FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

Insurance

Part 4

Resilience Recovery Renewal

OVERVIEW

Welcome to our fourth briefing on how COVID-19 is affecting financial institutions and its impact on current industry trends. In this edition, we focus on insurance, a sector where total premiums in 2019 amounted to USD 6.3 trillion or 7.2% of global GDP.[1] As always, in addition to sharing our own opinions, we reference the views of external commentators.

Please bear in mind that our views are based on hypotheses that may change in a rapidly developing situation and there are doubtless other perspectives.

Takeaways

- **Insurers came through the initial turbulence of the COVID-19 pandemic in relatively good shape**. Their balance sheets, however, are under pressure as they are invested heavily in corporate bonds at risk of downgrades and default. Near zero interest rates are pushing many insurers to invest in other asset classes seeking higher returns but for more risk.

- **Despite fears early on in the crisis that COVID-19 could be the most expensive insurance event ever, insurers encountered relatively moderate business disruption and travel insurance claims, although there is scope for higher payouts and litigation in the future**.

- Supervisors are being proactive not only over the resolution of coverage disputes, but in the treatment of policyholders whose products no longer offer the same value. COVID-19 poses both reputational issues from insurers, but also highlights the need for insurance products to which the sector can respond.

- **Existing trends such as digitalisation and ESG have received new impetus from COVID-19, accelerating change significantly**. Productivity has not grown in the sector since the 2008 financial crisis with premium growing less than GDP. Digitalisation and InsurTech will reduce future costs, providing the opportunity to improve profitability but requiring investment. While climate change poses significant risks to the prudential soundness of insurers, it is creating badly needed opportunities for insurers as long-term investors — if issues around prudential regulation can be resolved.

- **The importance of emerging markets to insurance — the pivot to Asia — is growing, with China on track to become the largest insurance market by the 2030s**. The region represents significant opportunities for global insurers as markets with low penetration and a growing middle class. On the other hand, it represents a long-term and capital-intensive project competing against large domestic champions.

Setting the scene

Since the financial crisis of 2008, growth in insurance in mature economies has struggled to keep up with GDP. In Japan, one of the largest insurance markets after the US, life insurance premium volume, for example, has shown little growth over the last half decade.[2] Instead, the centre of gravity for growth is shifting to emerging markets in the Asia Pacific region. This reflects not only the growth of a consumer middle class in these economies, but also a slowdown in property & casualty lines in mature markets due to advancing technology, for example, better risk prevention in places of work and safer vehicles on roads. Ironically, immediately prior to the onset of COVID-19, insurers had enjoyed rising premiums in 2019 of over 4%, in large part driven by life business and growth in China. In light of the economic shock from the pandemic and accompanying restrictions on economic and social activity, premium income has fallen in 2020 — the impact varying across different business lines and regions — and there are likely to be losses on investment portfolios reflecting the risk of corporate bond defaults. Here low interest rates — cut even lower by central banks early in the crisis to stimulate economies – are also an issue.[3]

Most economies that were in recession or experiencing negative growth in the first part of the year, are now once again growing although (especially in Europe) "the bounce back" is weakening, making a U-shaped — rather than a V-shaped — recovery more likely. China is the exception, having avoided recession in 2020, and will be the region with the strongest growth next year. Although the recovery is positive for insurers, most economies will be smaller than they would otherwise have been. This is important as regards demand for insurance products, the future growth in premiums and balance sheets. More positively, COVID-19 is reminding consumers of the need for insurance. Similarly, trends such as growing middle classes in emerging markets, smaller state pensions and an ageing population are creating new demand for life and pension products.

Existing trends such as digitalisation and ESG have received new impetus from COVID-19, accelerating change significantly. With so much business now conducted virtually and attitudes transformed, digital technology that has been under development is now being used (e.g., for premium quotes, policy confirmation and issuance, and settlement).[4] Technology is vital to boosting productivity in an industry that has not seen real growth for over a decade, therefore increasingly seeing squeezed profits.[5] As for sustainability, it is recognised that climate-change risk has the potential to expose the vulnerability of the economic system just as COVID-19 has — especially for life and pension businesses that must plan for long time periods.

