STEPS 2/20

Massive state support in response to the COVID-19 pandemic highlights the markets' vulnerability

The COVID-19 pandemic has hit the global economy at a sensitive moment. The crisis does cause an unprecedented economic downturn, challenges the health systems and will cause major capital market uncertainty over the long term. Within ten years since the last upheaval, the global economy now faces its third cross-regional and even global crisis since the turn of the millennium, following the severe economic turmoil triggered by the terror attacks in September 2001 and the 2008 financial crisis. However, the lasting impact of COVID-19 on growth distinguishes it from the previous crises. In January 2020, the International Monetary Fund (IMF) predicted global growth of 1.9% for 2020. It has since revised that prediction to a -4.9 % downturn, which is set to impact the developed economies in particular.

The response of the central banks and politics to these events has consistently been to loosen financial and monetary policy for the benefit of the economy and society. The current pandemic is not different, as the markets have again been promised «whatever it takes» to cushion the shock of a sudden economic downturn.

The US alone has pledged approximately USD 2,800 billion in financial aid. The EU will prepare an EUR 750 billion recovery fund for its member states and a seven-year budget of EUR 1,074 billion. At the same time, France and Germany will provide EUR 500 billion and EUR 1,000 billion respectively in subsidies, loans and tax relief to their own economies. The central bank measures offer additional support.

Moreover, there is widespread consensus that these measures are necessary to prevent an even more severe recession. Nonetheless, global developed market debt has increased from 70 % of the Gross Domestic Product (GDP) to over 105 % in the past ten years. The IMF believes the current measures for economic aid will increase this figure to a steady 122 % in the developed world by the end of 2020.

Notwithstanding the scale of the support, we are not convinced as to its effectiveness. The political position seems to be that the cost of national debt is negligible. That is diametrically opposed to the economic viewpoint. As demonstrated by the US economists Carmen Reinhart and Kenneth Rogoff in their famous 2010 paper «Growth in a Time of Debt», debt incurred to combat flagging income and production weighs on future demand. This structurally weakens growth, as the measures don't quite provide the increase in income necessary to service the debt and promote investment. It would make more sense to apply the funds where they would bring more than a short-lived feel-good factor since the growing debt detracts from the relative benefit derived from always resorting to the same measures, which simply make the global economy more vulnerable in the event of future crises.

After the lockdown, the developed economies could find themselves in a deflationary phase, possibly of Japanese proportions. The massive excess capacity in some economic sectors such as aviation, tourism or entertainment needs to be balanced out. The corporate world will adapt its marketing to the new reality, thereby expanding their online presence and investing more in process digitisation and cybersecurity. Unsettled by the high drop in corporate revenues, growing insolvencies and rising unemployment, which may well average out at just under 10% in the eurozone, private households will consume less, but save more. However, if the political response to the crisis is to increase borrowing, this will simply dampen future growth.

SI Re expects an initial short-term recovery in the eurozone in 2020 and the start of 2021. Following that, we envisage a stagnation or possibly a slight economic downturn. We thus share the view of the World Bank that the economy will not, as previously predicted, return to pre-crisis levels by the end of 2021.

The consequences of COVID-19 for the insurance markets remain quantifiable for now

Ideally, a well-diversified insurance sector displays a low correlation to the various asset classes. That is one important factor underpinning the security provided by insurance policies. The turbulence that impacted the insurance sector in the first quarter of 2020, thus initially manifested itself in the investment side of the business. From the end of January, equity funds broadly collapsed by about 30% . On the bond front, the corrections mainly affected specific COVID-19-sensitive loans. Hidden reserves, accumulated during the previous year, were erased and transformed into unrealised losses. Depreciation in value totalled 30% of investments.

As a result, the solvency ratios of insurers in Switzerland dropped by 30 percentage points on average. In the meantime, the capital markets recovered as news of the seemingly limitless bail-outs emerged in the second quarter. As such, solvency ratios are just below pre-crisis levels.

The insurance industry was able to withstand the turmoil during the first half of 2020 due to its good capitalisation, as the solvency test includes pandemic scenarios in its solvency quotient calculation on an annual basis. Fortunately, the pandemic scenarios accurately reflected the consequences of COVID-19.

The rating agency Fitch forecasts a rise in the reinsurance industry's combined ratio from 101.1% to 103.5% for 2020. Non-life reinsurers are therefore likely to post an underwriting loss for the fourth consecutive year. Willis Re concurs with a forecast of pre-tax losses in the region of USD 30 billion for the global reinsurance capital base. While equity capital in the reinsurance sector will thus fall by around 5% , the return on equity will fall from 9.6% in 2019 to a mere 0.6% for 2020.

