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NAVIGATING THE PANDEMIC'S NEXT WAVES

Insurers will need COVID-19 crisis war rooms to manage real-time decision-making

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Risk-based management came into its own in the 2008-2009 financial crisis, amidst huge market turbulence and massive government intervention. Add fear for human life and deliberate restriction of normal societal functioning and you've got today's novel coronavirus (COVID-19) pandemic — negatively impairing almost all financial and operational aspects of businesses at once.

We are optimistic that containment efforts underway across major geographies and zones will be able to check the first wave of the pandemic within months. This initial success, however, will mean that proportions of local populations infected and recovered by summer will be well below what is necessary for "herd immunity." As a result, iterative and potentially uncontrolled cycles of outbreak and containment will continue to play out at varying intervals and speeds globally until an effective vaccine is available (not likely for another 18 months at a minimum, and potentially much longer).

There is, therefore, no "new normal" on the horizon and organizations and societies need to brace for an environment that will continue to be massively complex and volatile for a prolonged period.

Navigating a large financial-services firm through this period will require a leadership mindset tuned to absorbing large, complex, and evolving datasets, along with an aptitude for "three-dimensional chess," capable of developing and deploying contingent management action plans in real time.

Executive teams must be integrated to an extreme, with every part of the enterprise operating at "clock speed." Achieving that requires rapid assimilation of emerging data and cascading of coherent and consistent planning scenarios throughout the organization. This kind of speed and alignment is not feasible without an effective COVID-19 crisis war room serving as mission control for business operations for the foreseeable future.

As executive teams transition from human safety, connectivity, and business continuity efforts to developing forward-looking projections and plans, we think a construct similar to that outlined below is required.

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INFORMING THE CRISIS WAR ROOM

Scenario identification and quantification forms the bedrock of crisis management. Scenario analysis, alongside stress testing, has long been a core part of risk and capital management. However, far fewer firms have embedded scenario analysis into their strategic and business planning processes.

As things stand, it's extremely difficult to plot even a best estimate path through the current crisis, let alone to have a degree of conviction about likely outcomes. The only available response is to characterize different potential pathways, determine leading indicators for each of those pathways, and build operational and financial optionality into the system to allow you to respond as greater certainty emerges.

Many companies have created a crisis war room of some form, initially focused on near-term operational issues. As these immediate issues settle, that war room should pivot to helping the business navigate through the coming months and years, based on an understanding of these different pathways. And to gain that understanding requires a model designed specifically to support these key decisions (see Exhibit 1). The model consists of four components, which we discuss below.

Exhibit 1. Key components of the Crisis War Room

1 COVID-19 insights engine

Dynamic, multi-country projections of epidemic development, updated daily based on new data and government policy responses

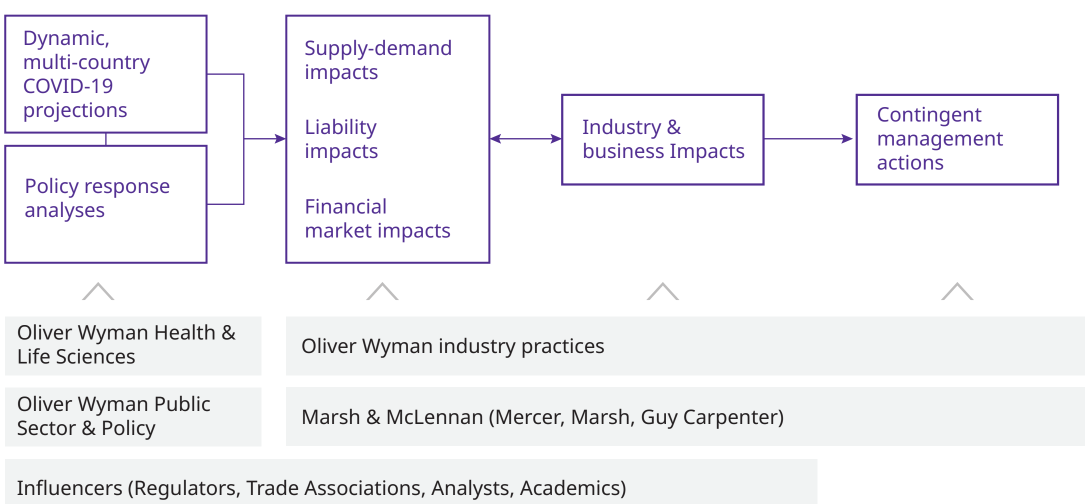
2 Economic impacts

Quantification of evolving scenario impacts on key business and financial drivers

3 Industry & business impacts

4 Decision making

Providing the basis for a sound set of contingent business plans for e.g. cost and capacity management, capital and liquidity planning, operations and technology management, and staffing actions



COVID-19 INSIGHTS ENGINE

DYNAMIC, MULTI-COUNTRY COVID-19 SCENARIOS

At the core of this crisis war-room approach must be a small set of possible COVID-19 scenarios, taking into account what we know of the epidemiology and potential public policy and health system responses.

