ISSUE 4: Leaders' commentary on latest crisis developments

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COVID-19
Virtual Roundtable

THE INSURER
Global risk capital intelligence

How will (re)insurers cope with the economic shock?

In this edition:

- ILS – proving the non-correlation case?
- Pricing and demand
- US insurers on the front foot
- Political pressure growing
- European dividend bifurcation
- Exclusion scrutiny continues

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GUY CARPENTER

The economic shockwaves of Covid-19

The past seven days have been arguably the most eventful yet in terms of Covid-19's impact on the global insurance industry.

Regulatory pressure in Europe led to a flurry of cancelled dividends – principally in the UK. The approach, however, was inconsistent depending on the interpretation of the local regulator. Late on Friday, for example, ended with Generali confirming it will pay its dividend.

Thomas Buberl, the group CEO of Europe's largest insurer Axa, encapsulated the frustrations of investors when he questioned the inconsistency.

"It is a relatively difficult to accept that we live in a common Europe," complained Buberl to the Financial Times.

"We have the same capital standards and yet there are very different applications across the different regulators."

As you would gather from his response, French regulatory authority ACPR is adopting the same cautious stance as the UK's Bank of England.

Across the Atlantic, and the US appears the most advanced in debating a long-term solution with a draft PRIA bill in Congress that provides for an aggregate event deductible of $250mn and an aggregate annual cap of $500bn.

US auto insurers also upped a gear last week – the ten largest carriers all unveiled different premium credit schemes in response to the impact the lock-down is having on traffic use.

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> **Thomas Buberl**

On a negative side, pressure on the industry over its reliance on pandemic exclusions continued last week with more negative headlines in many countries' newspapers.

Looking ahead, the economic impact of the lock-down will be a significant theme this week as countries debate how and when to ease the quarantining.

This is a big theme in this week's roundtable.

At the same time, we also explore the role of alternative capital. It's an interesting dilemma. As Guy Carpenter's David Priebe points out, the ILS secondary market performed extremely well in Q1. However, we are also likely to now enter a fallow period for new ILS issuance because of the market turmoil. As the year proceeds, will the sector respond with fresh investor demand underpinned by its non-correlating strengths and can it tackle its Achilles' heel – tail risk? With exclusion wordings in such focus, our panel of leaders also explore this week the dilemma of toughening exclusion wordings at renewal. How concerned should the industry be to the potential threat the Plaintiff Bar will exploit such moves as an admission of cover.

It makes for fascinating reading...

Rebecca Hancock,
News Editor

THIS WEEK'S PARTICIPANTS

Luca Albertini,
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Andrew Horton,
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David Matcham,
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David Priebe,
Chairman, Guy Carpenter

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By adding communicable disease exclusions on renewals and new business, is the industry in danger of a tacit admission that there was exposure in expiring covers?

Luca Albertini: I believe in many instances policy wording is updated in light of perceived lack of clarity, and when insureds try to push for a non-plausible claim. In these cases insurers tend to clarify what is included and excluded for avoidance of doubt.

This is definitely true for emerging risks like cyber, for example, and also for some very old risks which have been widely uninsured such as the impact of a pandemic on commercial enterprises.

We have pandemic risk appetite (subject to being paid a premium), but we have received the cold shoulder from many risk managers.

Andrew Horton: Language that has been added to some policies is to re-emphasise the intent at the time of writing the risk and this gives clarification to clients moving forward.

David Matcham: It would be unusual and irresponsible for insurers not to review policy language in the light of a large loss event. At any renewal an underwriter's role is to evaluate the risk in front of him or her and add clarifications that will be to the benefit of buyer and seller.

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> **David Matcham**

David Priebe: While some policyholders and attorneys have attempted to advance this argument, it fails to account for the simple truth that policy wordings change regularly and for a variety of reasons. Each change does not indicate a prior defect. Policy wording amendments, or the introduction of new exclusions, are made to provide clarity and for the understandable desire to minimise litigation.

American courts, and the British tradition upon which they draw, have long rejected this line of reasoning, characterising it as the mistaken notion that "because the world gets wiser as it gets older, therefore it was foolish before."

Thomas Sepp: Coverage certainty is what matters for all parties involved. Therefore, we have started reviewing policies at renewal to ensure coverage is not exposing us to undesired risk as the further development of the coronavirus pandemic is unpredictable.

Overall, the insurance industry will hardly be able to offer meaningful capacity to their clients for pandemic events which are different to local infectious disease outbreaks. Pandemics challenge the general concept of insurability as a large number of customers globally is affected at the same time and there is no common fund of premiums to indemnify losses which are potentially catastrophic.

The only sustainable large scale solution for pandemic risk coverage is based on a collaboration of insurers, policyholders and governments or capital markets.

What impact will Covid-19 have on the role of alternative capital in the P&C industry? Does it create additional opportunities or will the ensuing financial crisis lead to retrenchment?

