Economic Scenario Generators

How can you be sure that your ESG is right for you?

SEPTEMBER 2014

Many insurers use an Economic Scenario Generator (ESG) to assess market risk. As for other external models, it is crucial that the business is able to understand the ESG well enough to be able to challenge its key assumptions and use it effectively in decision making.

It is crucial that the business is able to challenge the ESG and use it effectively in decision making.

However, with ESGs typically relying on complex maths and generating millions of numbers, this is easier said than done.

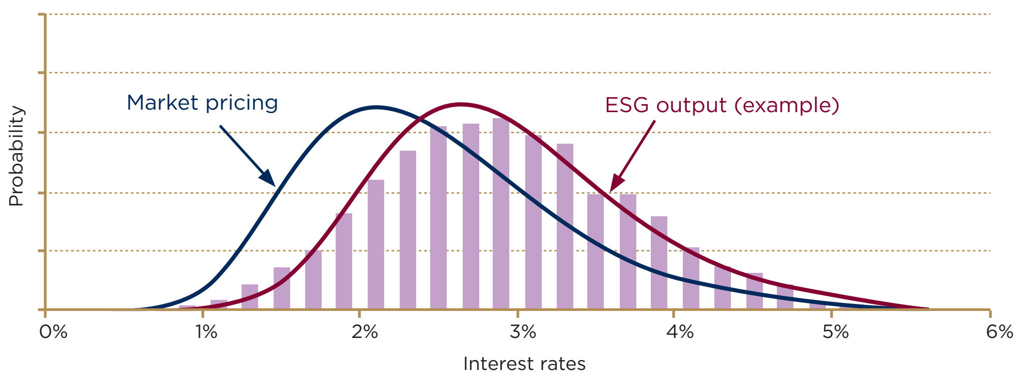
In our experience, insurers often have **three key questions** about their ESGs. Answering these is key to withstanding regulatory challenge.

1. How exactly does our ESG work?
There are various types of ESG. Each has different strengths and weaknesses depending on the ESG provider, the insurer and the way that the ESG is being used.

A key step is to understand the main moving parts of the ESG and how they affect the results. The complexity of ESG models can make this difficult. It's important to identify the key features and communicate them using layman's terms and simple graphics. This enables you to cut through the jargon to identify what really matters.

The complexity of ESGs can make it difficult to understand the key features.

Where will interest rates be in 5 years' time?
How the ESG output compares to real world gilt market pricing



2. What are the limitations of our ESG and how important are they?
To properly understand risk, it is essential to consider the real world, to make sure a model is relevant given prevailing financial conditions. Identifying where the output of ESGs differs from internal views on market conditions and the economic outlook is a key part of this.

For example, where investment market pricing implies that there is a significant chance of very high inflation (or deflation) over the next 20 years, it is important to ensure that these risks are adequately reflected in the ESG.

It is also essential to understand what conditions might invalidate some of the ESG's key assumptions. This can be done via a system of "flags" relating to key market indicators, which are reviewed quarterly. If one or more flags are triggered, then the investment committee can consider whether to modify the relevant ESG assumptions to produce an updated view of market risk.

A system of flags can be used to trigger a review of assumptions regarding market risk.

3. How can we demonstrate that our ESG has been appropriately validated?
Regulators require firms to demonstrate appropriate validation of external models. This goes well beyond having suitable user manuals and technical appendices from the ESG provider. It involves being able to challenge the key modelling assumptions to ensure that they are appropriate for the context in which the business is using the ESG. Robust documentation, tailored to focus on the specific areas raised by the regulator, is also vital. To do this effectively, you need to make sure your validation team has specific investment expertise and is sufficiently independent.

Contact us
LCP's insurance and investment teams have extensive experience of building and validating ESGs for insurers. Call John Clements, Catherine Drummond or your usual LCP consultant to see how we can help you.

John Clements
Partner
john.clements@lcp.uk.com
+44(0)20 7432 0600

Catherine Drummond
Partner
catherine.drummond@lcp.uk.com
+44(0)20 7432 0637

LCP is a firm of financial, actuarial and business consultants, specialising in the areas of pensions, investment, insurance and business analytics.