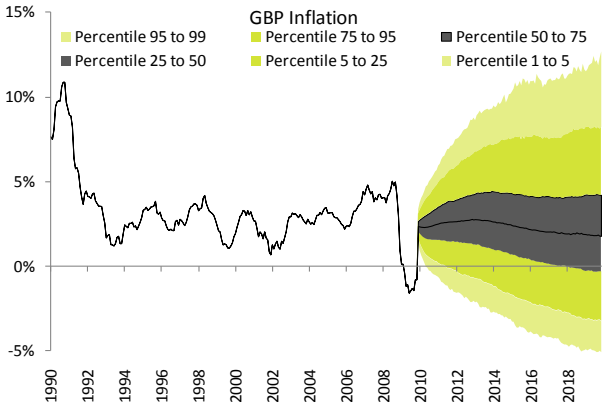


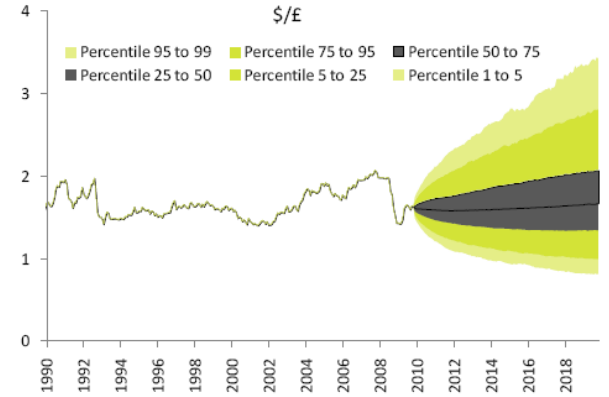
Economic scenario generators – What?

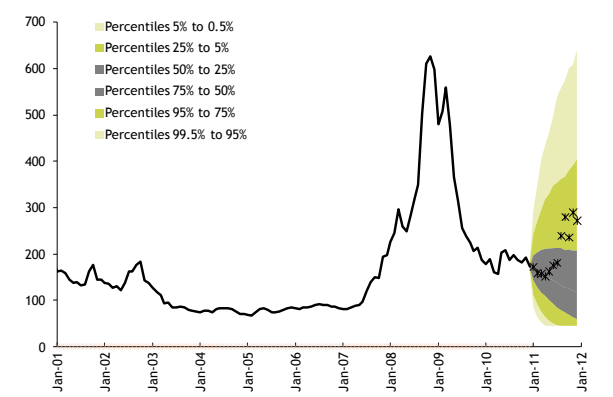
Sample ESG outputs

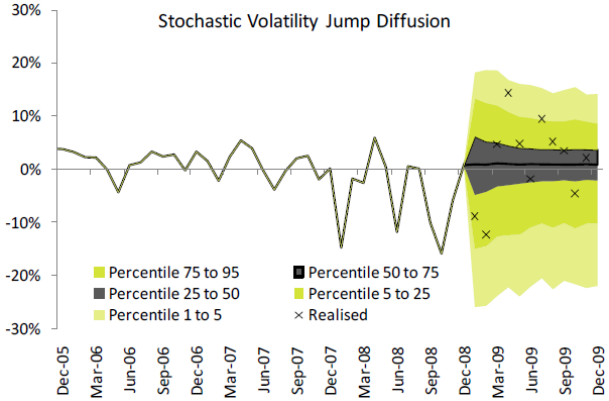












Economic scenario generators – How?

ESG modeling process

- Goal: Realistic and justifiable projections of financial and economic variables
- Roadmap in principle
  - Develop and document stylized facts and beliefs
    - E.g. interest rates are mean reverting
    - Credit spreads and equity returns are negatively correlated
  - Structure, calibrate and validate models
  - Validate and review the stylized facts and model regularly

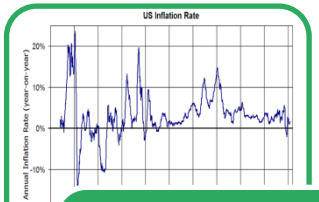
$$dr(t) = \alpha(\mu' - r(t))dt + \sigma dZ(t)$$

$$d\ln r(t) = \alpha(\mu' - \ln r(t))dt + \sigma dZ(t)$$

$$dr(t) = \alpha(\mu' - r(t))dt + \sigma\sqrt{r(t)}dZ(t)$$

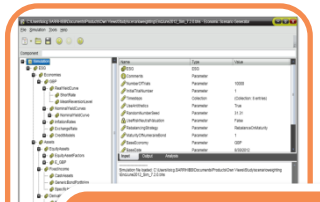
Models

- Mathematical models developed to reproduce the dynamics of financial markets



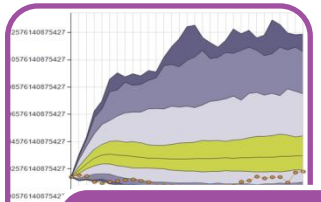
Calibration

- Use market, historical data and judgment
- Generate model parameters specific to application and market conditions



Calculations

- Software implementation of mathematical models
- Use parameters determined through calibration



Outputs

- Thousands of trials
- Each trial represents an history of what could happen in the future

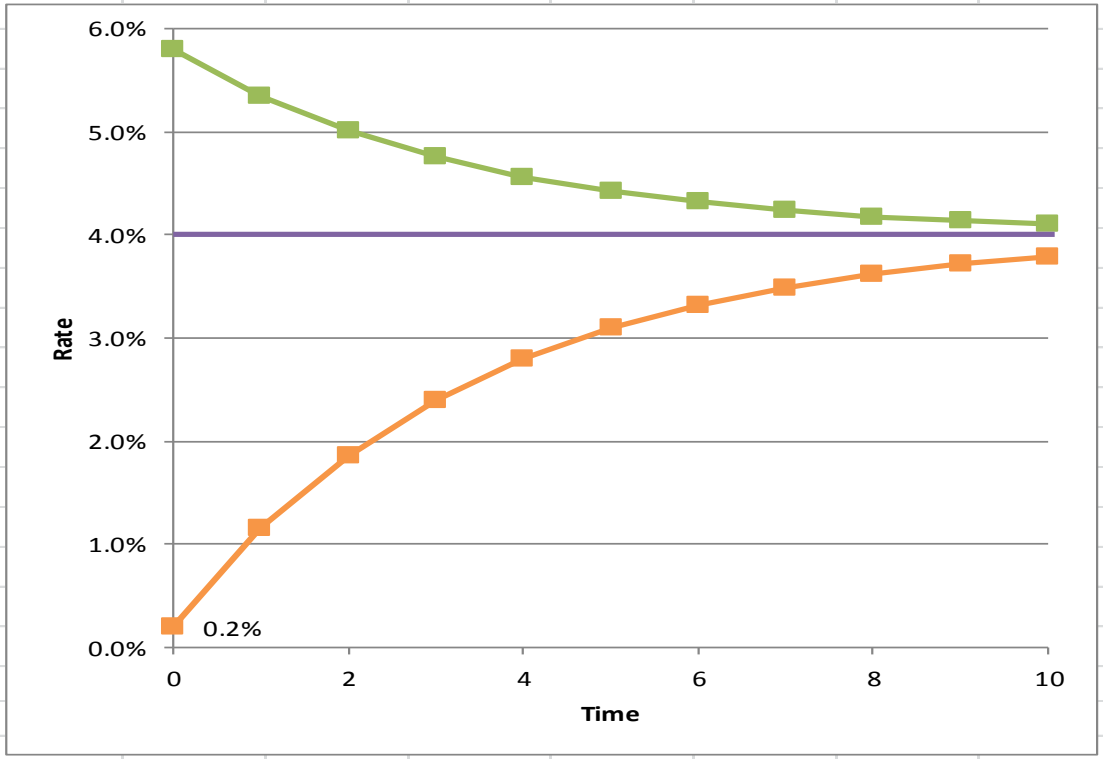
A simple deterministic interest rate model

