To Our Subscribers

We want to thank our new subscribers and welcome everyone to the fifth issue of the ARM quarterly newsletter! We hope you find this publication valuable. With a few short articles meant to provide unique insights, we present ideas about how to address specific problems and introduce potential risks that may not yet be on your radar.

The primary authors are Dave Ingram and Max Rudolph. We have been active participants in the risk management, actuarial, investment and insurance spaces for many years.

Subscribers are encouraged to suggest topics for articles and ask questions of the authors during our follow-up webinars. Ever cognizant of regulatory requirements, leveraging them to add value to your company in practical ways, will be our focus.

Published by Actuarial Risk Management (ARM), the Strategic and Risk Solutions for Executives (SRSE) subscription is free to all.

A free webcast is also available and our podcasts covering these topics is called Crossing Thin Ice. If you would like to further engage the authors as consultants or for continuing education purposes, please reach out. More info can be found throughout this newsletter. We hope to help you find a solution that meets your needs!

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We hope you will join us on our journey!

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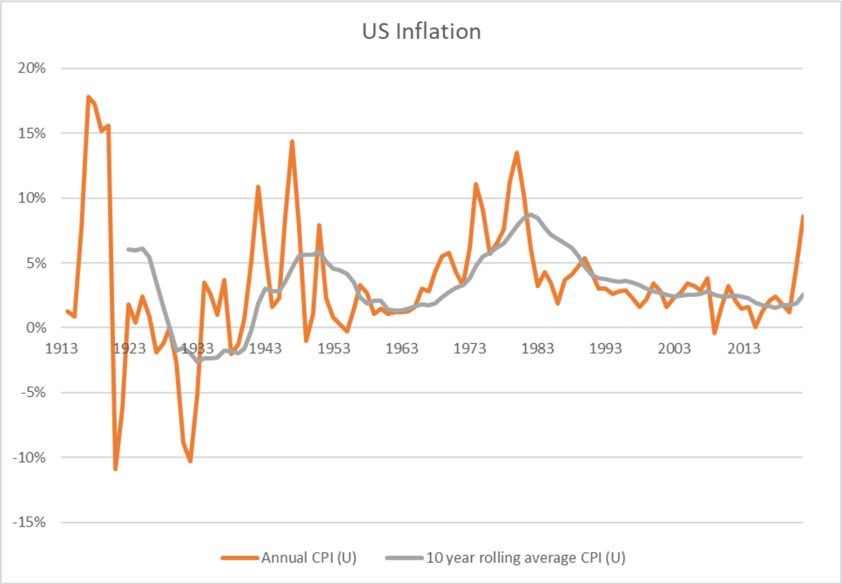
Inflation

The inflation we have been experiencing feels bad to almost everyone. But to a large degree, it has so far been the brush of a feather on the cheek compared to a hammer on the head of the inflation of the 1970s and 1980s.



COVID triggered the so called "Great Resignation" which both put a crimp in supply chains, also causing a surge in wages with employers often having to pay new hires much more than prior staff.

Inflation is a major risk though because we do not know for certain the future course of any of those four recent drivers of inflation. COVID keeps evolving into new variants, each one more contagious than the last. On the other hand, the Federal Reserve seems to be committed to working against future inflation as it is one of their two major charges. The future of the conflict in Ukraine is seen as much more uncertain now than it was expected to be a year ago. The Great Resignation seems to be settling down some, but workplace attitudes likely have "permanently" changed in ways that we do not yet fully understand.

Coming off a 30-year period when inflation averaged just above the 2% per year Fed target, the 6.5% calendar year CPI increase in 2022 seemed extremely high. But the chart above shows that in the 1970s the US lived through an entire 10-year period when inflation averaged 1.4% higher than the current one-year result.

