OLIVER WYMAN

HOW EUROPEAN INSURERS CAN MANAGE THE IMPACT OF COVID-19

The World Health Organization declared the COVID-19 a public health emergency on January 30, 2020, as the pandemic spread across the world, threatening the global economy.

The situation is fast-moving, with every sector and facet of society affected. In this publication, we share an overview of how European insurers are being impacted as well as priorities to consider going forward.

COVID-19 IN INSURANCE: DISTURBANCE AHEAD

Businesses face immediate challenges, in particular the safety of employees and communities and implementation of business continuity plans. Rather than address these fast-changing issues here, we recommend you visit our Coronavirus hub. The hub is updated daily and contains our COVID-19 primer, perspectives on the epidemiology of the novel coronavirus 2019, updated projections of the potential impact of the pandemic, and our perspectives across industries and functions (including insurance risk functions).

Providing a high-level view of the impact of COVID-19 across insurance in Europe is challenging, given the differences in business models, business mix, and geographical or market-specific distinctions (for example, government-provided healthcare, distribution mix). There is also uncertainty as to how long this crisis will last and the longer-term impact on society and the economy.

We have considered the key emerging issues across commercial lines, personal lines, health, and life insurance. The impact on each area is very different: in some instances it is focused on insurance liabilities, in others on operational challenges, and in still others a change in asset values and Asset-Liability positions. For all, though, a prolonged economic downturn will have a profound impact on future business plans.

COMMERCIAL LINES

Much of the focus of discussion in commercial lines has been on **business interruption**, given the closing of markets, infrastructure, and transport in many countries. There is wide expectation that claims in this area may be limited by exclusions relating to pandemic risks or requirements for infectious conditions to be named. In addition, business interruption policies tend to be linked to some form of physical damage, theft, or cyberattack taking place to trigger a claim. Non-damage business interruption without exclusions will be heavily hit, but that may be a small proportion of the overall business-interruption commercial line. However, there is increasing pressure in many countries from governments, regulators, industry bodies, and consumer groups for claims related to business continuity to be covered under exceptional conditions. Insurers will need to consider carefully their positions here, as there will be a trade-off between maintaining the economic integrity of the business as defined by the terms and conditions, and maintaining customer trust, and hence lifetime value. The implicit social contract between the insurance industry and its customers will come under intense scrutiny – we have already seen the French Insurance Industry commit to contribute 200 million to the country’s Solidarity Fund to support micro and small businesses. Other lines of business such as **event cancellation** and other **contingency protection** could also experience significant claims, although past experience suggests that in some cases pandemic exclusions are also applied. And depending on the length of enforced business shut-downs across countries, we would expect to see an uptick in Property claims, whether legitimate arson and damage, or due to fraud.

However, beyond the business lines that are immediately affected, there will be many more lines affected by second-order effects and the economic recession that is expected to follow the current crisis. For example, there is already evidence of cyber risks increasing, as remote working becomes the norm, introducing vulnerabilities into the system. Interruption of cross-border supply lines and an economic downturn will result in losses in trade credit and associated lines.

Finally, there are business lines that may not attract more claims, but where demand may change significantly over the longer term. For example, marine, aviation, and transport (MAT) and energy volumes are likely to be significantly reduced, given the falloff in global demand.

Over time, the focus will shift from understanding first-order and second-order exposures (and the potential political or wider pressures related to them), to thinking through how the market dynamics will develop in terms of propositions, demand shifts, and price hardening.

PERSONAL LINES

While some personal lines may experience higher claims (such as travel insurance and wedding cancellation), these may also be subject to exclusions, potentially limiting the overall losses. Specialist monoline players will be severely impacted, but these are small parts of the personal lines market. For the larger lines of business, for example motor and home, social distancing measures are expected to reduce claims experience in the near term as homes are occupied more and vehicles are driven less – the longer these measures persist the greater the impact of this on the results overall.