A deterministic mean reverting process

$$dr(t) = \alpha(\mu' - r(t))dt$$

r(0)	0.2%	5.8%
mu	4.0%	4.0%
alpha	0.25	0.25

t	Rate	Rate
0	0.2%	5.8%
1	1.2%	5.4%
2	1.9%	5.0%
3	2.4%	4.8%
4	2.8%	4.6%
5	3.1%	4.4%
6	3.3%	4.3%
7	3.5%	4.2%
8	3.6%	4.2%
9	3.7%	4.1%
10	3.8%	4.1%



A simple stochastic interest rate model

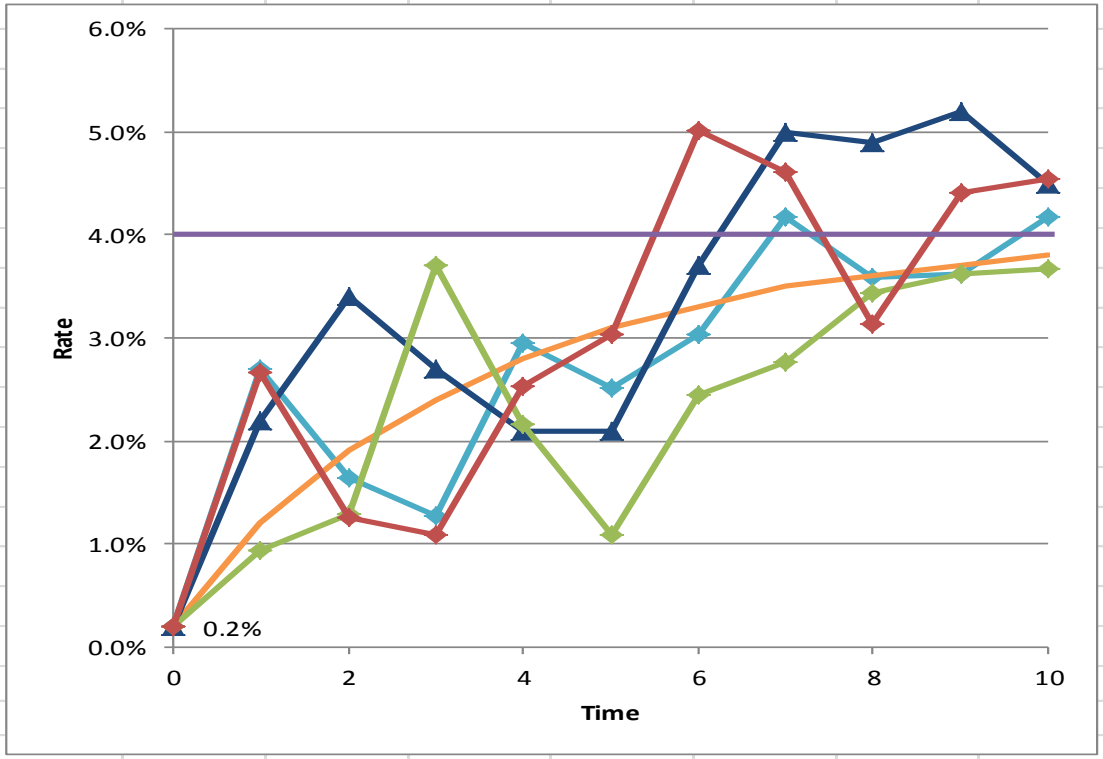
1-Factor Vasicek

$$dr(t) = \alpha(\mu' - r(t))dt + \sigma dZ(t)$$

random shocks

r(0)	0.2%
mu	4.0%
alpha	0.25
sigma	1.0%

t	Rate	dZ
0	0.2%	1.555
1	2.7%	(1.394)
2	1.6%	(0.954)
3	1.3%	0.998
4	3.0%	(0.696)
5	2.5%	0.142
6	3.0%	0.907
7	4.2%	(0.550)
8	3.6%	(0.060)
9	3.6%	0.455
10	4.2%	



Variations

Other simple interest rate models

» 1-Factor mean-reverting short rate models

Model	Mean Reversion	Distribution of Rates	Positive Rates	Analytically Tractable
Vasicek $dr(t) = \alpha(\mu - r(t))dt + \sigma dZ(t)$	Y	Normal	N	Y
Cox-Ingersoll-Ross $dr(t) = \alpha(\mu - r(t))dt + \sigma\sqrt{r(t)}dZ(t)$	Y	Non-central chi-squared	Y	Y
Black-Karasinski $d\ln r(t) = \alpha(\mu - \ln r(t)) + \sigma dZ(t)$	Y	Lognormal	Y	N

» Limitations of these mean reverting 1-factor short rate models

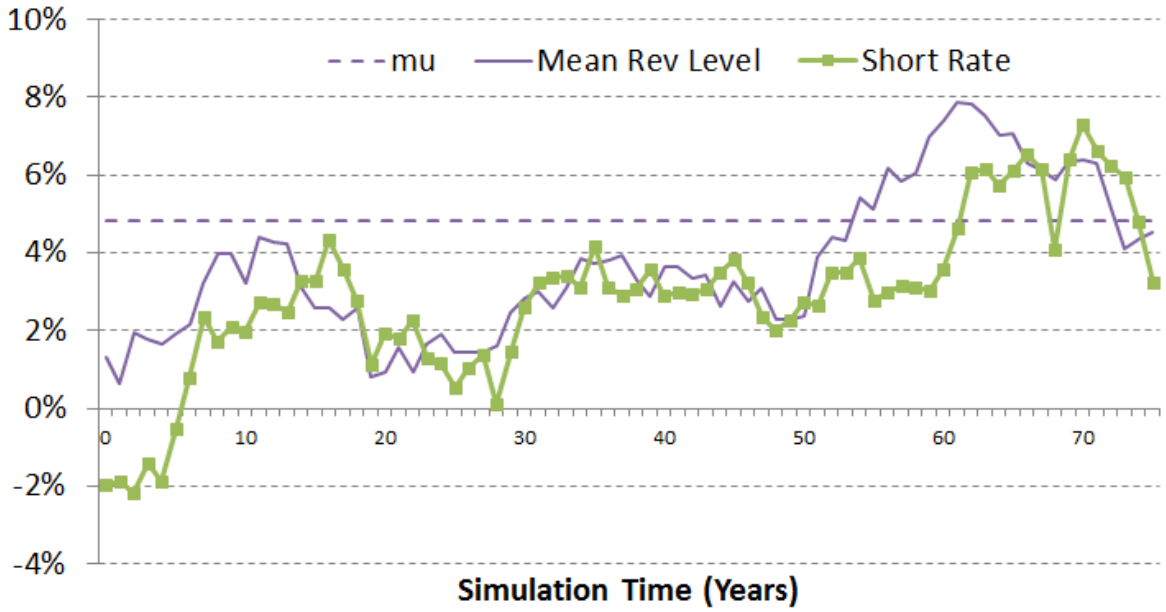
- All points on the yield curve are perfectly correlated
- They do not fit the initial term structure