Oliver Wyman's health and data experts have built a model that captures these factors. At this point, our base case estimate is for the initial pandemic wave to be under control in many countries globally by mid-June. We will then see a very fragile system emerge as many areas look to relax social restrictions. While some experiments (for example, within Sweden) are underway that are providing valuable insights into how feasible it may be to allow the epidemic to continue without severe restrictions on movement, this is still a far from certain outcome. In addition, while we have calibrated our models to capture social distancing and other control measures, it is not yet clear how partial relaxation will impact contagion speed. This is further compounded by the issue of travel restrictions: If Country A or State B has contained the virus, what restrictions should it impose on Country C or State D where the pandemic is at a different/more elevated level? What will be the impact of these travel restrictions on trade?

Given the uncertainty in infection trajectories at this point, we think it critical for war room constructs to build access to broad and live datasets that can inform scenario planning. For example, are we seeing a trend in the data that suggests the pandemic can be controlled within a geography through relaxed measures? What can we observe from actions in places that have emerged from the initial epidemic (such as China, Hong Kong, and Singapore) or appear to have a slower spread (such as Japan) that will shape border controls and travel restrictions?

Sufficient attention to local detailing of scenarios will be very important and will differ across individual businesses. At a minimum, every organization should be maintaining up-to-date projections for each major geography in their business footprint and supply chain — including locations of major suppliers and any outsourced operations.

POLICY RESPONSE ANALYSES

In addition to responses to limit the outbreak itself, we see a wide range of government fiscal and monetary actions intended to mitigate the economic impact of the pandemic. These are evolving rapidly and will continue to do so. The United States, for example, has passed the US CARES Act providing $2 trillion in relief but may need to do still more; plus, the impact of the measures taken — on small businesses, for example — have yet to emerge. The crisis war room will need to maintain views on the effect of policy responses on employment, customer demand, economic impacts, and credit defaults. To the extent possible, lessons and parallels from prior crises should be considered and incorporated. But do not assume that this crisis will mirror the past: Already, we see forecasts from the International Monetary Fund (IMF) that suggests the COVID-19 recession will be materially worse than the 2008 global financial crisis.

ECONOMIC IMPACTS

We see three critical transmission channels from health and policy scenarios into strategic and financial outcomes: shifting customer, channel, and distributor behaviors and the resulting impact on revenues; loss patterns vs. those expected (such as insurance claims and loan defaults); and valuation changes driven by asset movements and asset liability management (ALM) decisions.

SUPPLY-DEMAND IMPACTS

Restrictions on travel and movement are already driving major demand impacts, with many industries, including travel and hospitality, and small enterprises struggling to remain viable. And we are only at the early stages of the crisis. Scenarios should be used to inform a view as to how the demand landscape across industries and sectors will evolve. How prolonged and acute will demand drops be? Where will the effects be permanent (for example, a shift to digital channels)? How effective will government intervention be? What will be the impact on revenue projections by major product lines? What are the implications for cost management and investment programs across the enterprise?

Some insurance lines will only be affected temporarily, and others such as motor may even benefit in the short term. But we could also see some business sectors permanently changed — in terms of sector size or in how business is done — which in turn could have a long-term impact on revenues and nature of cover required.

LIABILITY-SIDE IMPACTS

It's hard to overstate the impact to the liability side of balance sheet businesses. Banks are already preparing for sharply elevated credit defaults. For commercial insurers, we are closely watching business interruption claims where policy conditions and government actions will have significant consequences. Similarly, we expect an uptick in commercial property claims, as well as the more obvious impacts on travel and health insurance premium volumes. The impact on personal lines such as motor and property is less clear, with anticipated lower claims incidence during lockdown periods potentially offset by higher claims fraud and pricing pressures in the longer term, as seen in previous recessions. For life insurers, rapidly declining rates and equity markets have acutely affected positions, and the impact on claims will depend fundamentally on the capacity of the health systems to cope with the wave of serious COVID-19 cases and whether case overload leads to wider life-saving treatments being delayed (for example, cancer treatments), and hence higher mortality at the insured lives age groups.