Luca Albertini: The attractiveness of ILS to investors has been its diversification benefit at attractive risk adjusted returns. This was proven in 2008 and since then, substantial capital has been committed.

In the short-term, some managers could be affected by redemptions from investors seeking liquidity or seeking to rebalance a portfolio when other losses made ILS investment a larger percentage of the portfolio. In the long-term, the relative performance of ILS in 2020 will sustain fresh capital. However, if political pressure causes losses to alternative capital for risks which were excluded and not priced, investors would be alarmed.

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Andrew Horton: Alternative capital historically has played in the more straightforward parts of the insurance industry such as property catastrophe reinsurance. However, there is the possibility to be innovative and for the alternative capital providers to step into events such as the next pandemic crisis. This will provide more capacity to areas of the world where economic losses are going to be much greater than losses covered by insurance.

A big issue for alternative capital providers is correlation at the tail. Alternative capital is looking for asset classes that diversify away from equity and fixed income risk. The pandemic has proven that it is correlated which may prove a headwind.

David Matcham: Alternative capital is such a big part of the reinsurance and retrocessional markets now. Carriers will continue to evaluate opportunities and participate where they can.

David Priebe: The outperformance of ILS capital during the peak period of Covid-19 market volatility has once again demonstrated the benefit of investment allocations into the asset class. A quick comparison of return between the beginning of February and early March reinforces this point: the S&P 500 was down 23 percent while the Swiss Re Catastrophe Bond Price Return Index fell by just 0.8 percent. This reaffirms the low correlation that ILS has to broader capital markets.

The ILS market has, therefore, performed extremely well so far, and issuances that were in progress through much of March were closed with no issues. This bodes well for the significant opportunities on offer going forward, although there are a couple of near-term challenges that the market must meet.

With more than $4bn of capital being freed up in the second quarter of 2020 from existing ILS opportunities, it is crucial that the ILS market remains open and competitive during this period. Equally important, we believe investors should seriously consider supporting pandemic coverage needs that will inevitably follow Covid-19. After all, pandemic risk has a low overall correlation to financial capital markets and can help diversify investors' portfolios from the most common and frequent financial market risks – namely, recessions, asset bubbles and geopolitical situations.

Thomas Sepp: For capital markets it could get worse before it gets better. However, investors will continue to seek diversification and long-term opportunities in the volatile markets we're seeing and several insurance risks, like natural catastrophe, are completely uncorrelated to capital markets.

We think there will continue to be significant investor interest in accessing insurance risk. For the alternative risk transfer market, opportunities are out there for creative solutions to new problems and situations. However, we don't

see and don't expect a significant increase in transactions directly covering losses related to COVID-19 or pandemics in general.

How do you expect collapsing yields and the hit to investment portfolios from Covid-19 market volatility to affect the commercial insurance and reinsurance pricing cycle?

Luca Albertini: The pricing cycle was on course for a hardening in many areas due to a combination of a changing view of risk and a reduction of available capital, particularly in the retrocession market. The combination of reduced yields and losses in the equity portfolios will further reduce available capital both for primary companies and reinsurance companies.

The combination of all of these elements can only sustain the upward pricing trend for commercial insurers and for reinsurance pricing in particular, as reinsurers add reduced retro capacity at higher cost to investment losses and lower returns.

Andrew Horton: Logically, falling yields should impact pricing in insurance policies. If we look at what happened during the financial crisis from 2007 – 2010, the impact of falling yields had no impact in the short term but may have had a positive impact on pricing in liability policies. Historically, liability policies had run to a high combined ratio, often over 100 percent, and profitability was made up through investment yields.

However, one could argue that liability pricing rose after the financial crisis due to increased claims. If profit isn't made through investment yields then insurers are reliant on their underwriting profit, so generally prices should rise as yields fall. This will be challenging in a recessionary environment.

> "Looking forward from here, capital, as well as loss costs trends and reserve adequacy, are likely to have a more direct influence on pricing
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David Matcham: A loss of investment income will undoubtedly put pressure on insurers to maintain underwriting discipline and sustain the conditions of a hardening market. Hopefully, however, investment portfolios will see a significant recovery as economic activity begins to return to normal.

A more important effect on future pricing is likely to be the claims experiences of different sectors and the future underwriting environment as businesses adapt and reassess risk in the light of Covid-19.

David Priebe: The correlation between lower yields and pricing is well known but there are a couple of important caveats: (1) the impact of interest rate movements takes a few years to materialise fully, given the duration of carriers' asset portfolios; and (2) capital has traditionally had a greater bearing on pricing.

Global commercial insurance and reinsurance pricing was already on the increase prior to the Covid-19 crisis.

Looking forward from here, capital, as well as loss costs trends and reserve adequacy, are likely to have a more direct influence on pricing. The short-term impact of asset portfolio performance is unlikely to be as significant, perhaps with the exception of ILS, where capital availability is more directly impacted by higher credit spreads and the ability to redeploy funds.