More variations

A richer yield curve

- Multi-factor models
  - Adding stochastic variables allows imperfect correlation between different points on the yield curve
  - E.g. 2F-Vasicek
    - Z_1, Z_2 are standard normal variables
    - The mean follows a mean-reverting stochastic process
    - Imperfect correlation between different points on the yield curve

$$dr = \alpha_1(m(t) - r(t))dt + \sigma_1 dZ_1(t)$$
$$dm = \alpha_2(\mu - m(t))dt + \sigma_2 dZ_2(t)$$



The mean reversion level now follows a stochastic mean reverting process to the long term average mu

More variations

Matching the initial term structure

- Time-varying parameters
  - Models can be extended to fit the initial term structure of rates using time-varying parameters
  - E.g. 1 factor Black-Karasinski

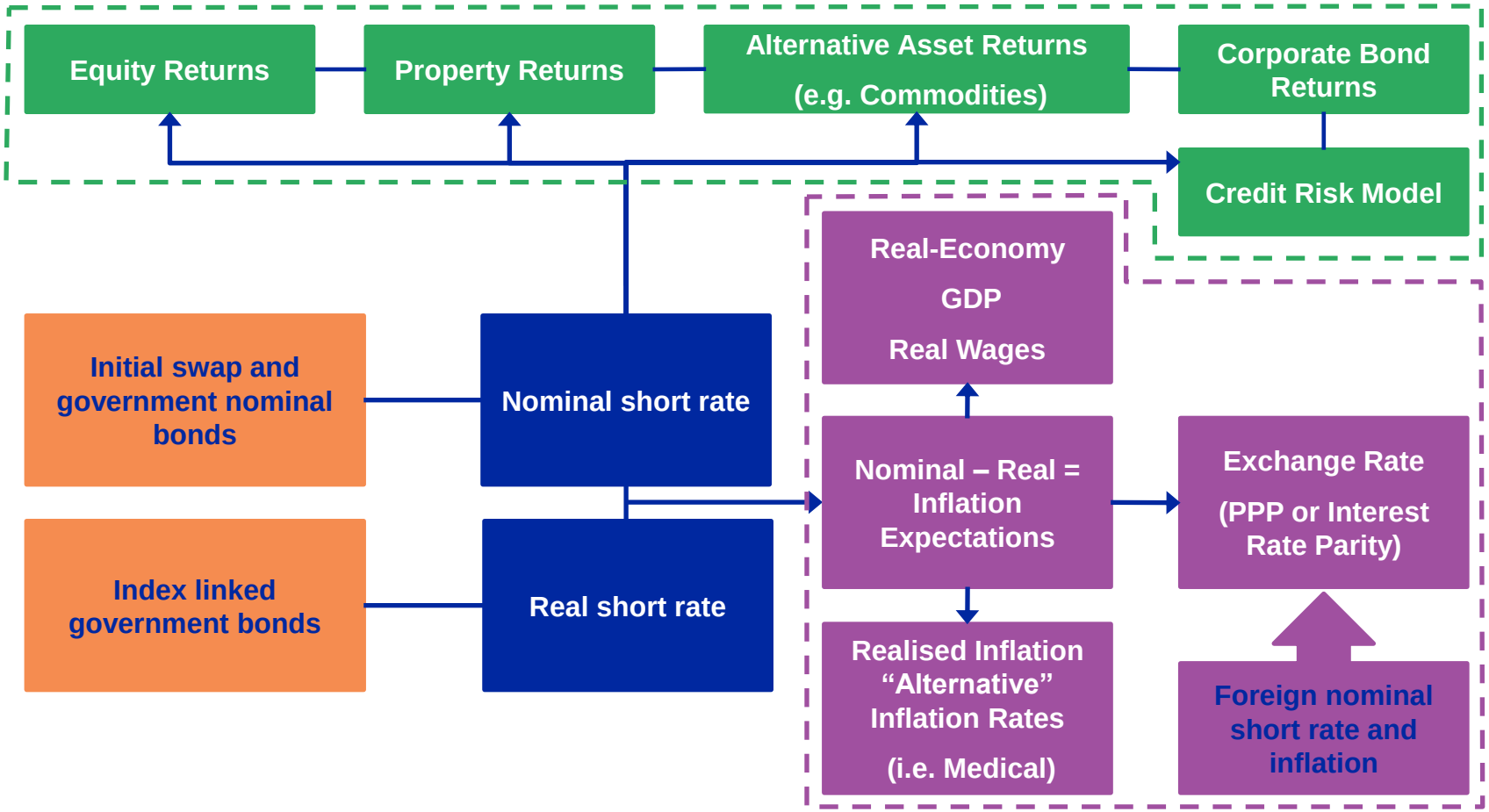
$$d \ln r(t) = \alpha\left(\mu(t) - \ln r(t)\right)dt + \sigma dZ(t)$$

Mean reversion level becomes a function of time

  - μ(t) can be calibrated to be consistent with the initial term structure
    - Referred to as “no-arbitrage” model
    - Models without this feature referred to as “equilibrium” models

