SESSION SUMMARY - BERLIN SEPTEMBER 2020

What does the Covid-19 crisis mean for insurance companies and their regulation (Solvency II, global framework)?

1. The impact of the COVID-19 crisis

1.1 The crisis is unique with multipronged consequences for the insurance sector

A regulator stressed that the COVID-19 crisis is different from previous crises, particularly the last financial crisis. It is a health crisis in the first instance, but it has also created severe economic impacts. It has elicited a huge public response and it has required everyone to adapt.

The crisis initially posed an operational challenge for the insurance sector, which then had to respond to the effects of the crisis. Market volatility continued to be an issue. The interest rates in areas, due to the massive interventions of central banks, created even more of a push for the 'low for long' scenario on the interest rate side.

There have also been consequences on the liability side because insurers are also insuring and protecting households and the real economy. Initially, claims arising from the crisis were more focused on life and health but, with government interventions and lockdowns, the crisis began to affect insurers more on the property and casualty (P&C) side with event cancellations, business interruptions, and so forth.

The reactions of supervisors in terms of insolvency, profitability and business model risks are being monitored. The industry is 'not out of the woods yet'.

1.2 On the liability side, the extent of the impact depends on the product mix

An industry representative explained that the extent of the impact on an insurance company depends largely on their product mix. While there has been a much bigger impact on the life side, product and geographic mix remains very important. For many firms, an offset between mortality and longevity risk will lessen the impact. Large insurers have benefitted from their product mix in balancing out the different impacts of COVID-19, making the crisis fairly manageable on the liability side.

1.3 On the asset side, significant liquidity provided stability

An industry representative underlined that all markets were affected on the asset side, not just the insurance sector. The initial market liquidity problems were improved, however, by the significant balance sheet liquidities of individual companies that, in turn, provided a source of market stability for the industry as a whole. Large companies have been able to take advantage of some of this dislocation by being a net purchaser of assets, even in the most disruptive quarter. With their long-term liabilities and ability to invest, they have been able to weather the short-term market disruption. The insurance industry has therefore acquitted itself very well and has been a force of stability.

Despite this success story, another industry representative underlined that the industry was nevertheless unprepared for the crisis. It was an unexpected event, but it is the job of insurers to manage unexpected events. More work is required on risk management, looking beyond the quantitative models that have been the focus of Solvency II.

1.4 Operational challenges

An industry representative outlined the operational issues, particularly related to business continuity, monitoring and planning, that were caused by the crisis. Focusing on these issues has been important in avoiding collapse or disruption and in keeping staff safe as well as providing consumers with confidence.

Suitable governance and business continuity plans have proved effective in dealing with the crisis. Such plans can entail, for example, crisis cells convening on a daily or weekly basis to address constantly evolving developments and to disseminate information throughout the company. Companies have also had to initiate, or expand, remote and home-working plans. The representative's organisation had already implemented home working before the crisis and plans to expand this in the future.

1.5 Reputational issues

An industry representative highlighted the issues that have been raised in the media about non physical damage business interruptions, ambiguity, litigation and so on.

Another industry representative stated that the reputational concerns have been very different from one market to an other. At both the European level and the national level, a solution needs to be devised that involves public-private partnerships. This is first and foremost a political decision and there are many technical hurdles, but these can be overcome. The European Council and the European Commission have to decide whether they really want a European cover and whether it would be acceptable to have some citizens protected and some not.

An industry representative (Engelhard) stated that reputational risk is a mixed issue in the US market as compared with the European market. On the P&C side, business interruption insurance became an issue in some markets.

There is no real private sector solution for government healthcare mandates to shut down the real economy, as this is not really an insurable risk from the private sector side. The reputational issues have largely been addressed by 'ex post facto' cover with the significant fiscal and monetary stimulus. Ultimately, however, there is no ex ante way to insure against the entire economy shutting down.

