MONETARY AND CAPITAL MARKETS

Special Series on COVID-19

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Regulatory and Supervisory Response to Deal with Coronavirus Impact—The Insurance Sector

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COVID-19 impacts the insurance sector mainly through insurers' investments, as well as to a lesser extent on claims. Health insurers are likely to experience a significant number of claims related to COVID-19 but this will be mitigated by deferral of nonurgent medical procedures. While it is difficult to quantify the impact at this stage, the standard view based on work on previous pandemics is that the impact on the liability side of the balance sheet for other insurers is likely to be limited. Many insurance supervisors have taken regulatory actions to ensure business continuity and flexible treatment of policyholders. The International Association of Insurance Supervisors (IAIS) issued a public statement to describe the steps to address impact of COVID-19 on the insurance sector.[2] The European Insurance and Occupational Pensions Authority (EIOPA) has encouraged use of flexibility within the Solvency II framework. Public trust in supervisory authorities is critically important to mitigate any potential run on insurers. Modification of solvency calculations should be made with full transparency and should be considered only after all supervisory measures have been taken. Troubled insurers should develop credible plans to restore their financial soundness if short term losses linked to the crisis have a severe impact and threaten to lower capital below regulatory minima. Supervisors should ensure that supervisory measures do not incentivize or require the fire sale of assets through enhanced liquidity risk monitoring and management.

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[2] *IAIS Executive Committee takes steps to address impact of COVID-19 on the insurance sector* (IAIS, March 27, 2020).

I. THE MOST SIGNIFICANT IMPACT ON INSURERS FROM COVID-19 WILL BE ON THEIR INVESTMENTS

In the United States, insurers hold about 21 percent of all corporate bonds and 20 percent of all municipal bonds on issue.[3] European insurers hold in excess of EUR 10 trillion of investments[4] and are particularly important in long-term markets with more than 40 percent of euro area investment in bonds with maturity over ten years held by insurers.[5] With equity markets falling significantly, and spreads on higher risk bonds increasing, market value losses are likely to be substantial and immediate. This will have an adverse impact on the economic solvency of insurers. As an example, Aviva, a U.K. life insurer, announced its solvency ratio declined from 206 percent at year end to 175 percent on March 13 as a result of market losses.[6] The impact is likely to also be negative for life insurers over the medium to long-term if the central bank actions extend a low for long rate scenario. Insurers share prices have declined more substantially than the overall equity market reflecting investors views of the impact on insurance companies.

II. THE IMPACT ON HEALTH INSURERS IS LIKELY TO BE MIXED WITH A SPIKE IN CLAIMS OFFSET BY DEFERRAL OF NONURGENT HEALTH CARE

Health insurers are likely to experience a significant number of claims related to COVID-19, including the costs of testing and care for those diagnosed with the disease. This will be partly mitigated in the short-term by deferral of elective surgery and other nonurgent medical procedures. The impact will vary across countries depending on whether or not there are extensive government provided health services. Where there are primary government health services, there may even be a temporary reduction in claims as nonessential health care gets deferred. For countries like the United States and Switzerland, where private health insurance is central to the provision of health care, claims are likely to spike but ultimately the increase is limited by the capacity of the health care system. There may also be transitioning of some services to lower cost options like telephone consultations. The impact on premium volume is unclear as intuitively one would expect a loss of policyholders when the economy goes into recession. However, in China, there have been significant increases in health insurance premiums likely through an increase in the number of policyholders seeking coverage.[7] For example, Ping An Health Insurance Co had an 83 percent increase in premiums over the first two months of the year.[8]

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[3] *The role of insurance investments in the U.S. Economy* (Centre for Capital Markets Competitiveness, Winter 2019).

[4] *European Insurance—Key Facts* (Insurance Europe, October 2018).

[5] L F Rousová and M Giuzio, *Insurers' investment strategies: pro- or counter-cyclical?* (ECB Working Paper series, July 2019).

[6] *Insurers weather the coronavirus storm - but for how long?* (Insurance ERM, March 20,2020).

[7] The China Banking and Insurance Regulatory Commission has required a reduction in premiums for some regions to alleviate poverty so in such a regulated environment, increases in premium are likely the result of increased number of policyholders. Health insurers in South Africa are expecting lower lapse and surrender of their existing policies.

[8] *Life and health insurance sales jump up to 80 percent in China* (Insurance ERM, March 19, 2020).