ESG structure

One economy

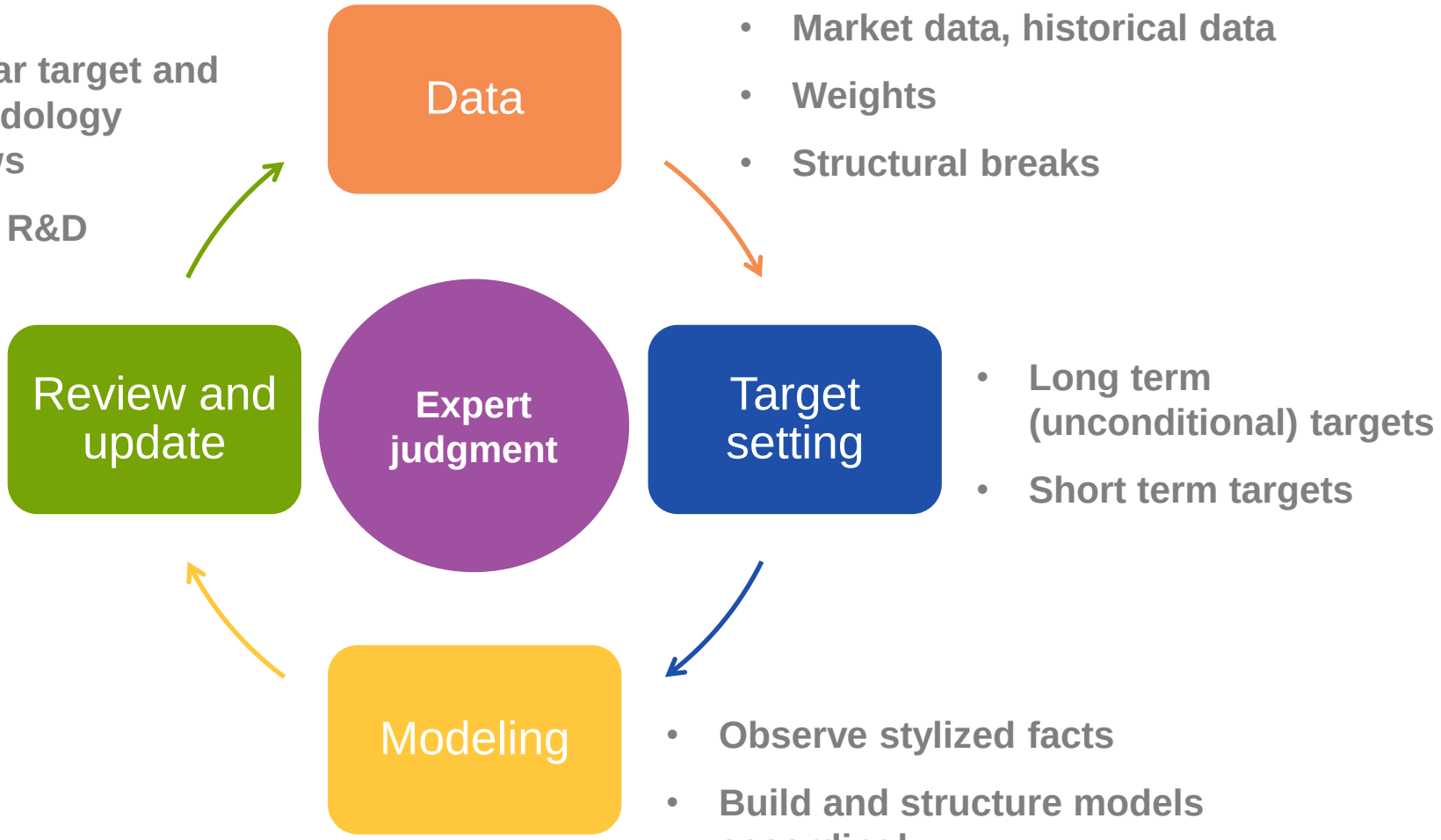


ESG calibration

Overview

- Optimization of model parameters in order to match pre-defined criteria, for example:
  - Market prices
  - Expected returns and volatility
  - Higher moments of distribution such as skew and kurtosis
- For Real World modeling the challenge is setting the pre-defined criteria (targets)
  - What should the volatility of interest rates be?
  - What use can we make of historical data?
  - Should the calibration reflect average long-term market risk or risks conditional on the current market?
- It's a core component of the ESG
- Different applications of the ESG may require different calibrations
  - Risk management: Calibration targets focus on volatility/dispersion/mean level
  - Asset allocation: Calibration targets focus on risk premia

Calibration approach



- Market data, historical data
- Weights
- Structural breaks

- Long term (unconditional) targets
- Short term targets

- Observe stylized facts
- Build and structure models accordingly

- Regular target and methodology reviews
- Model R&D

Correlations and dependencies

A good model should capture appropriate relations between different market risk variables

- Structural relationships
  - E.g. nominal – real = inflation
- Statistical relationships
  - E.g. periods of high equity volatility tend to be associated with low returns
  - In times of stress correlations across markets increase

Modeling dependency is difficult

- From a modeling and calibration perspective
- Difficult to discern co-movements data / history
- Correlations are not stable in time

In practice

- Can only target a few pair-wise correlations
- Verify other correlations are reasonable

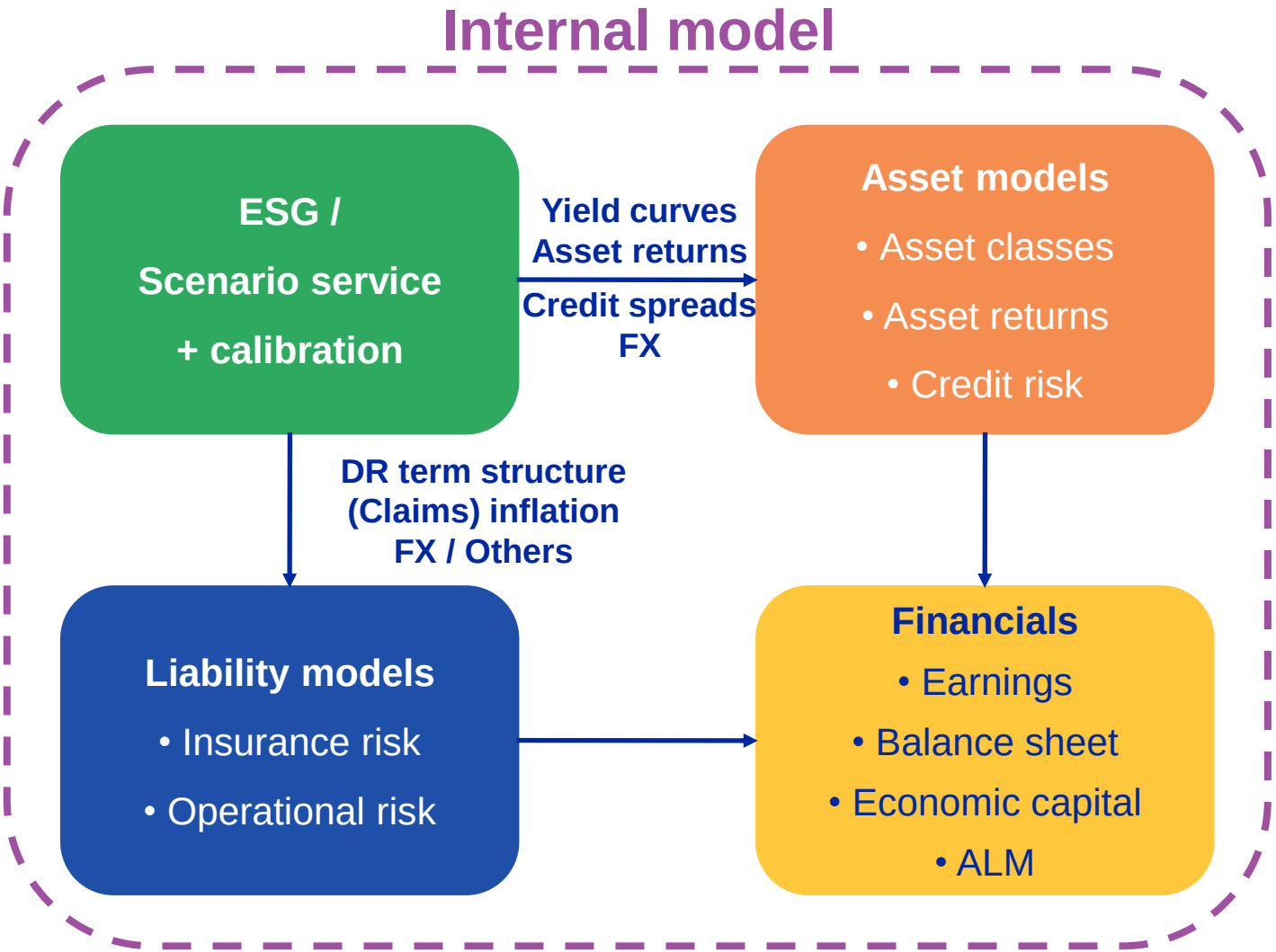
2

Usage & Trends

Economic scenario generators – Where?