2. Effectiveness of the measures to deal with the crisis

2.1 Solvency II

An industry speaker stated that Solvency II has responded well to the crisis because of the way that it is built around bricks of risk drivers. Whatever the reason for a financial crisis, it can be captured under the proper submodules of Solvency II. Combining the bricks to create scenarios in a creative and modular way leads to good responses and correlations between the different types of risks. This is where the analysis in Pillar 2 may need to be deepened.

Solvency regulation cannot simply be built around scenarios, however. Scenarios help build a story and allow for clearer communication both internally and externally but, in the end, the bricks are doing the job in the first place.

A regulator pointed out that the resilience of the industry is due to Solvency II. In addition, insurance sector supervisors did not provide capital reliefs, as banking supervisors did, but instead concentrated on operational relief, allowing for, for example, Solvency and Financial Condition Reports (SFCRs) to be delivered later. Aside from that, not much had to be done.

Another regulator warned that the crisis is not yet over and that there will be more to learn over the coming weeks and months.

Solvency II worked very well in March and the volatility adjustment (VA) helped to stabilising the effect of the crisis. The European framework has proved that, in the face of high volatility, it can provide ways of stabilising the insurance market. However, there are certain elements that need to be reassessed, for example in relation to the wave of downgrades.

In addition, supervisors were able to exercise some flexibility in the short term. Overall, supervisors did not have to do much because it was not necessary to go beyond what was decided at the European Insurance and Occupational Pensions Authority (EIOPA).

2.2 The long-term perspective

A regulator cautioned that the long-term picture is not yet clear. The significant measures taken by central banks on rates will mean that the rates will be lower for longer. This has an enormous impact on the liability side for life insurance companies in particular. This needs to be assessed and potential future lessons need to be identified as the crisis unfolds.

Another regulator stressed that the crisis will impact the profitability of the undertakings in 2020. For 2021, insurers are expected to take this decrease in profitability into consideration when distributing earnings to external shareholders.

The solvency capital requirement (SCR) is under pressure somewhat in some cases, though not dramatically, due to a declining yield curve. The volatility adjustment has proved its effectiveness.

2.3 Addressing the operational and reputational challenges unveiled by the crisis

A number of regulators stressed that there is a risk of customers discovering ex post that their contract does not in fact cover pandemic-related risks due to unclear policy wording.

A regulator noted, however, that the problem of unclear policy wording may be exaggerated in the media. A survey of the French industry showed that only 4% of contracts were unclear as to whether pandemic risks were covered. The media stories nevertheless give rise to a reputational risk. Supervisors need to therefore ensure that insurers are sufficiently clear in their contracts and in their advice to customers as to what is and is not covered. Clarity ex ante avoids reputational risk ex post.

Another regulator stressed that the German picture on wording clarity is not as clear-cut as in France, with many insurers using different wording. Policy wording should therefore be more standardised so that there is clarity over what is and is not covered. This greater clarity, however, will likely mean that policies will generally not cover pandemic-related risks unless they are very expensive.

A regulator stated that supervisors need to be able to deal with relatively new risks that they have not been used to dealing with, or have not prioritised, in the past, such as cyber risks and reputational risks arising from unclear contracts. Supervisors should have a review process that ensures that good governance of these risks is taking place.

In addition, the relationship between supervisors and the industry needs to be simplified. In particular, the system of reporting could be more efficient.

Overall, the measures taken to address the risks should last beyond the crisis and apply equally to normal circumstances.

An industry representative commented that the crisis has revealed a need to re-evaluate the definition of a pandemic risk. Pandemic risks were previously only linked to mortality or morbidity, but this crisis has impacted upon the economy, social issues and business norms.

3. Future implications

3.1 The consequences of the Solvency II review

An industry representative stated that attention still needs to be paid to the issues that existed before the crisis and highlighted the importance of having a system that does not produce volatility. Equally, the system should not over-calibrate but rather help to provide look-through views so that supervisors do not overreact.

A regulator stressed the need to finish the Solvency II review by the end of the year, even though the full dimensions of the crisis will still not be known then. The main lesson learned so far is that no fundamental changes are necessary to the current proposals but that some fine-tuning may be required.