III. THE IMPACT ON LIFE INSURERS AND PROPERTY AND CASUALTY (P&C) INSURERS WILL MAINLY COME FROM INVESTMENT LOSSES, NOT FROM CLAIM EXPENSES

For life insurers, a spike in mortality rates is likely but it is not clear as this stage how significant that will be. Some Financial Sector Assessment Programs (FSAPs) include a pandemic scenario[9] as part of stress-tests on life insurers, which showed little impact on the insurance liabilities of the insurance sector. Life insurers could face larger claims if the COVID-19 pandemic is more severe than the scenarios applied. [10] However, life insurers with more longevity risk (e.g., guaranteed annuities) will experience a reduction in risk profile, as mortality rates increase. Car insurance is usually the most significant line of business for P&C insurers, so with people driving less, car insurance claims are likely to decline substantially for a few months.[11] The lines of business likely to be adversely affected are business interruption insurance, travel insurance, credit insurance (including trade credit insurance), and event insurance. Business interruption insurance and travel insurance policies often have pandemic exclusions. Although these exclusions are expected to limit losses, there are material litigation and political risks in some countries, challenging the applicability of pandemic exclusions. Despite exclusions, COVID-19 is likely to be one of the most significant events in the history of the P&C insurance industry.[12] P&C insurers premium income is likely to decline in line with declines in economic activity.

IV. MANY SUPERVISORS HAVE TAKEN REGULATORY ACTIONS TO SUPPORT BUSINESS CONTINUITY AND FAIR TREATMENT OF POLICYHOLDERS

Some supervisors are supporting a grace period on premium payment. Others are exempting conduct requirements (such as face-to-face explanation) to reduce the risk to intermediaries and their clients. Many supervisors are limiting data requests to essential data on the latest market impact and exempting or relaxing non-essential reporting and other requirements to facilitate business continuity of insurers. Timely handling and payment of claims are important to keep public confidence in the insurance industry and supervisors seem to be prioritizing their monitoring efforts on such payments and ensuring that insurers have sufficient liquidity. Some U.S. supervisors are requiring health insurers to cover COVID-19 testing without copayment by the policyholder which will increase claims costs for those health insurers. In addition, the National Association of Insurance Commissioners and state regulators are relaxing their statutory accounting standards to include premium receivables beyond 90 days past due in admitted assets.

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[9] Most of the scenarios assumed 1.5 additional deaths per 1,000 insured lives, which is widely recognized by industry experts as a once in 200 years event. See for example:

- Japan FSAP stress-test identified that a pandemic shock would have a minor impact on capital resources. See Technical Note-Systemic Risk Analysis and Stress Testing the Financial Sector, September 2017.
- U.S. FSAP stress-test also included a pandemic scenario and found that the liability impact of the pandemic seems to be manageable and smaller than other catastrophic events (such as earthquake and hurricane). See Stress Testing-Technical Note, July 2015.

[10] The 1.5 per 1000 excess mortality is larger than the expected mortality from COVID-19. For example, the 1.5 per 1000 excess mortality if applied to the U.S. population would result in approximately 500,000 deaths compared to the estimates of 60,000 to 240,000 from the U.S. government for COVID-19.

[11] Some insurers are beginning to offer premium rebates acknowledging this lower level of claims.

[12] Insurers face biggest-ever losses, Lloyds chief (Financial Times, April 24, 2020).

V. THE IAIS ISSUED A PUBLIC STATEMENT[13] TO DESCRIBE THE STEPS TO ADDRESS THE IMPACT OF COVID-19

The statement describes that insurers are generally well-capitalized with sophisticated risk management capabilities, which should help the sector withstand the shocks. The statement also highlighted some adjustments to the work program to provide operational relief to member supervisors, insurers, and other stakeholders. The changes to the timeline include delays in: (i) implementation of the Holistic Framework for the mitigation of systemic risk in the global insurance sector[14], (ii) data collection for the Insurance Capital Standard confidential reporting, and (iii) development of supporting material, with public consultations generally deferred by at least six months.

VI. EUROPEAN REGULATORS HAVE TAKEN A FLEXIBLE APPROACH TO ADDRESS EXCESSIVE MARKET PRESSURE

The Solvency II (the European Insurance Regulation) Framework is based on a market consistent balance sheet and thus, the current market stress had a material impact on their solvency coverage ratios. The EIOPA issued a statement noting that Solvency II provides flexibility in extreme situations in the ladder of supervisory interventions, including measures to extend the recovery period of affected insurers. There have been some additional actions by a few National Competent Authorities including:

a. U.K. Prudential Regulation Authority (PRA) is allowing new application of transitional measures on the insurance liabilities. Those measures would allow insurers to revert to a valuation approach mostly based on Solvency I[15] and thus, release the pressure from the lowering of interest rates.

b. The Italian Institute for the Supervision of Insurance fast tracked a change in Solvency II with respect to the valuation of insurance liabilities by bringing into regulation changes to the application of the country-specific volatility adjustment, a move that will likely strengthen Italian insurers' regulatory Solvency II ratios.[16]

[13] The public statement issued on March 27, 2020 is available at https://www.iaisweb.org/news/iais-executive-committee-takes-steps-to-address-impact-of-covid-19-on-the-insurance-sector.

