GuyCarpenter

Novation Case Study for Captive Insurers

INFLATION IMPACT ON LEGACY LIABILITIES

Captive insurance companies, like traditional insurance carriers, have always kept a watchful eye on present and emerging risks that can threaten the adequacy of their legacy reserves. In recent months, one particular emerging risk has been gaining significant attention–**Inflation.**

Inflation has been suppressed at artificially low levels for so long that many captive managers have grown accustomed to ignoring its potential impact. However, suddenly, inflation has come into focus once again.

Due to the compounding effect of inflation over time, its impact on captive legacy reserves can be significant. The exhibit below (using National Council on Compensation Insurance (NCCI) payout factors) shows the effects of a 2% inflation shock on a sample portfolio. The difference between expected reserves and post-inflation reserves is shown in the heat map and demonstrates the degree to which the two can diverge. Reserve increases are required for all years, with the greatest deviation from expected occurring in 2014, 2015 and 2016. Furthermore, additional risk factors, such as adverse development, will be exacerbated as a result of higher underlying reserve estimates.

At the end of the day, managing inflation risk should be on the minds of all risk managers, and legacy liability products can help mitigate the potential impact of inflation and other risks impacting tail reserve risk.

Median Impact of Inflation on Sample Workers Compensation Portfolio

Calendar Year	Expected Reserves ($)	Inflation Impacted Reserves ($)	Net Impact (%)
2001	40,000	42,040	5.10%
2002	50,332	53,420	6.13%
2003	53,926	58,154	7.84%
2004	58,380	63,861	9.39%
2005	62,793	69,639	10.90%
2006	67,164	75,490	12.40%
2007	72,356	82,296	13.74%
2008	79,190	90,912	14.80%
2009	85,923	99,598	15.92%
2010	92,559	108,359	17.07%
2011	101,527	119,674	17.87%
2012	111,111	131,843	18.66%
2013	122,037	145,624	19.33%
2014	135,696	162,468	19.73%
2015	153,976	184,364	19.74%
2016	180,999	215,614	19.12%
2017	222,999	262,767	17.83%
2018	292,786	339,205	15.85%
2019	424,957	480,803	13.14%
2020	723,375	794,805	9.87%

Source: Guy Carpenter

Novation Case Study–Group Captive

Delivered financial closure to a captive client from multiple decades of liability exposure by structuring and executing a large novation of prior-year liabilities from the captive to third-party legacy reinsurance markets. This innovative transaction terminated the captive's liability from potential adverse developments from ~20 prior years of workers compensation (WC), automobile liability (AL) and general liability (GL) business written, and simultaneously transferred and eliminated the client's obligation to post a few hundred million dollars of collateral (to a third party).

Motivations

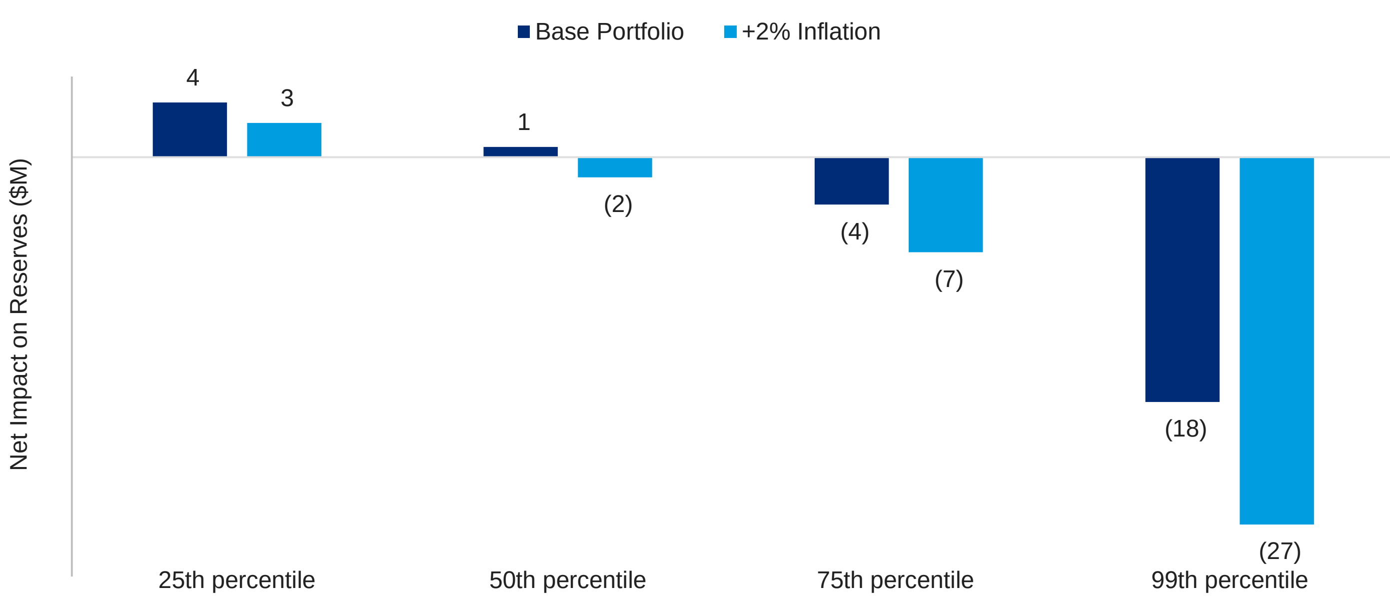
- Free up trapped capital.
- Decrease operational overhead.
- Reduce the impact of inflation on their legacy reserves.

Benefits

- Released approximately USD 18.5 million in reserves and USD 2 million of capital for the group members.
- Eliminated all future collateral obligations for novated years.
- Removed inflation risk.

The exhibit below demonstrates how a 2% "inflation shock" could negatively impact a group captive's ultimate reserves at multiple confidence levels.

Group Captive Case Study–Net Impact of Inflation at Key Confidence Levels



Source: Guy Carpenter

Contact

Guy Carpenter's Captive team is committed to understanding the increasingly complex needs of captive insurance companies and the uniquely dynamic nature of the captive marketplace. To learn more about our legacy liability capabilities and solutions, please contact any of the following team members:

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About Guy Carpenter

Guy Carpenter & Company, LLC is a leading global risk and reinsurance specialist with more than 3,400 professionals in over 60 offices around the world. Guy Carpenter delivers a powerful combination of broking expertise, trusted strategic advisory services and industry-leading analytics to help clients adapt to emerging opportunities and achieve profitable growth. Guy Carpenter is a business of Marsh McLennan (NYSE: MMC), the world's leading professional services firm in the areas of risk, strategy and people. The Company's 83,000 colleagues advise clients in 130 countries. With annual revenue of nearly $20 billion, Marsh McLennan helps clients navigate an increasingly dynamic and complex environment through four market-leading businesses including Marsh, Mercer and Oliver Wyman. For more information, visit www.guycarp.com and follow Guy Carpenter on LinkedIn and Twitter @GuyCarpenter.