The short-term focus for personal lines insurers is therefore more on the operational challenges relating to maintaining customer service levels. Nevertheless, there could be challenges in key processes relating to sales, renewals, and claims where documents (such as vehicle registration or proof of roadworthiness) need to be physically produced or where "wet" signatures are required. In China, many insurers automatically extended the duration of policies that were up for renewal during the lock-down period. In markets where the level of digitalisation is low, these challenges will be more important. Beyond the business continuity plans for call-center operations and other functional areas, claims fulfilment could be more challenging depending on the availability of the network of services providers. In many markets, this is now fragmented, with third-party provider networks fulfilling these services. A particular focus will be required on assistance services (such as breakdown, home emergency, elderly care emergency assistance), which could be increasingly difficult to deliver at a time where customers are anxious and vulnerable. Maintaining these services to those with the greatest need will be important for businesses.

Over the medium term, the impact of a possible economic downturn will need to be considered. While a benign claims period could lead to premium reductions, increased fraud could somewhat offset this effect and a strong focus on affordability could result in lower retention rates and increased shopping behaviour. Not surprisingly, we are also seeing a dramatic reduction in new car/auto purchases which will reduce the amount of "new new" business into the sector. It remains to be seen again whether this is a short-term dip that will be followed by a surge after social distancing ends, or a more permanent fall in overall demand.

LIFE INSURANCE

The impact on life protection insurers will depend on whether the exposure is more weighted to longevity or mortality risks. This will vary by players and by market.

Where insurers are focused on mortality protection, the deaths directly linked to COVID-19 are not expected to result in very high claims, as the elderly population where the COVID-19 driven mortality rate is highest are not those that are typically covered by protection products. Nevertheless, we have seen markets where the healthcare system has been overwhelmed and are having to apply more widespread triaging, which could result in a spike in mortality across all age groups and demographics. The opposite is true for insurers with high exposure to longevity risk, where we might expect to see releases of reserves over time.

Traditional long-term savings and investment contracts will be particularly affected by the combination of materially impaired assets (equity and credit) and long-term ultra-low interest rates. This will impact unit-linked policies, where material declines in fund values will reduce fee revenues and profits, but especially guaranteed and General Account products where insurers' ability to (re)invest to meet guarantees will be even more challenged than before. We have already seen a significant change in the composition of new money, where the bulk is now coming from existing policies with higher guarantees. As these conditions continue, insurers will have to dip further into their reserves to maintain guaranteed payments. Where these long-term guaranteed products are associated with mortality riders, the combination is particularly negative. Life Insurers will also have to weigh up whether and how to provide premium holidays and other temporary support to in-force policyholders, with the trade-off being maintaining liquidity and cash flow vs. triggering lapses with consequent liquidation of assets.

Most European life lnsurers' balance sheets are holding up well so far (as at the time of writing), off the back of robust risk-based solvency regulation (Solvency II, SST, solvency risk appetite calibrations) and extensive stress and scenario testing. However, as the crisis continues we anticipate particular strain on credit portfolios, and in extreme conditions the risk of a breakdown of the Matching Adjustment process if significant assets get downgraded below BBB. As such, the focus of financial management is on managing down through any trigger levels, reviewing hedging and reinsurance programs, and longer-term management of financial resources.

HEALTH INSURANCE

The impact on health insurance will depend heavily on the role played by the government in each healthcare system, as well as how the current crisis impacts private provision of services. We are increasingly seeing private capacity being redirected or requested to support the emergency public systems; but how these are used and the impact on the broader healthcare space will differ in each market. As such, it's difficult to identify general trends or impact across markets.

In many European markets, testing and treatment of cases relating to COVID-19 is being coordinated by public providers and as such the direct impact on private medical insurance is expected to be limited. The recovery profile, and the role and extent of private "top-up" (for example, moving to a private room/ward once discharged from intensive care) is unclear at this point.

The immediate focus for private medical insurers, however, is dealing with a surge in requests for services relating to access to medical professionals, whether physical appointment booking/fast-tracking or online medical consultations. This is driving additional claims and presenting challenges to deliver the services during a period where customer anxiety over health matters is sky-high. This could turn into a growing challenge for insurers to demonstrate the value of their propositions (already considered unaffordable in many markets) or an opportunity if the demand can be met successfully.

EIGHT PRIORITIES FOR INSURANCE TOP EXECUTIVES

We expect most executives to be focusing on the most immediate priorities linked to operational and continuity challenges, understanding their risks and exposures and balance sheet position in a consistently shifting landscape. Over time, the challenges in each area will evolve and eventually opportunities and actions will need to be considered. The table figure below provides a high-level summary.