Inflation hawks have been predicting this inflation since the Fed actions of 2008 and 2009 that followed the Global Financial Crisis. We finally got the inflation that they were predicting, but to get this result it took three big events: A major pandemic, historic money supply expansion from the Fed to fight the economic effects of the pandemic as well as the invasion of Ukraine by Russia. In addition,

Some economists argued that much of this was "temporary", and some of it has been. Gasoline prices actually fell by 1.5% in 2022. But many of the price increases have been persisting, causing other prices to rise:

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Inflation (cont'd)

- Catch up on wages - workers wishing to get higher wages due to prior inflation in cost of consumer goods, along with cost-of-living allowance (COLA) automatic adjustments for Social Security

- Catch up on prices - businesses wishing to get higher prices to catch up with cost of goods and labor

- Anticipation of future inflation impact on wages and prices (expectations)

- Catch up on profit margins - businesses looking to get higher profit margins in prices that may have had inadequate margins in the past as prices are changing

- Increased interest rates demanded by lenders to achieve a positive real return

- Increased interest rates due to Fed actions to raise rates; to reduce economic activity; to reduce demand; to reduce inflation are themselves an increase in costs to businesses with floating rate debt

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Inflation (cont'd)

Insurers are impacted several ways by inflation

- Expenses – mostly wages but all other expenses may rise
- Claims – Some coverages have fixed claims amounts, such as life insurance, but many are indexed to costs that will be rising.
- Investment returns – rates on new investments are likely to rise. Credit spreads and defaults may increase as well due to pressure on businesses profits due to their rising expenses.
- Asset values – may continue to fall as higher interest rates lead to higher discounts on future cashflows while increased expenses and lower demand for some products reduce expectations of future cashflows and increase default rates.

Insurers can react to the past and future inflation by addressing each of those four types of impact:

- Expenses - short term contracts can be re-priced – longer duration contracts will need to be creative with solutions including automatic and outsourcing
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- Insurers can react to the past and future inflation by addressing each of those four types of impact:
- Expenses - short term contracts can be re-priced – longer duration contracts will need to be creative with solutions including automatic and outsourcing
- Claims – fixed claim policies may offer no underwriting coverage to help with overhead and those indexed to higher costs (e.g., auto repair) will need to re-price.
- Investment returns – insurers have been forced to reach for yield during the low-rate regime and may now be able to take some risk off the table with more focus on investment grade bonds.
- Asset values – the recent rise in rates has extended the duration of residential mortgages in some portfolios by a factor of two – what other surprises are over the horizon? Historical stress test scenarios should be tested.

Sign up for the associated March 15 webinar at
https://us02web.zoom.us/meeting/register/tZcqcu-rqjIsGtwt0S_npRysx0nXIbTZINip

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Inflation Interview: Octavio Rojas

We asked Octavio Rojas, a Venezuelan actuary, to share some of his experience living and working in an inflationary environment.

How do we need to think about this inflation that we are experiencing now?

We have to treat it as a complex model. This inflation is a global issue. It is a problem that arose from COVID and the war in Ukraine, which are both international problems. So, it's an issue that has to be considered in terms of a global market and trades and so forth.

Octavio, what is your experience with inflation?

Personally? Well, that's quite an interesting question given that, for those of you who don't know me, I am from Venezuela. There, from the end of the 1990s to today, it has had first a high inflationary environment and secondly, it also had a period of hyperinflation. To be considered a high inflationary economy a country must experience a three-year period where inflation gets close to 100% or higher. For it to be labeled hyperinflationary it must have at least two months in a row with 50% or higher inflation. Since the 1990s, Venezuela hasn't been able to actually get into low figures. Right now, according to the government, last year, we had 300% inflation. So that's my experience. I found that there is a lack of information regarding inflation as a whole including in the actuarial issues. Then I decided to actually do research, even pursuing a Ph.D. in actuarial mathematics where my research topic was going to be surrounding inflation for pension systems.

What are some reactions you've seen to inflation that have not been helpful?

In countries with defined contribution Social Security programs, they saw that people needed money, they weren't able to work because of COVID, so they allowed people to actually take some money out. That's a big problem because if they take too much money out of their individual accounts when they retire, they will be with less income than what they need to live.

Insurers found that people stop paying their premiums. They need money in order to pay for medicines or to buy food which is more expensive because of inflation.

What strategies have insurance companies or pension plans taken in reaction to inflation that has been effective?

An issue that has been widely discussed, in particular in some African countries, Indian countries, and some Latin American countries, is inclusive insurance. This insurance could be affordable for people to actually have some insurance

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Inflation Interview (cont'd)

coverage for health issues, property issues, and crops. So that has actually started being introduced with some very interesting results to date.