Drivers

- Regulators
- Rating agencies
- ERM best practice



Economic scenario generators – Where?

ESG and ORSA

- ORSA to become a worldwide requirement
  - ICP 16
- NAIC ORSA
  - Guidance manual (November 2011)
  - RMORSA Model Act (September 2012)
- Increased ESG usage for preparing the ORSA Summary report
  - Section 2- Insurer's Assessment of Risk Exposure
  - Section 3- Group Risk Capital and Prospective Solvency Assessment
- ESG called for:
  - Assessment of economic risks on the company risk profile
  - Assessment of market risk
  - Capital adequacy assessment
  - Multi-year modelling for the prospective solvency assessment
  - Assessment of risks in both normal and stressed environments
  - Model validation, stress testing and sensitivity analyses

Market risk management

Market risk is important

- Tends to be underestimated especially since asset management is typically outsourced
- Investment income is a very significant share of insurers' earnings
- Low yields / volatile environment

Stretching for yields

- What happens when interest rates rise?
- How do I model "new" asset classes?
- Do I have enough granularity on credit?
- Liquidity?

A schematic market risk model

ESG Distributions for:
Cash return
Govt bonds return
Corporate bonds returns
MBS returns
Equities returns
Alt. asset returns
…

Asset allocation:
Cash %
Govt bonds %
Corporate bonds %
MBS %
Equities %
Alt. asset %
…

Investment risk for the P&C insurance industry

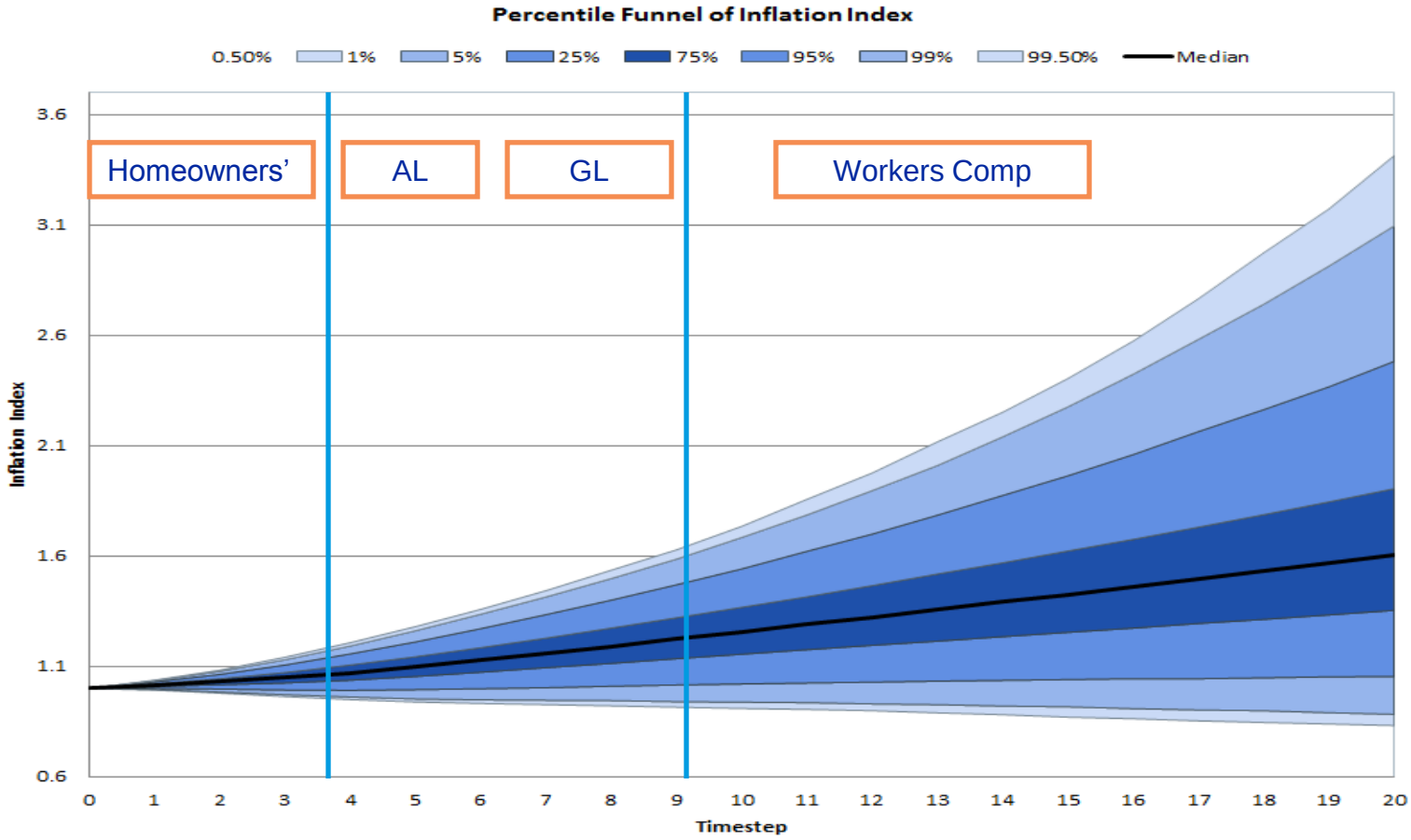
Where are interest rates going and what is their impact?