Three areas to watch

When looking to see how insurers are being affected by COVID-19, three of the key areas to watch are:

Claims

Early on in the crisis, it was predicted that COVID-19 could be the most expensive insurance event historically because of the range of exposures.[6] Global total losses are estimated at USD 50 billion-100 billion.[7] Nevertheless, insurers have to date encountered relatively moderate business disruption and travel insurance claims given policy exclusions, although where there is ambiguity — particularly over business disruption — there is scope for higher payouts and litigation in the future. The potential for claims overall is likely to be higher in the US, where there are significantly greater payouts on workers' compensation compared to Europe.[8] On the other hand, the reduction in economic activity and the effect of lockdowns has reduced claims, especially in motor, marine, aviation and transport, as well as health. Whether, and to what extent, claims bounce back depends on how quickly the economy recovers and how COVID-19 changes the market place.

While at first glance a low level of claims might be good news, care is needed not to feed the popular image of insurers as happier to accept premiums than to pay claims. This is important because it could lessen demand for new products if customers see insurance as offering little value, remembering the crucial economic risk mitigation function that insurance plays. There is also risk of a vicious circle, where in light of high profile disputes over COVID-19 coverage, insurers seek to limit their future exposure by revisiting policies, for example, widening exclusions, limiting the insured peril and ultimately, increasing premiums thereby reducing demand.[9] It is reported that the cost of directors' and officers' insurance (D&O) has doubled after an increase in class actions, partly due to the impact of COVID-19.[10]

Balance sheets

There is a virtuous circle involving the provision of financial services, the health of the economy and the strength of insurers and their balance sheets. There is no global prudential standard as there is for banks, but insurers' capital requirements must reflect all potential balance sheet risks whether they derive from market, credit or underwriting. Overall, solvency coverage ratios for general and life insurers remain healthy.[11] In the UK, for example, the industry holds approximately 50% more capital than required under the EU's Solvency II prudential legislation.[12] This is despite concerns, during the period of market volatility in the spring, that Solvency II exaggerates the impact of short-term price movements in financial markets on insurers' balance sheets and solvency positions.

During the initial stages of the pandemic, insurers globally faced liquidity mismatches and credit risk. Their shares suffered considerable falls as investment portfolios were exposed to large losses both across their fixed income and equity holdings — although financial markets have since recovered.[13] Nonetheless, given the high allocation of insurers' assets to bond investments, there remains the potential for losses on investment portfolios as a slowing economy increases the risk of corporate bond defaults.[14] Moreover, with interest rates close to zero, some are looking to take more risk for higher returns (e.g., increasing private credit investment) leaving them more vulnerable to credit downgrades — which require more capital to be set aside — and insolvency risk.[15]

What's more, the EU's insurance and pensions authority is concerned that in cases where there is a high degree of interconnectedness between insurers and banks, risks could spill-over from other economic sectors to insurers' and pension funds' balance sheets. The authority is assessing if structural change in the sector is needed.[16]

Regulatory expectations and litigation

Internationally, regulators are being pro-active over COVID-19 coverage issues. In the majority of countries, business interruption coverage comes as an add-on to commercial property insurance often triggered only as a result of damage to physical property. In the UK, the financial conduct regulator has sought declarations in the courts over the meanings of selected terms with a view to quickly resolving ambiguities. It has also required insurers to manage pro-actively those claims where coverage is in dispute. The Insurance Council of Australia has taken similar steps. Meanwhile in the EU, courts in France and Germany have held in favour of policyholders. In the US, hundreds of lawsuits have been filed on this issue and close attention is being paid to the UK proceedings, as many policies use similar wordings or raise factual issues. Some US states have even proposed legislation, which if passed and held to be constitutional, would retrospectively require insurers to cover business losses related to the virus.[17] In May 2020, the International Association of Insurance Supervisors went as far as warning against such steps that could threaten financial stability.

More generally, where benefits are no longer available or an insurance product is no longer of practical use because of the pandemic, many regulators expect insurers to review products to confirm they continue to offer policyholders value.[18] Insurers have had to offer discounted premiums reducing their income, although fewer new claims are being generated by the slow-down in economic activity. More controversially, at the request of supervisors, many insurers have suspended dividend payments protecting their reserves to the detriment of their share price.