Are countries providing inflation adjustments to pensions that are aligned with the needs of retirees?

Yes, in many countries they want to help retirees with inflation adjustments to their Social Security benefits because they are the most vulnerable. But consumption by retirees is completely different from that of families, where you have kids and so forth. Often the diet that a retiree may require, given their health issues is different. On the other hand, you'll find that there won't be so much going to the cinema, but they will have higher medical costs which have increased even more than other factors. It's very important to actually be able to take this into consideration because their shortfall will eventually fall on their family.

Octavio Rojas is an ARM consultant and Pension Actuary located in Venezuela.

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Inflation - Contrarian View

While many worry about inflation, and rightfully so, in the US we have recently been experiencing disinflation (slowing of inflation), and longer-term pressures could lead to deflation.

Japan provides recent experience about how a country deals with deflation. The US nearly experienced deflation in 2020 before the stimulus packages reignited price increases. The most recent longer-term bout with deflation in the US was associated with the depression from nearly a century ago. Recently, only when the Fed initiated a tight monetary policy did the transitory inflation peak subside.

There are forces working in both directions for inflation. Large levels of government debt, measured by debt to gross domestic product (GDP), signal inflationary pressures and a weak currency. Floating exchange rates reflect relative strengths and weaknesses, so require another country or major currency (e.g., Euro) to offset any changes. Longer term demographic trends signaling decreases in the working age population (low fertility rates) and increased older populations (longevity) are deflationary. So is the cost to repair the damage caused by wars and climate change.

The wildcard in this analysis is the velocity of money (VM) metric, which measures the number of times money changes hands in a year. In the 1980s VM was thought to be a constant, but experience showed this to be false many years ago. Recently it has bottomed out from historic lows and started to rise. It is said that a low value of VM means people are worried about their own economic situation, so they save rather than spend, while a high value means there is concern with the entire financial system blowing up so encourages immediate spending.

No one knows for certain how this will play out, making it important for risk managers to stress test in multiple directions. A high inflation scenario, say one that increases the inflation rate each year by 3% until reaching 15% then staying there for 5 years before falling, provides one challenge. Another type is faced by an inflation scenario that decreases 2% per year until it is negative and stays there for 5 years. These are good tests for capital levels. Test of reserve adequacy are not as extreme. Stress tests should reflect the current environment and be regularly reviewed for possible updates.

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Actuarial Risk Management

Strategic Risk Focus for Insurance Company Board Members and Executives

Two-part training program on May 24 and June 7 at 2 pm ET leveraging CGAD requirements to demonstrate the importance of risk management processes and the most common current concerns. Register for free: Part 1 and Part 2

Additionally for a fee, we offer a private session customizing Part 1 and/or Part 2 to incorporate specific information that reflects your company's unique ERM program, key risks and Board role for just your Board members and Executives.

Part 1 (May 24)

ERM & Board Role

- General introduction designed for new board members and executives and as a refresher for current board members and executives who have been less involved in ERM in the past
- Primary components of Insurer ERM Program
- Fundamental Board roles in ERM

Free registration for Part 1 here

Part 2 (June 7)

Current Focus of Insurer ERM Programs

- Provides broad perspective on risks most concerning to over 200 insurance executives for 2023 (identified in ARM's Dangerous Risks Survey) and the level of ERM practice by over 60 insurers (from ARM's ERM Practices Study)
- Essential background for board members to provide meaningful oversight to management in the area of ERM

Free registration for Part 2 here

"While Enterprise Risk Management is a continuous process, Own Risk Solvency Assessment (ORSA) and NAIC Corporate Governance Annual Disclosure (CGAD) require insurance company leaders to annually report on their risk management program including direct Board involvement."

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- Available on the ARM website

Webcast

- One-hour live webcast once each quarter following the newsletter publication
- Webcast includes brief presentations, interviews with authors and live Q&A with your questions answered regarding the newsletter topics

Podcasts

- Two per month
- Delivered by Dave Ingram & Max Rudolph
- Presenting material from the newsletters and webcasts in a totally audio format.
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> “While insurers have been challenging by low interest rates and the pandemic, the next few years will see a radically changing environment for insurers. We will be using this provocative platform to identify emerging risks and delve into what we see as the drivers of future success.”

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