- Risk scenario #1: Interest rates remain near historical lows
  - Continued pressure on profitability from weak investment income
- Risk scenario #2: Interest rates continue rising
  - Capital volatility

Inflation and reserves

Inflation risk on reserves

» Inflation risk can be very significant especially on long-tailed lines of business



Impact of inflation on loss reserves

Traditional reserving methods and capital models

- 2 Questions
  - What inflationary assumptions underlie current reserve levels?
  - How much will current reserve adequacy be impacted if future inflation differs from expectations?
  - These questions cannot be answered when inflation is dealt with indirectly
- LDFs reserving methods
  - Usually, no explicit inflation adjustment: Past inflation is implicitly reflected in the selected LDFs
  - And is projected forward (if no trends adjustments), without consideration for inflation variability
  - Usually undiscounted
- Capital Models
  - Look at reserve variability, usually discounted reserves
  - Use ESG outputs
    - Interest rates, inflation indices
- Incorporate inflation as an explicit risk factor
  - By explicit consideration of inflation, its economic impact on the overall balance sheet can be gauged

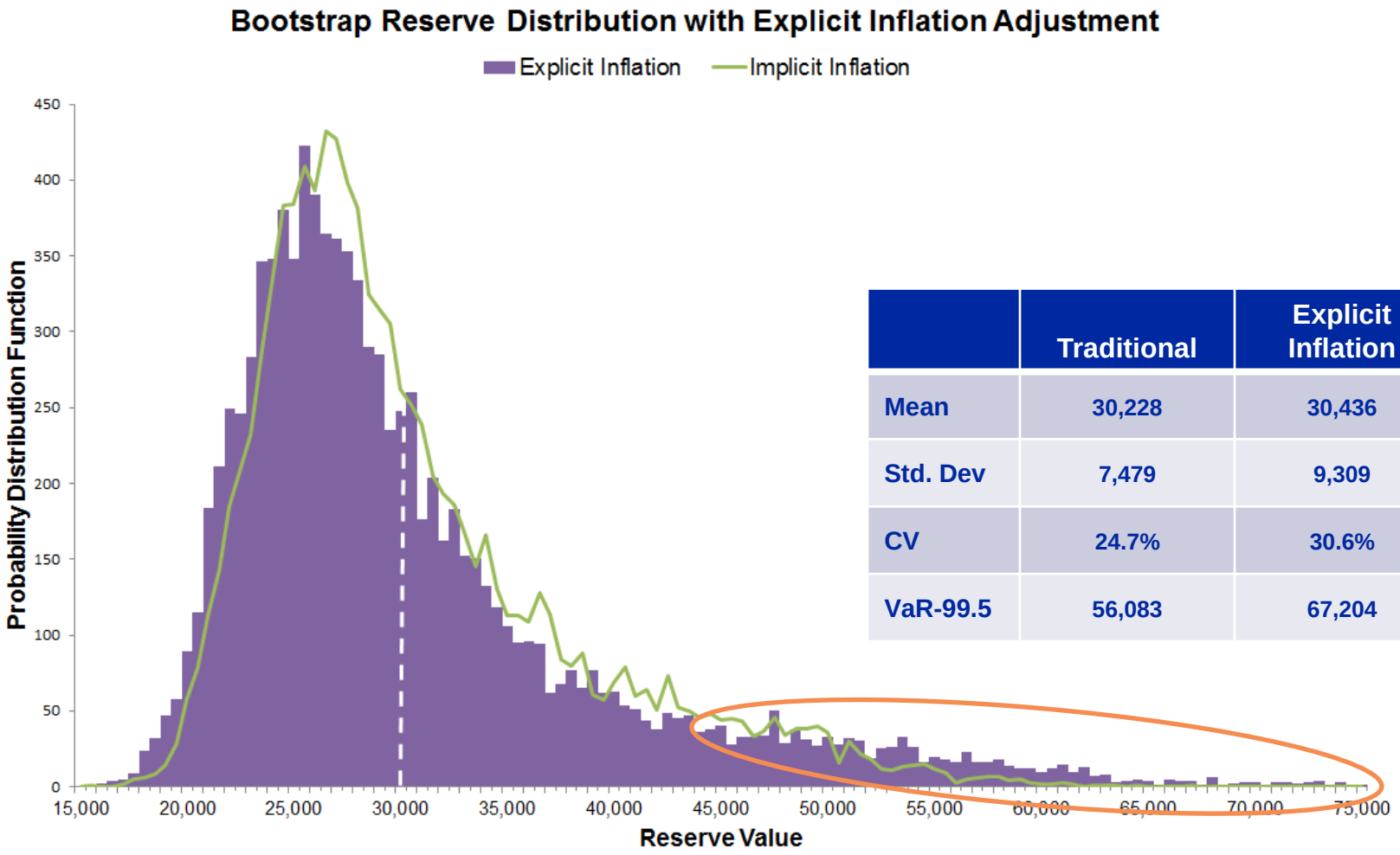
Explicit consideration of inflation in reserving

3 steps using existing reserving models

1. Factor out the effects of inflation from historical loss data
   - Establish profile of loss costs
     - What portion of the loss payment is medical, wage, legal fees…
   - Identify those economic indices which best measure the inflation in those costs
     - Claims inflation v. CPI-like indices
     - Gearing effect of deductibles
   - Determine the timing of the inflationary impact (accident date, report date, paid date, …)
     - E.g. for WC, the wage portion may be at time of accident while the medical portion is at time of payment
     - Give consideration to the changing proportions of types of cost as the development period mature. E.g. medical may be paid early and wages later in the development of an accident year
   - Test these relationships on historical loss development patterns and find the combination which best explains the long term growth in claim costs
     - E.g. Masterson
2. Forecast the reserve using current methodology
3. Replace the effect of inflation including an assumption of future inflation
   - Various economic inflation measures with different characteristics
   - Specific claims inflation calibrations