The impact of COVID-19 on the insurance sector

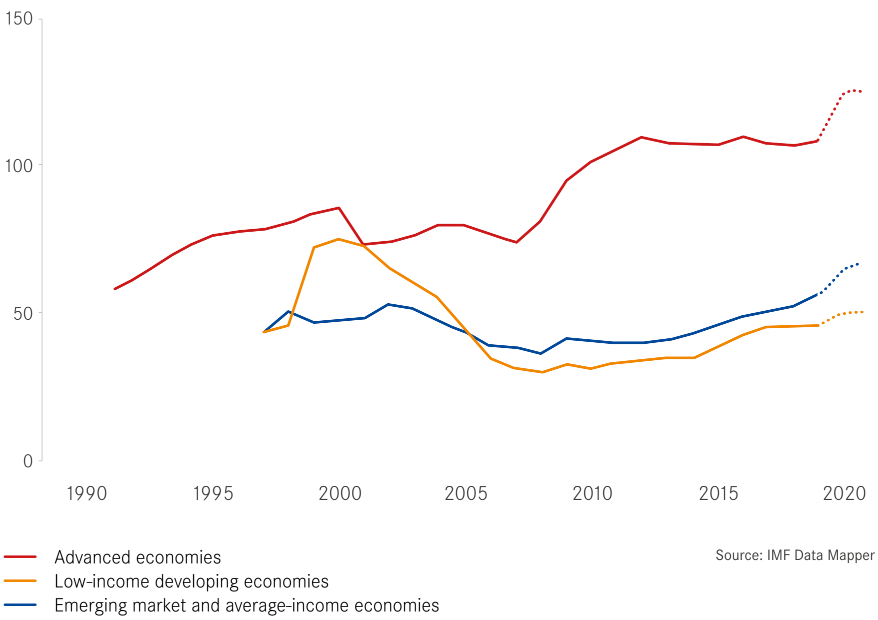
There is considerable uncertainty over the volume of claims resulting from the pandemic. Insurers and reinsurers have reported USD 20.5 billion in claims to date. In its top-down approach based on industry exposure, Willis Re sees losses amounting to USD 30–80 billion, depending on the claims scenario.

From an insurance perspective, insured losses are comparable to those of natural catastrophes, i.e. USD 67 billion a year on average over ten years (2009–2019).

In Europe, the main claims burden in the non-life business stems from policies covering the cancellation of cultural and sporting events.

There were also business interruption claims under fire insurance policies, as some insurers provide epidemic cover for business closures due to infection. The distinction between epidemic and

FIGURE 1: PUBLIC DEBT IS RISING STEADILY IN THE DEVELOPED MARKETS
(Gross debt position (as % of GDP))



Source: IMF Data Mapper

pandemic was not clearly defined in the majority of the cases, and the industry is paying for that now. Contract wordings need to be adapted to clarify that distinction.

Furthermore, travel and legal protection insurance, export and credit insurance as well as public liability are all affected both in Europe and worldwide.

There are also signs, alike during the financial crisis, that COVID-19 will lead to defaults in mortgage-indemnity business (insurance against the risk of non-payment of mortgage loans). In the US especially, mortgage-indemnity providers have been posting rising losses as growing unemployment due to the lockdown means more private households have not been able to keep up with their loan payment obligations. Consequential claims will be likely to occur, since insurers cede most of their risk to the alternative capital market or reinsurers through excess-of-loss policies.

However, some claims burdens were reduced due to the lockdown as a result of business and social activities being restricted to an unprecedented extent. As a result, motor insurers and, in some cases, project insurers may benefit.

Ultimately, insurers will face lower premium volume in some business lines, particularly those where premiums are related to the insured party's turnover such as fire business interruption, project or marine insurance. Premium deferrals or waivers may also materialise for some professional groups that experienced pecuniary difficulties during the lockdown.

The economy must become more resilient

The COVID-19 pandemic outlines that, following the preceding two crises – the terror attack of 9/11 and the financial crisis – the global economic system is able to provide enormous sums to cushion the effect of a sudden economic downturn. However, these funds are unlikely to trigger the dynamics required to ward off deflation. This may result in government debt becoming unmanageable, thus limiting the scope to counter future crises effectively. A rethinking of macroeconomics is absolutely necessary.