Exhibit 1. Current situation, upcoming challenges and opportunities for insurers

	CURRENT STATUS	UPCOMING CHALLENGES	OPPORTUNITY WINDOWS
DIMENSION 1: PROPOSITIONS	• Non pandemic and pandemic coverage (usually reinsured) • Impacts on revenues depending on business lines and footprint (see above) • Continuity plans deployed in order to secure revenues generation	• Propositions adjustment and reputational risk mitigation • Private investments advantage vs. lower yields in public markets • Portfolio defense, including in the next P&C renewal campaign • Higher costs with lower revenues • Efficiency of continuity plans	• Propositions overhaul (to include pandemic risks) • Private investments based products equipment boost • Digital distribution boost • Footprint adjustment • Targeted M&A (e.g. travel and assistance)
DIMENSION 2: OPERATIONS	• Depending on markets' containment level, distribution and back-office operations adjusted to restrictions • Rise in claims to be processed by carriers back-offices… • …and rise in absenteeism with potential patients among employees	• Securing employees and business • Managing additional claims with lower resources • Mitigating costs of claims increase • Securing a reasonable level of quality of service	• Remote work acceleration • Empowering managers • Review of operations make or buy tradeoffs • Fintech/insurtech broaden partnerships
DIMENSION 3: BALANCE SHEET	• Sound solvency levels for the majority of insurers • Absence of toxic assets if compared to 2008 crisis	• Rising credit spreads and risk of higher default for both public and private debt • Continued pressure on equity markets • Pro-longed period of ultra-low interest rates	• Overhaul of financial resource management in new market conditions

Specifically, we see eight priorities for Insurance leadership over the coming weeks and months.

1. **Prioritise across your different activities** to be present for your customers and fulfill their most critical needs, given the potential shortage in resources and drop in operations efficiency.

   Identify your most critical services and processes to maintain customer service and trust, and for which customer segments and products. For example, prioritising support to customers most in need over providing general inquiry support. Introduce comprehensive triage processes to achieve prioritisation with a clear view as to what efficiency and satisfaction levels you are targeting across these different categories. In these times, it is important that all service personnel understand how they should be working, and why, and have clear scripts to deal with difficult customer conversations.

   Finally, reshape the operating model to reduce silos across different service functions. To do this, quickly retrain all service staff in all critical functions to allow for agile redeployment, and plan ahead to anticipate peaks in activity as the government response evolves.

2. **Commercial insurers** should understand the extent and nature of **potential "hidden" pandemic exposures**, particularly in their business interruption lines. While contractually most policies will have material pandemic exclusions, that is not always the case or the wording is not definitive. Moreover we anticipate increasing pressure on the industry by governments and industry lobby groups to honor the "social contract" implicit within insurance – the cost of which would be many multiples of current claims estimates.

   Even if the end result is relatively low payments, a wave of claims accompanied by legal action could be a major cost and hassle for years to come. Insurers should measure their potential exposures to a range of scenarios, be very clear what their current posture is regarding contract terms, and ensure they understand the trade-off inherent between contract terms, maintaining lifetime customer value, and maintaining trust in the industry itself. And be prepared for the social mood to move against them quickly.

3. **Review and optimise financial and risk management strategy** while most European insurers are reporting that their balance sheets remain resilient, most companies' risk and capital management frameworks have not been designed to address this magnitude of global economic crisis. The outlook remains very uncertain, and we could be at the start of a prolonged period of ultra-low interest rates, stressed credit, and underperforming equity markets.

   In this context, it's important for insurers to review their overall financial resource management strategy to ensure it remains relevant to the circumstances. In particular we recommend the stress testing of credit portfolios at a very granular level, drawing on deep sector-level economic analysis to assess underlying counterparty-level exposures, risk drivers and correlations. This allows you to draw out a deeper understanding on where and how losses from downgrades and defaults could arise. This applies as much for the illiquid book as for the traded book, and has specific implications for the Matching Adjustment portfolio.

Reviewing risk appetite frameworks, solvency triggers and actions, and exposure limits to ensure they remain suitable for the environment is also key. In particular, do the proposed actions still make sense? If not, there may need to be formal changes signed off at the board level.