Reserve variability

Bootstrap results – nominal reserve

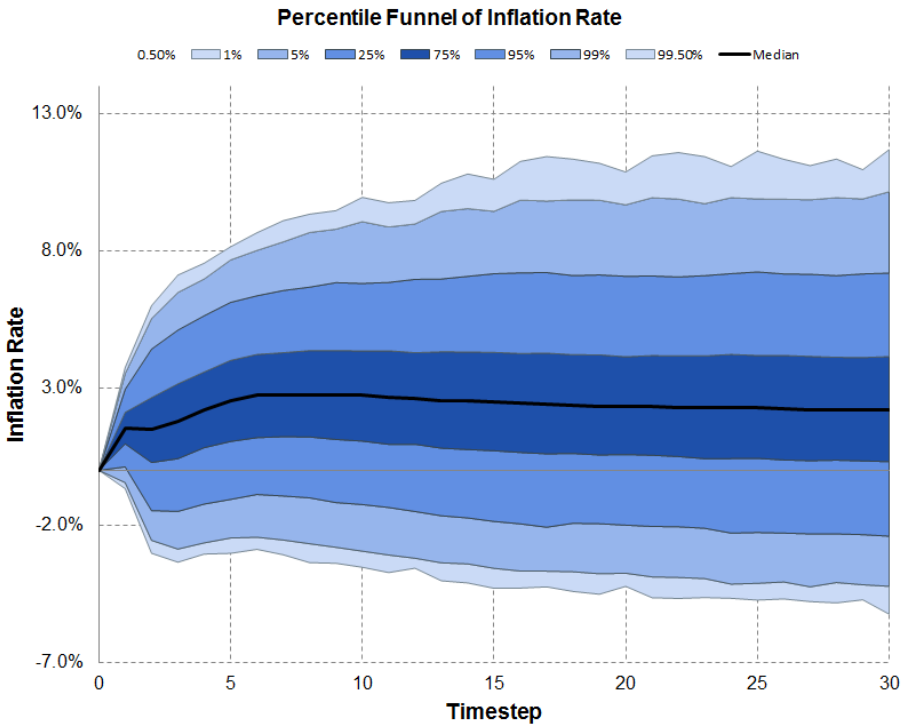


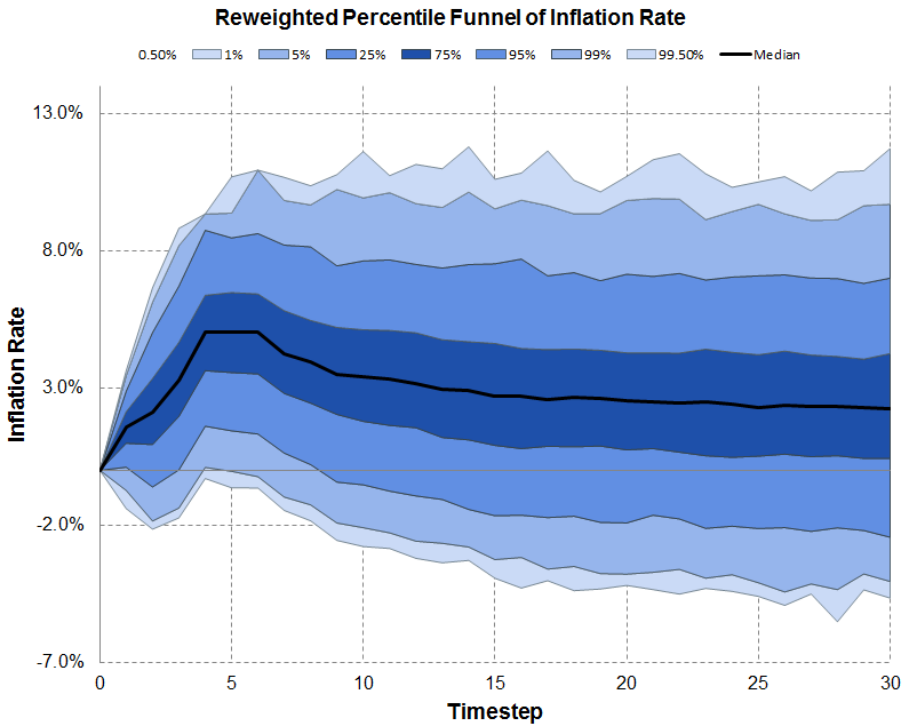
	Traditional	Explicit Inflation
Mean	30,228	30,436
Std. Dev	7,479	9,309
CV	24.7%	30.6%
VaR-99.5	56,083	67,204

Inflation stress test

Hard to achieve without explicit inflation treatment

- Requirement from some regulators / rating agencies
- E.g. target inflation at 5% for year 4, 5 and 6

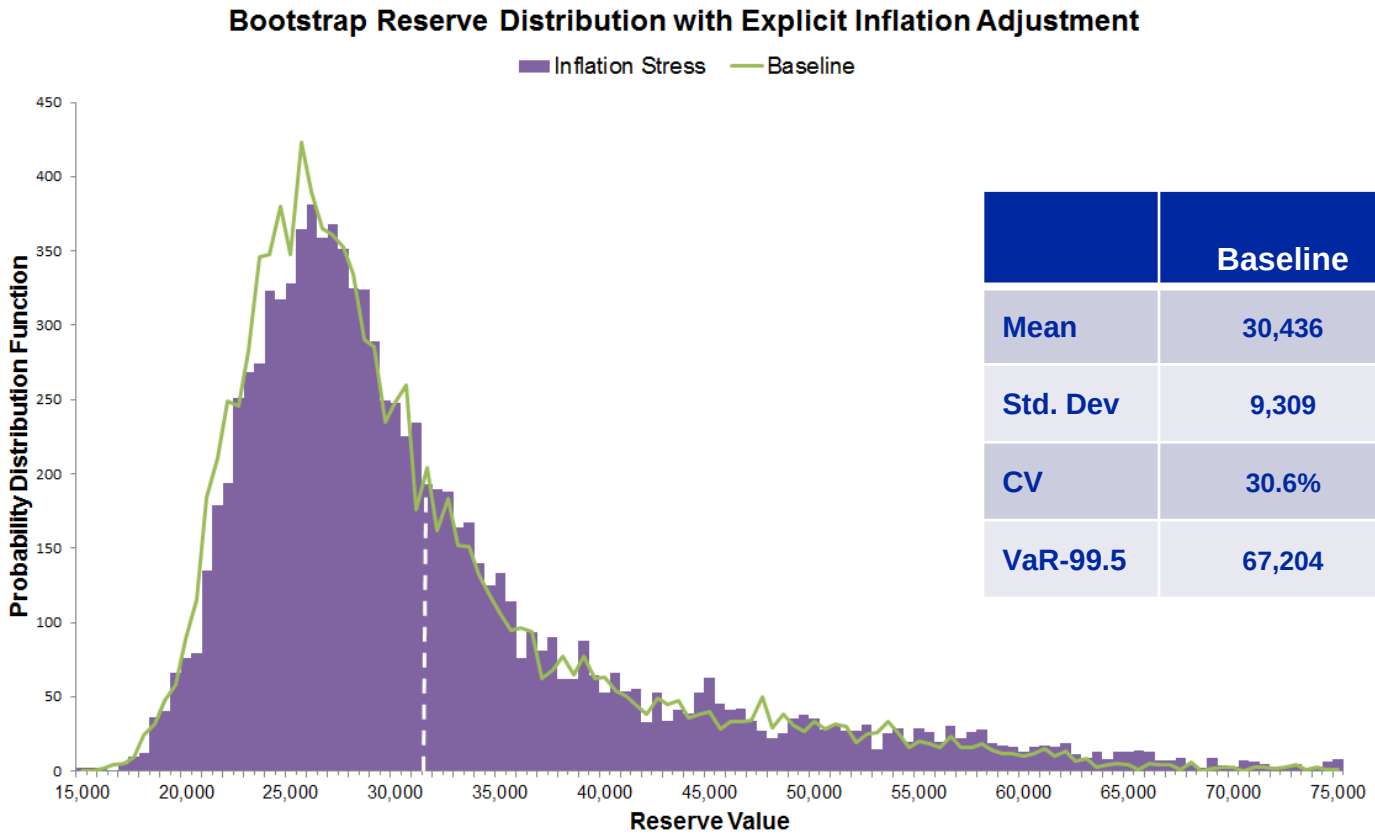




Inflation stress test

Results

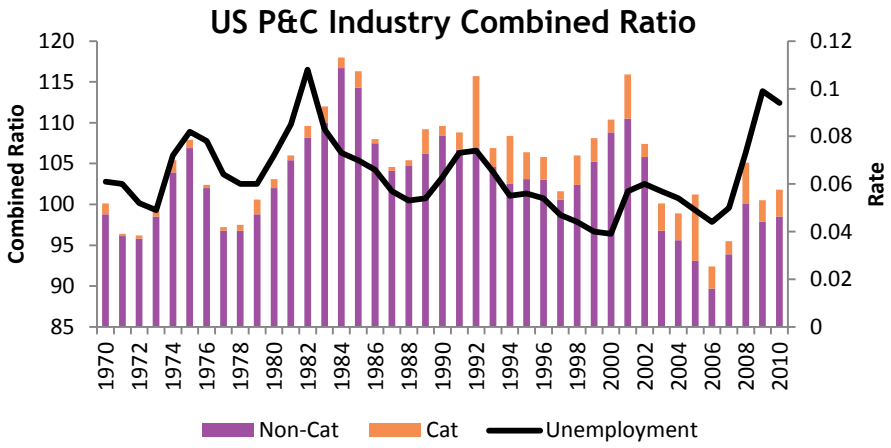
- Noticeable impact
  - Even without leverage