Thomas Sepp: The wholesale shift in capital markets will undoubtedly reduce investment income, and many insurers rely heavily on this income to support profitability. We expect that as a consequence of this, insurers will further review their pricing, especially on long-tail lines creating rate momentum in such classes more broadly.

But in any situation, we take the view that we are an underwriting business, not an investment fund, and where we add value is by smart risk transfer on a sustainable basis. In the large corporate space, we have to continue to price risk on a per case/per segment basis – that's no different to our normal approach for these types of complex risks.

What danger is there that insureds will turn away from commercial insurers and self-insure if the industry doesn't relent to political pressure to pay out on coronavirus-related claims?

Luca Albertini: The political debate sets a very bad precedent. The insurance gap is due to bad risk management where known risks like pandemics are not covered and (in some areas) by the expectation that if something happens the taxpayer will eventually bail you out.
This is wrong.

The unfortunate consequences of Covid-19 should push the debate to induce risk managers to buy cover for pandemic and pay the appropriate premium, rather than relying on wording gaps and political pressure to get paid when they know full well this was not covered.

Andrew Horton: Commercial insurers' aim is to pay claims well. Insurers are paid a premium for the risks they take on and are expected to pay claims when insureds suffer from those risks. Some of the political pressures seem to be around getting insurers to pay claims for which they have not been paid for the risk.

> The industry may well cooperate with the government for a state-backed response to the largest incidents
> **David Matcham**

The insurance industry needs to think through how more of our clients' risks can be covered by insurance in return for paid premium, rather than clients instead choosing to self-insure. Self-insurance increases significantly when certain perils become virtually uninsurable. I don't think we're in that situation now, More of a 'business as usual' price correction part of the cycle.

David Matcham: The insurance industry is absolutely committed to paying all valid claims related to Covid-19. It will continue to play a vital role for most companies who are simply not big enough to self-insure against large losses and rely on insurers to help manage an enormous range of business risks.

The specialist nature of the London Market, in particular, can help to develop more effective and innovative coverage for future pandemic scenarios and the industry may well cooperate with the government for a state-backed response to the largest incidents.

It is important to note that pandemic cover has been available in the marketplace and, whilst not widely purchased, has provided valuable protection for a number of clients.

Thomas Sepp: I expect the strong partnership between companies and their insurers – in particular in the large corporate space – to continue. AGCS will certainly honour coronavirus-related claims where they are part of our policies.

We don't see the same potential

for coverage disputes here as in the retail or small business segment.

In the large corporate and industrial segment, you have a sophisticated risk management industry with professional insurance buyers who are well advised by brokers and other experts, and who are deeply familiar with their insurance programs and the contractually agreed terms and conditions.

Most policies are clear on coverage, and where that is the case and cover is in place, speed of claims settlement should be the clear priority.

In fact, we should look at this as an opportunity to demonstrate our claims pledge, especially in sectors such as the entertainment industry where we see a significant number of loss notifications.

Will insurers be able to maintain the momentum on pricing they need to outpace loss trends when many insureds are likely to be experiencing economic hardship and budget restrictions?

Andrew Horton: There is a difference between rate and premium increase. I think there will be a conflict between the need to potentially increase price – as insurance generally has not made much margin over the past three years – and a recession in which companies are cutting back and may reduce their exposures in order to spend less on insurance.

How this conflict plays out will vary by line of business and there are some lines that for several years have been loss making, which is difficult for the insurance industry to sustain.

That being said, insurers are very aware of the challenges many of our clients will have in a recession and therefore need to be thoughtful in how to provide the right coverage at the right price.

David Matcham: Claims profiles may well ensure that market hardening continues and that rates are maintained in a number of sectors.

> "I think there will be a conflict between the need to potentially increase price[...] and a recession
> **Andrew Horton**"

Yet it does not follow that overall premium income will increase and insurers could well see a loss of income as insured values fall and there is less business available. An economic recession, in itself, will also have an impact on underwriting as, for example, directors and officers' claims tend to rise in times of hardship.

David Priebe: The economic shock of Covid-19 has brought huge challenges to households and businesses, many of whom were already paying more for insurance protection in the lead up to the current situation.

However, the key drivers behind these rate increases – including shifting views (and appetites) of risk, higher loss cost trends and deteriorating loss experiences – will likely be exacerbated by the Covid-19 pandemic.

While some lines of business may be impacted more than others, the need to sustain, or even accelerate, price increases in stressed areas of the primary market is clear.

Whether these rate rises can compensate for the level of premium slippage carriers will inevitably experience from the collapse in economic activity is another matter.

Obviously, pricing adequately needs to account for a lower premium base, but much will depend on how quickly economies can recover.

Thomas Sepp: It is certainly a time when relationships and partnership come to the fore: we still have to write risks on a sustainable approach, and by accepting the risk we also accept the claims when needed.

For AGCS that means continuing a case-by-case approach based on technical assessment and pricing of each and every risk.

Generally, we are committed to take a consistent approach that is fair to all, and which reflects the risk that we are carrying and the claims we're paying.