

The Leveraged Cost of Inflation

Summary:

- **Leverage Impact of Inflation on Reinsurance Programs:** Gregory Kim provided an in-depth explanation to Lauren Nevens and the audience on how inflation, even at modest levels, can disproportionately increase ceded losses in reinsurance programs, affecting pricing, reserve adequacy, and overall risk management.
 - **Definition of Leverage Effect:** Gregory explained that the leverage effect refers to how a small increase in claims cost due to inflation can disproportionately increase ceded losses above the retention threshold, resulting in a non-linear relationship between inflation and reinsurance recoveries.
 - **Inflation Drivers:** Gregory identified three main drivers of inflation impacting claims: general inflation (labor, repairs, medical), social inflation (legal and social changes increasing settlements), and economic inflation (interest rates and capital costs), all of which combine to increase claim costs and affect reinsurance protection.
 - **Layered Program Structure:** Gregory described how reinsurance programs are structured with retentions and layers, and how inflation can shift more losses into higher layers, activating reinsurance more frequently and magnifying the impact on ceded losses and pricing.
 - **Reserve Adequacy and Underpricing Risk:** Gregory discussed the risk of under-reserving when inflation is underestimated, leading to underpricing of new and renewing risks, especially in long-tail lines where claims may settle years later at higher values.
- **Illustrative Examples of Inflation's Leverage Effect:** Gregory walked through three detailed examples, demonstrating how inflation impacts different layers of reinsurance programs and how aggregate losses and layer exhaustion risks are magnified.
 - **Single Loss Example:** Gregory presented a scenario with a \$200,000 loss split between a \$100,000 retention and a \$100,000 excess layer, showing that a 10% inflation increased the excess layer loss by 20%, while the retention remained unaffected, illustrating the leverage effect.
 - **Portfolio Loss Example:** Gregory expanded to a portfolio of ten losses, each \$200,000 larger than the previous, and demonstrated that while the average inflation was 10%, the impact on higher layers was much greater, with the 1x1 layer experiencing a 23.3% increase and previously untouched layers now incurring losses.
 - **Historical Loss Adjustment:** Gregory adjusted ten years of \$200,000 losses for 10% annual inflation, showing that older losses inflate to over \$500,000, and that higher layers, previously unaffected, now experience significant losses, further illustrating compounding leverage effects.
- **Genesis Strategies for Managing Inflation Risk:** Gregory outlined strategies Genesis employs to manage inflation risk, including enhanced claim monitoring, scenario testing, careful underwriting, and close collaboration with clients.
 - **Claim Monitoring and Reserving:** Genesis strengthens claim monitoring and reserving practices, encouraging clients to work closely with Genesis claim associates to ensure reserves reflect current inflation trends.

- **Scenario Testing:** Genesis runs multiple inflation scenarios—baseline, adverse, and extreme—to assess the impact on reinsurance programs and ensure pricing and coverage remain aligned with current and potential future costs.
- **Underwriting Long-Tail Lines:** Genesis underwrites long-tail lines with extra care, recognizing the heightened pricing pressure and uncertainty associated with claims that may settle years in the future.
- **Client Collaboration:** Genesis collaborates closely with clients to monitor emerging trends and respond early to inflation risks, ensuring that protection remains relevant and effective.
- **Inflation Factor Determination and Analysis Frequency:** Gregory clarified that Genesis derives baseline inflationary factors from a mix of industry publications and internal data, and performs inflation analysis at both macro and client-specific levels, varying by line of business.
 - **Sources of Inflation Factors:** Gregory stated that Genesis uses a combination of public industry data and internal experience to determine baseline inflationary factors, with the mix varying by line of business depending on available data.
 - **Frequency and Granularity of Analysis:** Gregory explained that inflation analysis is performed at least at the portfolio level, and more granularly by line of business and client when sufficient data is available, with special segmentation for public entity business such as auto liability for K-12, universities, and municipalities.
- **Treatment of Paid Loss Credits and Interest on Reserves:** Gregory responded to an audience question, explaining that Genesis does not discount nominal inflation for paid loss credits or interest earned on reserves, instead analyzing inflation on a gross basis.
 - **Gross Analysis Approach:** Gregory clarified that Genesis does not separately discount for paid loss credits or interest earned on reserves when analyzing inflation, opting to keep the analysis straightforward and gross.