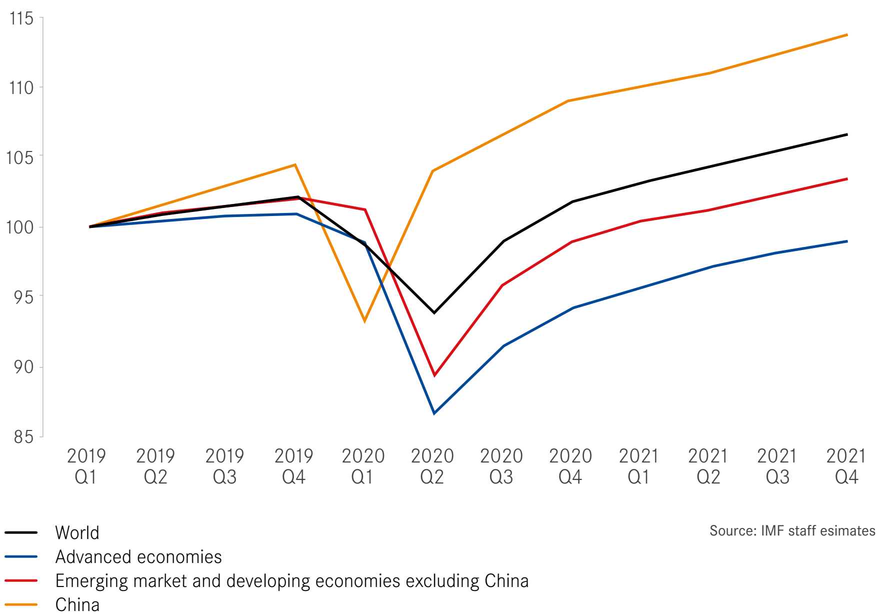
During the crisis, insurers showed that their investment strategies account for the requirements of their insurance obligations. Insurers who pursue a very cautious investment strategy, as SI Re does, emerged practically unscathed from the volatility of recent months.

The general economy needs to become more resilient and robust to be prepared for future crises. The corporate sector will ever less be able to rely on their federal governments for intervention to the extent seen during the COVID-19 crisis in case of an unforeseen situation or event for which no party can be held liable. Businesses need to put more effort into making their own provisions. However, the state can contribute through tax incentives so companies can use profits to accumulate reserves.

The (re)insurance industry in particular with its long-term balance sheet liabilities should be enabled to form extra volatility reserves for investments before taxes. It would then be better equipped to withstand extreme market fluctuations. Hand on heart, there is no real substance behind the current stock market highs and they will have to be corrected to a realistic level in the not too distant future.

In view of the extent and systemic nature of the pandemic risk, additional measures will be necessary to provide the required cover. The insurance market does not have sufficient capacity in itself to bear the risk of an accumulation of insured events, capital market collapse and recession caused by a pandemic.

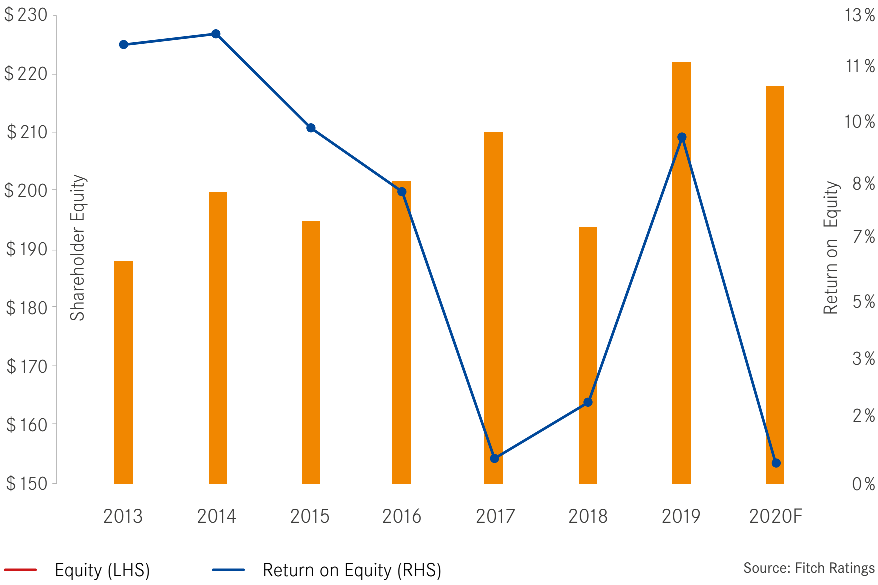
FIGURE 2: QUARTERLY WORLD GDP
(2019: Q1=100)



Source: IMF staff esimates

Premium costs would also be extremely high due to the limited scope for diversification. A public-private partnership, however, could improve insurability and mitigate the risk. One solution could be to form risk pools as already done for the coverage of terrorism or natural catastrophe risks. Insurers join together for those events and cover the risk up to a certain level. When losses exceed a predefined threshold, the respective federal government contributes or assumes liability. That is how, for example, Extremus insurance in Germany or Pool Re in the United Kingdom are organised, both of which cover terrorism risks.

FIGURE 3: CORONAVIRUS LOSSES WILL LIMIT RETURN ON EQUITY IN 2020



Source: Fitch Ratings

Note: Data represent peer group of reinsurers monitored by Fitch, excludes Berkshire Hathaway

SIGNAL IDUNA
Reinsurance Ltd

A subsidiary of
SIGNAL IDUNA Group

Bundesplatz 1
Postfach 7737
CH-6302 Zug
Switzerland
Telephone +41 41 709 05 05
Fax +41 41 709 05 00
www.sire.ch