In the aftermath of a crisis, it is usual to see evidence of increased levels of fraud and scams. This time is no exception and the incidence of fraud is expected to increase should the recovery be slow and prolonged. Insurance Europe, for example, expects to see an increase in cases of professional liability insurance fraud during the second half of 2020 or in 2021, due to the economic difficulties experienced by businesses. Moreover, we will see new fraud methodologies using sophisticated digital tools. Undoubtedly, insurers should expect to incur losses and the expense of investigation and litigation.

THE FUTURE IMPACT

Let us look at some of the ways that insurance is changing as a result of COVID-19.

Climate change

The pandemic is providing fresh impetus to environmental, social and governance concerns. Climate change is especially relevant to insurers because of the nature of their business. Life policies such as annuities and endowments have product life spans potentially extending over decades with assets held to match. Non-life general insurance can underwrite risks with long tails, such as asbestos, with claims received many years after inception. General insurance covers weather-related events with extreme events becoming more frequent and, therefore, the potential liability greater.

Insurers are susceptible to three main risks from climate change: first, physical risks such as natural catastrophes damaging property or those that disrupt supply chains; second (and ironically), risks arising from the transition to a lower-carbon economy, when carbon-intensive financial assets are revalued; and lastly, risks from third-party liability claims by those who suffer loss and damage from climate change and then seek to recover from others (e.g., D&O cover).[19] As a result, climate change poses significant risks to the prudential soundness of insurers — their balance sheets — and consequently the protection of policyholders. Insurers have the challenge of pricing policies to reflect adequately these new risks while also ensuring they hold both sufficient, resilient assets against liabilities that may not materialise for decades. Regulators are increasingly focusing on these issues as part of their prudential supervision. ESG can help filter long-term risks to improve investment returns.

Insurers are amongst the largest institutional investors. Insurers and pensions represent approximately 80% of global institutional asset-management business.[20] As is the case for other asset managers, new initiatives are reducing the incidence of greenwashing through better classification of the environmental impact of investments and by introducing new duties of disclosure to investors. Increasingly "soft" law, such as the recommendations of the Task Force on Climate Related Financial Disclosures or TCFD, is being replaced by "hard law," with Europe in the vanguard and other regions following. While this creates a burden on insurers to implement and comply with, it is increasingly a necessity to carry on business rather than — as previously — a marketing opportunity.

Climate change is also creating new opportunities for insurers as long-term investors. To date, there has been a shortage of long-term investment to match liabilities of such duration, but there will be a wider range of higher quality illiquid assets in future (e.g., infrastructure projects to finance low carbon alternative technologies). In Europe, the industry is welcoming the EU Green Bond Standard on the basis it has the potential to become a global standard for green bonds. As we discuss below, while insurers' long-term business models create both a need and an ability to invest in long-term sustainable assets, there are flaws in the EU's Solvency II prudential legislation that create disincentives to do so. If these can be overcome, there is potential for investment in green bonds together with other sustainable investments, remembering that currently 70% of insurers' assets are in fixed income. [21]

Solvency II

Many corporates have taken on an additional debt burden because of COVID-19 and will emerge into the recovery stage over-leveraged. Governments have recognised that this is a constraint on future growth and that additional equity or equity-like finance investments should be developed. Insurers and pension funds with their long-term liabilities are well suited as investors in growth capital. This comes at a time when insurers have been turning to illiquid assets to secure a better rate of return when bonds offer historically low yields, much of it in or backed by property.[22] UK insurers are seeking to take advantage of the end of the Brexit transition period to amend Solvency II to reform the "risk margin" that requires more capital to be held against long-term business such as annuities. Although insurers would like to invest in assets other than government and corporate bonds, such as infrastructure and (in taking over) corporate pension schemes, because the risk margin is very sensitive to interest rates it is consequently volatile. A complication is that while life insurers are in favour of change, non-life businesses that conduct more business in the EU are not so affected — particularly property & casualty insurers, which wish to remain aligned.[23] However, this may be resolved, as EU insurers are lobbying for changes to Solvency II as part of its upcoming review and the European Systemic Risk Board has identified lessons from the COVID-19 crisis that highlight the need for adjustments.[24]

Digitalisation

Like other areas of financial services, the trend toward digitalisation has been accelerated during the COVID-19 pandemic.[25] Prior investment in new technology such as distribution, underwriting, claims management and, where applicable, advice has helped insurers' business models remain resilient during 2020. In fact, they have shown high levels of operational resilience in continuing to service clients by processing claims without excessive disruption and responding promptly to enquiries from customers. Operational risks such as cyber-attacks from home working are reported by the industry to have been well managed, with contingency plans minimising service interruptions. Although networks and ICT systems were stretched, they were sufficiently robust not to suffer major disruption. Insurers, nevertheless, need to invest in maintaining the operational resilience of their systems and controls to limit potential losses and expense on compliance and associated litigation, bearing in mind the increasing legal and regulatory obligations in the area.