Recovery plans may also come to the fore, and should also be tested for their relevance and implementability. As with previous financial crises, are there advantages to moving early, or do you have the resources to see things out without having to resort to expensive remedial actions?

Longer term, the interaction and trade-offs between maintaining solvency and maintaining dividends will become visible. So much of investor confidence is driven by management being seen to have the situation under control, so be clear to investors how trade-offs are being managed and what is likely to drive changes in stated dividend actions over the medium term.

In time, the pandemic may provide **tactical asset buying opportunities**. However, given the unique nature of the COVID-19 crisis, such a strategy will involve greater speculation than in other financial crises. It is critical that first and second lines work together to ensure that such opportunities are captured within a suitably controlled environment. Many limits frameworks will not have been designed with such extreme circumstances in mind, and may need to be adapted.

4. **Model the potential impact on business plans for the medium and long term as recession scenarios are now confirmed by asking the following questions**

- What are the implications of a deteriorating economy on each of your business lines? Where are your risks/exposure to the economic downturn?
- What is the cost base required to ensure financial resilience over the planning horizon, and what are the implications for business operations?
- How is your business portfolio going to look further down the recession? Are there business segments that are going to be significantly exposed in the mid-long term (such as marine, aviation, transportation, SMEs), and what are the implications for your participation strategy?

5. **Start planning your next moves to protect or increase your market share.**

This can be strategic, such as assessing M&A opportunities in light of the drop in market capitalisations and the specific context of some insurers (accelerating efforts to clean up and optimise life insurance back books).

Or it can be tactical, for example with property and casualty renewals where insurers can adopt defensive or offensive strategies to capture clients through simpler and hassle-free customer journeys, or even the inclusion of pandemic risks and/or specific pricing terms?

6. **Accelerate your digitisation efforts, both for short-term and medium-term needs**

We anticipate that insurers will need to put in place tactical digital operations to replace processes that currently rely on face-to-face interactions (such as agency and IFA distribution requiring a "wet signature"). In the first instance, these need to be optimised to allow for business-as-usual as much as possible. However, this also provides a trigger to accelerate digitisation efforts as the crisis exposes the limitations of existing systems, many of which are decades old. Insurers should strike a balance between short-term band-aid solutions and accelerating more fundamental digitisation efforts.

7. **Role model your organisation and reassure your environment** to increase employee engagement, client loyalty, and investor support. This crisis is challenging leadership models like nothing before, and the risk of undershooting is at least as big as overshooting. In our view leaders should start by reviewing and updating human-resource processes aimed at ensuring employees' physical and mental wellbeing. You should be generous with your time and resources during this temporary shock, and you will be rewarded with greater loyalty and productivity over a much longer term.

   You should also ensure there is consistent corporate communication regarding the company's core values and its current strategy, as well as the new priorities induced by the pandemic. Establishing regular, dedicated communications to share with employees, clients, and partners is also key – without them stakeholders will naturally assume the worst. Finally, consider how to manage and reassure investors. What information will you share in terms of financial results, dividends, and earnings expectations, and with what frequency?

8. **Grasp the opportunity to transform your ways of working**

   We are in the midst of one of the greatest social experiments of modern times, and ways of working are adapting and evolving at an extraordinary rate. Workplace psychologists suggest it takes around 90 days to change habitual behaviours, which means we have a unique opportunity to fundamentally change the way we go about our business. Leaders should pay attention and note all the ways employees are finding to make the business more efficient or effective, and ensure these changes are adopted into future business as usual.

   Equally, this is also an opportunity to move to one side all of the old tropes that prevent the business from making the deeper operational changes that can simplify and transform the business. While the focus for now is on keeping things running and ensuring customers get the service they need in such times, leaders should not miss the opportunity to drive change once the immediate crisis has abated.

These are unprecedented times, and it's likely that our societies and economies will be permanently changed as a result of this pandemic. Insurance has always played a critical role in providing greater certainty to individuals and businesses through risk pooling, risk sharing, and access to long-term investments and savings, which in turn allows for entrepreneurship, economic stability, and growth. This role is more visible and more important than ever before, and the longer-term outlook for the Insurance industry will be strong provided we navigate this near-term turbulence.

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