COVID-19 has provided valuable information on where the crisis management tools from the regulation, such as the volatility adjustment, are ultimately fulfilling the tasks that they were designed to fulfil. Though there is a potential for overshooting, the VA has worked well to dampen procyclical effects. The problem in some countries is that this overshooting might lead to an inappropriate profit distribution, which should be worked on by local generally accepted accounting principles (GAAP). However, an industry representative stressed that risks of the VA undershooting during times when the interest rates spreads would be much more magnified than during the Covid19 crisis and be similar to those observed in the 2008-2011 crisis – exist and still have to be addressed.

Undertakings' leeway for dealing with additional streams is becoming increasingly limited, which will put pressure on supervisors to ensure that there is a balanced solution for the Solvency II review. A regulator (Bernardino) stated that EIOPA is aiming for a balanced solution for the Solvency II review.

A regulator highlighted the need to define what a 'balanced' revision of Solvency II means. What matters over the coming years is rebuilding the economies. Insurers, as investors, have a role to play in that, and this should not be forgotten in the revision of Solvency II. While prudential objectives should not be mixed with other objectives, equally, long-term investments should not be penalised, as they are necessary for the economy. Without a strong economy, there is no strong insurance sector and no strong banking sector, and this systemic dimension needs to be embedded into the review of Solvency II.

A regulator stated that the volatility caused by the crisis has hugely influenced the SCR of the companies. This can limit the amount of flexibility that supervisors can use. Supervisors need tools within the framework that work better in smoothing excessive short-term volatility. Emergency measures should be put in place if necessary. The long and complex process of extending the recovery period in the case of a breach of an SCR needs to be simplified in order to provide more flexibility to supervisory intervention in the future.

While liquidity risk has generally not been an issue during the crisis, it certainly was a concern for supervisors at the outset. A monitoring system was therefore put in place and supervisors investigated any possible access to emergency liquidity sources. These measures are not sufficient, however. Instead, they also need to ensure good risk management of liquidity, involving better monitoring, better stress tests and a better capability of the companies to set their own liquidity buffers and contingency plans. This should apply to all companies and not just the big groups.

3.2 Global standards

An industry representative stressed the need for a long-term perspective, particularly when looking at the lower-for-longer rate environment. The public sector needs to consider whether it wants a system where policyholders can get the long-duration-guaranteed products to protect them in crises. The low interest rate environment makes it very hard for insurers to provide those kinds of products and a prudential system that artificially creates 'non-economic volatility' will make it almost impossible. This is particularly true in the life insurance industry where companies take on very long liabilities. From a global standards perspective, it is important to balance the goals of long-term investment and long-term protection.

A regulator (Bernardino) maintained that the above concerns will be taken into consideration during the development of the Insurance Capital Standard (ICS).

3.3 The role of the insurance industry

An industry representative acknowledged that insurance companies can play an important role in supporting the economic recovery but that a few facilitating factors are required. In particular, the taxonomy project needs to be finalised and investments for insurance companies need to be made available. Insurance companies are eager to invest in infrastructure but there are not enough good infrastructure projects. Equally, insurance companies are very eager to invest in SMEs and yet there are not enough SME vehicles in Europe.

Another regulator (Bernardino) stated that the prime focus going forward should be on the recovery and on having a sector that can deliver for the consumers, for the citizens and for the real economy. There are three key points related to this: sustainability, particularly in relation to climate change; digital changes, which will persist in business models after the crisis; and long-term investments where demand will be incentivised by regulatory measures but where governments, the real economy and companies also need to generate supply.

4. Dividend policies

An industry representative acknowledged that the Solvency II review needs to be more focused on the long term so that insurance companies can invest long term and sell long-term protection products. However, consideration needs to be given to the fact that insurance companies use solvency to pay dividends. In this regard, the regulators have created a great deal of confusion with their ban on dividends, which will damage the Solvency II framework in the eyes of investors. Currently, the ability to pay a dividend in Europe depends on location, which is unacceptable from a competition point of view. The regulators need to come together to address these issues. ■