[14] The Holistic Framework is aimed to mitigate systemic risk in the insurance sector. The key elements of the framework include; i) an enhanced set of supervisory policy measures for macroprudential purposes, ii) a global monitoring exercise by the IAIS designed to assess global market trends, iii) mechanisms to allow for a collective assessment of potential global systemic risk and a coordinated supervisory response, and iv) assessment by the IAIS of the consistent implementation of the enhanced supervisory policy measures and powers of intervention.

[15] Solvency II provides a framework for transition from Solvency I valuation to Solvency II valuation over 16 years from the beginning of 2016–end of 2031. Insurers had to nominate to use this transition at the beginning of Solvency II application at the beginning of 2016. This PRA decision allows them to retrospectively make that decision.

[16] In Solvency II, insurers can apply a volatility adjustment to the risk-free discount rate curve. This adjustment has two components, a currency volatility adjustment (65 percent of the spread over risk-free rates earned by a reference portfolio) and a country specific volatility adjustment. The country specific volatility adjustment only applies when the country spread is greater than twice the currency spread, and the country spread is greater than 85 basis points. The change implemented was to lower the second threshold from 100 basis points to 85 basis points.

VII. SOLVENCY SYSTEMS BASED ON ECONOMIC VALUES EXPERIENCE MORE VOLATILE RESULTS BUT THIS IS PREFERABLE TO SYSTEMS THAT HIDE THE ECONOMIC IMPACT

Volatility in economic values will reflect two things: mismatches in the duration of assets and liabilities, and mismatches in the basis of valuations. Volatility due to duration mismatch is a choice that insurers have made through their product design and investment management decisions. Mismatches in the basis of valuations cannot be managed away completely because of the contractual obligations to policyholders, which create insurance liabilities differ from the nature of assets.[17] By utilizing clear economic valuation approaches and through public statements of actions by supervisors, the impact of market conditions is transparent to all stakeholders. The alternative of hiding market volatility behind locked-in assumptions and amortized cost valuations does not engender market confidence. Moreover, such an approach may avoid the need for discussions between supervisors and insurers to address the economic consequences of market volatility.

VIII. PUBLIC TRUST IN INSURERS AND THEIR SUPERVISORS IS CRITICAL

Public trust in insurers and supervisory authorities is critically important to mitigate any impact on the insurance industry. While a potential run on insurers is improbable at this stage, public trust in insurers and supervisory authorities will help avoid such an outcome. Two examples of a run on insurers could be policyholders demanding the surrender value of their life insurance policies or terminating cover of nonlife policies and demanding refunds based on unexpired risk. The first example scenario is more plausible in the countries where insurance products are used mainly for saving. While regulatory accommodation may be necessary as a temporary measure in an extreme market situation, supervisors should not signal a permanent lowering of standards applicable to insurers. Supervisors should closely monitor and hold discussions with insurers to analyze the impact on their capital and liquidity. Any measures, including temporary relaxation measures, should be made with full transparency and clear communication to the public to ensure the public trust of the supervisory authorities and the insurance sector.

IX. TROUBLED INSURERS SHOULD DEVELOP CREDIBLE PLANS TO RESTORE THEIR FINANCIAL SOUNDNESS IF THEY ARE GRANTED TEMPORARY RELAXATION OF SUPERVISORY MEASURES

Such plans should be agreed by and closely monitored by the supervisor to ensure that the plans are credible, and that insurers are satisfactorily meeting planned targets through concrete actions, such as suspension of dividends and reduction of administrative costs and/or remunerations. Supervisors should take stronger regulatory actions (such as imposing suspension of new business while the insurer is not meeting requirements) if an insurer fails to meet its recovery plan with clear public disclosure on their actions.

X. SUPERVISORS SHOULD ENSURE THAT SUPERVISORY MEASURES DO NOT INCENTIVIZE OR REQUIRE THE FIRE SALE OF ASSETS

Insurers tend to have common and concentrated exposures to sovereign bonds, deposits and bonds of the banking sector, major corporate bonds and listed equities. While insurers are providing stable and long-term

[17] This is due to the liquid markets for most investment assets versus illiquid insurance liabilities and that typically investment portfolios carrying some credit risk whereas insurance liability valuation should not recognize the default risk of the insurer.

financing, current market turmoil may have affected the risk appetite of the insurance sector. Moreover, fire sale of the assets by troubled insurers would have an impact on other insurers and on other parts of the financial system. In such an extreme market environment, insurance supervisors should support, where possible, insurers with long-term business models to be a stabilizing force in asset markets by purchasing or at least continuing to hold financial assets rather than selling them. Insurance supervisors should enhance their monitoring of liquidity positions of the insurance sector and improve the liquidity risk management practices of the insurance industry. In case of severe industry wide liquidity stress, supervisors should allow or require a stay on redemption of insurance policies to support the ultimate interest of policyholders.