InsurTech

In Q2 2020, global InsurTech funding saw a 71% quarter-on-quarter increase to USD 1.56 billion across 74 transactions, as later-stage and corporate venture capital investors adjusted to the initial pandemic shock, although deal numbers were lower than in Q1 2020. [26] Most of this activity was in the US, UK and China. Cyberport, for example, is the digital flagship of Hong Kong with numerous start-ups focused on InsurTech. InsurTech is coming into its own as the result of two developments. First, although the insurance industry has always been data-driven, much more data is now available. In the past, insurance companies relied mostly on answers in response to specific questionnaires and on statistical data. Recent technical developments gather much broader sources of data, including social media and other third-party data. Secondly, analysing this "Big Data" has become much more efficient. New technologies allow the interrogation and analysis of Big Data through the use of algorithms and artificial intelligence tools enabling, for example, more targeted products to be designed or fraud better detected.

With these developments has come market disruption and the emergence of new competitors, some of which are focusing on the most valuable aspects of the insurance value chain reflecting a move toward greater modularity of service provision. Different business lines of insurance are being affected at varying speeds, with the mass market (property & casualty) being the most advanced. To respond, incumbent insurers must either invest to develop the technology necessary to compete, or partner up or outsource with third-party providers. The use of Big Data not only runs up against data protection and privacy laws, but also ethical and regulatory concerns over potential unfairness to insureds. Carriers need to ensure they have the policies and procedures in place to remain compliant and protect their reputation.[27]

In future, successful insurers will be more productive and employ less staff across an automated "value chain" of product, distribution, pricing/underwriting, policy issuance and service, claims, IT and other support functions. We will see both a simplification of insurance products and portfolios to reduce costs and to focus on the most profitable.[28] While reducing future costs, to get there insurers will have to bear the expense of the investment necessary to digitalise their businesses, which for some — given their squeezed balance sheets — will require outside funding.

Pivot to Asia

The importance of emerging markets to insurance has been clear for some time. It has been predicted that China's share of global premiums will rise from 11% in 2011 to 20% in 2029. This would put China on track to become the largest insurance market by the 2030s and for the Asia-Pacific region as a whole including, for example, Singapore, Indonesia, Malaysia, to account for over 40% of global premiums.[29] Apart from the potential size of these markets, their growth is due to a growing and prosperous middle class. A relatively young population expects digital-ready services and is increasingly conscious of its needs, in particular, for health and life insurance given that social security and welfare systems are generally weaker than in European markets. Market penetration for insurance in many jurisdiction is still low, highlighting the potential business available. In China, domestic insurers have grown exponentially over the last decade and include the world's largest insurer by market capitalisation. These businesses have invested in technology, embracing FinTech including artificial intelligence. Just like regional Chinese banks, domestic insurers are now starting to look at opportunities across the region.

Until recently, regulation in China coupled with a lack of market knowledge was seen as a barrier to foreign insurers seeking entry. In light of recent macroeconomic and regulatory changes, however, these factors are less of an obstacle — although a trade war with the West may yet intervene. Assuming that China's economy exits the COVID-19 pandemic in a relatively better shape than other countries — it is the only region expected to have positive GDP growth in 2020 — the Asia pivot is likely to be reinforced. This trend is requiring global insurers to redirect capital from slower growing, more mature markets, as it is a long term and capital-intensive project. Reflecting the stresses placed on balance sheets by COVID-19 claims and the impact on invested insurance premiums, some global insurers are selling local Asian insurance businesses to strengthen their prudential standing or to focus on other markets.[30] This suggests that only the strongest and most digitally ready insurers will fully benefit as these markets grow.

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