FINANCIAL MARKET IMPACTS

The war room must maintain a live view on three principal financial market impacts: What will fluctuations in asset values mean for revenue projections, given asset-based fees? What does emerging data mean for credit impairments and defaults (and what does it mean for private assets in particular)? And finally, what will be the impact of prolonged, ultra-low interest rates?

By far the most complex to analyze, but potentially most important, is the impact of the crisis on credit assets. The combination of health and economic shock will play out across different industries and credit asset classes in very different ways. It's important, therefore, to develop a granular first-principles analysis to understand the potential impact on your book. For example: The rate of recovery of the travel and tourism industry will drive outcomes for commercial real estate; the combined impact of a recession on house prices and the mortality incidence of the disease itself will drive equity-release mortgage outcomes; for Solvency II-regulated insurers, the implications then of credit downgrades on the matching adjustment portfolio could lead to dislocations in the size and shape of the valuation interest rate for illiquid liabilities.

The potential impact of prolonged low interest rates is of course not trivial, especially where commitments were not fully hedged or where old guarantees apply to new money. Prior to the pandemic, many insurers were already faced with difficult trade-offs between locking in an interest rate gap through safer assets, taking on additional credit risk in search of yield, or running down reserves of unrealized gains on existing assets. Since the onset of the crisis, this has become even more acute. And so understanding the relative impact of a recession (of varying length and depth) on interest rates will be a key driver of business decisions in this space.

INDUSTRY AND BUSINESS IMPACTS

Financial planning and analysis (FPA) teams have a massive task ahead of them to produce a coherent set of reforecasts for each major COVID-19 scenario, with frequent adjustments as new information emerges on a daily basis. To understand how these drivers play through — and allow for fully-informed decisions — a full-company model is required, capturing contract-level effects on revenues, costs, and solvency, as well as the various corporate overlays (fixed costs, distribution costs, fund and company-level taxes, solvency ladders, and more).

The challenge is to get the trade-off right between a rich, detailed, and accurate model and one that can be created quickly and used to provide answers in the same timeframe as decisions are being made. New technologies can help, but this really calls for old-fashioned human judgment.

MANAGEMENT ACTIONS

It's amazing how quickly the crisis has unfolded. Before last month, we were already seeing management teams planning for an expected recession and turning their attention to the question of how to balance "vision" and "value" perspectives[1].

1 See Exhibits 1 and 12 in *'State of Financial Services 2020: When Vision and Value Collide.'*

As crisis impacts are examined and communicated with boards and investors, we expect a much greater focus on value and on managing costs.

We think striking the right vision-value balance is critical to the financial-services industry's future. Even before the crisis, there were many acute issues: poor shareholder returns in many sectors, flat market caps, and pressured price/earnings multiples. These headwinds were forming against a backdrop of unmet financial needs from consumers across retail financial services (insurance, retail banking, wealth and asset management). Our interpretation of these megatrends, widely shared by clients, was that certain areas of the industry did not have sufficiently compelling relevance to consumers and could be heading toward secular decline.

The pandemic, we believe, will accelerate the trends that were driving industry disruption before the crisis, and will lead to consolidation and a growing gulf between leaders and laggards. And we also believe that incumbents will be in a good position to meet unfulfilled consumer needs by assembling and absorbing fintechs and insurtechs, many of which are unlikely to weather the storm.

That said, insurance CEOs are now faced with managing a very difficult dynamic. On the one hand, the value imperative is very clear: Costs need to be managed downward and deferred until greater clarity emerges from the crisis; and where there's been a secular decrease in demand, costs need to be dramatically reduced (meaning radical automation of work and processes, as opposed to standard reengineering). In the most extreme cases, we anticipate companies making the tough decision to exit subscale and unprofitable lines, leading to a wave of consolidation — and opportunities to buy into the more strategic lines. On the other hand, there is still a vision imperative to halt the secular decline of the industry's relevance and the likely acceleration from the crisis that could lead to a downward spiral. This value vs. vision challenge is further compounded over the longer term by the likelihood of market opportunity (fewer competitors) and increased, albeit potentially different, consumer demand (for solutions to their unmet financial needs).

Effective vision vs. value balance requires action plans that maximize the chances of survival through the short-to-medium term while setting up the business to thrive over the longer term.

We are living through a period of uncertainty and volatility never seen in most of a person's lifetime. The impact of the COVID-19 crisis on human lives and health is nowhere near understood as yet, let alone the way the pandemic will change businesses and our way of life. Undoubtedly, mistakes will be made as businesses try to navigate through this storm. A robust war room, built on dynamic and real-time COVID-19 scenarios, is a must-have for management teams to manage through the uncertainties of the next 12 to 18 months — and it is likely to prove a valuable ongoing management tool long after the first wave of this crisis is passed.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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