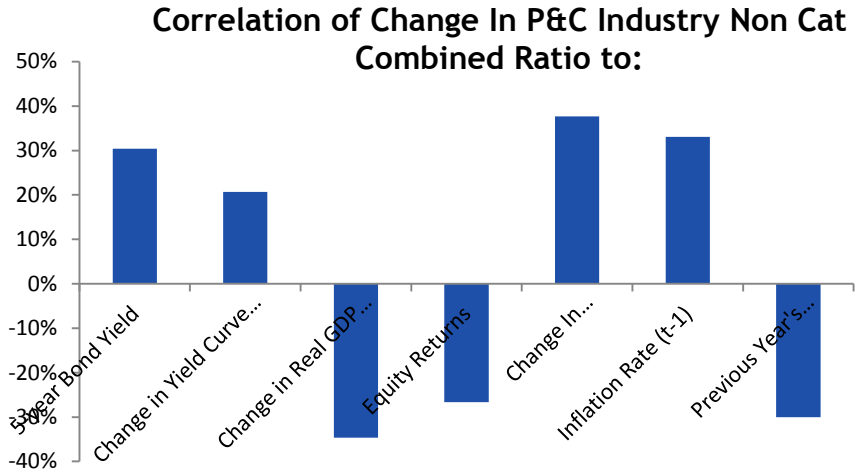


	Baseline	Inflation Stress
Mean	30,436	31,610
Std. Dev	9,309	10,448
CV	30.6%	33.1%
VaR-99.5	67,204	73,649

Economic drivers of P&C underwriting

P&C insurance risks depend on economic variables





- High interest rates are associated with lower underwriting profitability
  - Higher investment return offsets lower premium rates
- Negative shocks to GDP growth lead to increases in combined ratio
  - Downwards effect on exposure, premium rates, upwards effect on claims
- (Claims) inflation increases claims costs differently across LOBs
- Other drivers for specific classes e.g. unemployment, GDP, commodities...
- Economic variables also impact asset returns

Applications

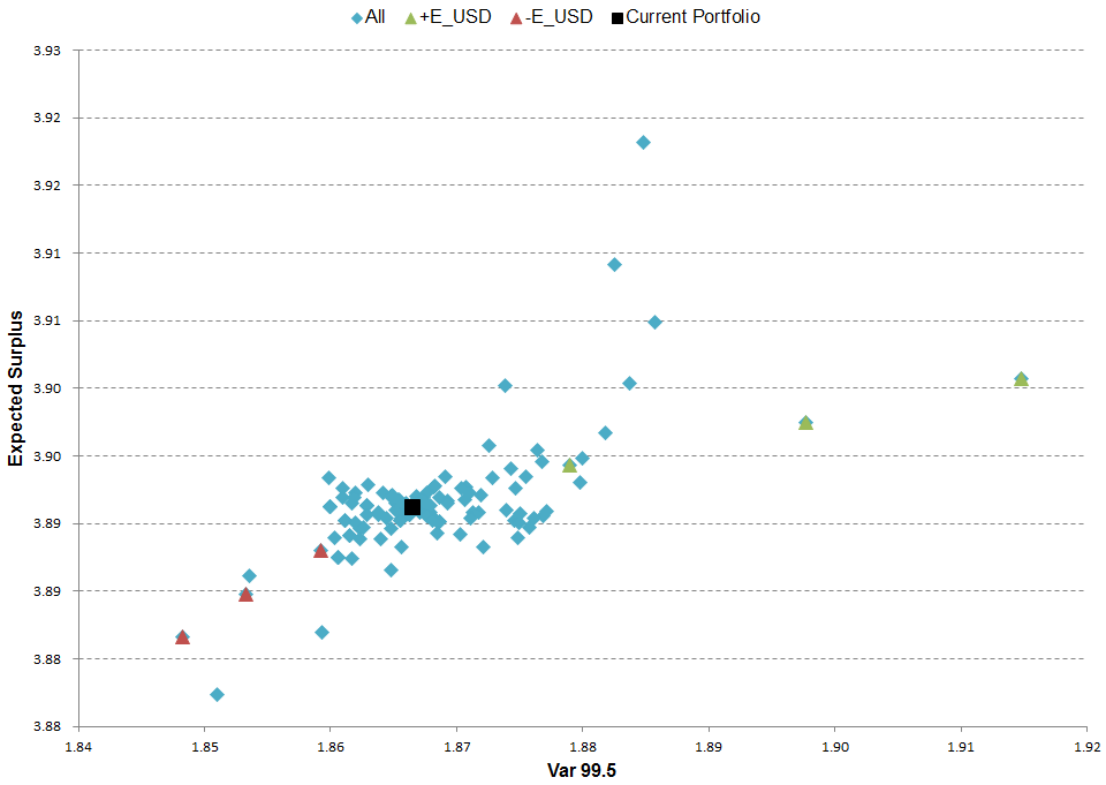
ESG and insurance risk models

ESG outputs (especially non-market risk factors) can have a wide range of applications to refine insurance risk models

- Impact of future economic environment, at the line of business level, on:
  - Reserve development
  - Volume levels
  - Rates
  - Profitability
- Enforce consistency between different economic drivers for different lines of business
  - Better capture of concentration / diversification between lines of business
  - Capture correlations between underwriting and reserving risks
- Especially useful
  - Multi-year models
  - Incorporating longer term effects linked to economic factors
- Improve modeling of interactions between market risk and insurance risk

Asset allocation

- Common economic factors influence both u/w and investment risks
  - Economic risks needs to be aggregated across assets and liabilities
- Consider company-level impact of asset allocation on risk profile



Summary

- Emerging regulation and accepted best practice are driving P&C insurers to adopt more sophisticated tools for understanding the potential future behaviour of the asset side of the balance sheet and economic drivers of liabilities
- Market and economic risks can make a material contribution to solvency capital and earnings uncertainty
- Usage of ESGs within the P&C industry is increasing
  - More scrutiny of the ESG outputs
    - Current economic environment
    - Challenged by companies views
  - ESGs being used outside the asset module of an internal model
    - Input in insurance risk models
  - More usage of economic capital models
    - New challenges
- Building successful ESG solutions requires users to access and build experience with these tools

Loic Grandchamp
P&C Product Manager
Enterprise Risk Solutions – Insurance
+1 212.553.2788 tel
loic.grandchamp@moodys.com

Moody's Analytics
7 World Trade Center
250 Greenwich Street
New York, NY 10007
www.barrhibb.com