COVID-19 Will Test Insurers' Resilience

March 25, 2020

Key Takeaways

- The capital strength typical of the insurance sector will help stave off widespread downgrades across the global industry as it faces the COVID-19 pandemic.
- That said, the situation will exacerbate existing weaknesses and we anticipate some targeted downgrades or outlook changes over the coming weeks as we actively review and stress our insurance ratings.
- Life insurers are more at risk, particularly those with relatively thin capital buffers and significant exposure to financial market volatility through their asset portfolios or product offerings.
- We are retaining our stable outlooks on the life insurance sectors in North America and EMEA, but revising the outlook for the APAC life insurance sector to negative.
- Regulatory solvency ratio volatility could increase deferral risk for hybrids. Issuers' capital management and mitigation actions, as well as possible supervisory interventions, will continue to be key to our rating analysis of hybrids.

PRIMARY CREDIT ANALYST

Dennis P Sugrue
London
(44) 20-7176-7056
dennis.sugrue
@spglobal.com

SECONDARY CONTACTS

Simon Ashworth
London
(44) 20-7176-7243
simon.ashworth
@spglobal.com

Tracy Dolin
New York
(1) 212-438-1325
tracy.dolin
@spglobal.com

Volker Kudszus
Frankfurt
(49) 69-33-999-192
volker.kudszus
@spglobal.com

Eunice Tan
Hong Kong
(852) 2533-3553
eunice.tan
@spglobal.com

ADDITIONAL CONTACT

Insurance Ratings Europe
insurance_interactive_europe
@spglobal.com

As COVID-19 continues its rapid global spread, the economic impact has worsened sharply. Nevertheless, S&P Global Ratings expects that the insurance industry's robust capital position and limited exposure to loss-affected lines of business will enable most insurers to absorb the impact of financial market volatility and manage the marginal increase in claims.

The rate of infection is accelerating globally and the center of the pandemic has shifted from China to Europe and the U.S. The World Health Organization designated the outbreak a pandemic on March 11, 2020. We forecast that the global economy will be in recession in 2020 as a result (see "Global Macroeconomic Update, March 24: A Massive Hit To World Economic Growth," published on March 24, 2020).

The economic disruption associated with the pandemic, combined with the collapse in oil prices and resultant extreme volatility in the capital markets, will have severe implications for global credit markets. That said, average rating across the industry is 'A', the highest average rating for any corporate or financial services industry we rate. As with other investment-grade issuers, we don't anticipate widespread downgrades across the industry.

Nevertheless, some ratings will be affected. To date, we have downgraded one insurer and placed two insurance ratings on a negative outlook or CreditWatch. In each case, the implications of

COVID-19 had compounded other factors, causing creditworthiness to deteriorate.

Sector Outlooks Largely Remain Stable

We consider that life insurance companies are more at risk of negative rating actions as a result of the pandemic than non-life players, because they have larger exposure to financial market risk. Table 1 describes our outlooks on the largest markets we cover.

Asia-Pacific's life insurance sector is in for a rough ride as turmoil in the investment market intensifies. Against a backdrop of investment market rout and a recession, we anticipate the region's insurers will see contracting capital buffers and weaker profitability in 2020 and 2021. Consequently, we revised the outlook for the Asia-Pacific life sector to negative. We consider the resurgence of legacy negative-spread policies in markets such as Taiwan, Japan, and Korea, combined with slower new business growth momentum, is bound to dent profit margins for the region's life insurance companies. In order to prepare for the impact of a flat yield curve, life insurers will likely need to shore up higher reserve provisions, hampering capital buffers further.

We are retaining our stable outlook on the EMEA life insurance sector. Ratings on EMEA life insurers benefit from strong capital positions that should be able to absorb recent capital market volatility. In many EMEA regions and product lines, life insurers can share investment losses with policyholders, and we recognize policyholder capital like the provision pour participation (PPE) in France and the free Rückstellung für Beitragsrückerstattung (RfB) in Germany as additional capital buffers that support our ratings. For life insurers, low interest rates will lower investment margins, however, we have identified this as the key risk for EMEA life insurers for some time and believe this is embedded within the current ratings.

We are maintaining our stable sector outlook for North American life insurers. We believe that most are well positioned to handle the immediate impact of COVID-19, given that they have built up of good capital buffers and liquidity. We have witnessed an evolution over the past decade toward more risk-sharing with policyholders through structural changes in product designs and via repricing and moderation of guarantee benefits. Likewise, the rising popularity of adding macro hedges on top of dynamic hedges should better protect financial strength in times of stress, although these strategies vary widely by insurer.

We are also maintaining stable outlooks for the regional non-life and reinsurance sectors as they all exhibit robust capital positions and have more prudent asset allocations that are less exposed to financial market volatility. In addition, their underwriting margins are expected to be largely stable in 2020 due to pricing discipline and limited losses from the pandemic.

The U.S. health industry outlook also remains stable as strong capital levels among the private health insurers and increased level of diversification and noninsurance flows among publicly traded insurers should mitigate credit risk arising from the expected profitability pressures. We will continue to track the spread of COVID-19 and related impact on medical services. We may revise the outlook if containment efforts fail to slow down the spread and medical services utilization reaches a level that would meaningfully affect capital levels at these insurers.

Table 1

Outlooks Remain Broadly Stable, but Life Insurance Sectors Under More Pressure

Region and Sector	Sector outlook (12 months)
Western European primary life insurers	Stable
Western European primary non-life insurers	Stable

Table 1

Outlooks Remain Broadly Stable, but Life Insurance Sectors Under More Pressure (cont.)

Region and Sector	Sector outlook (12 months)
Global reinsurers	Stable
U.S. property/casualty insurers	Stable
U.S. life insurers	Stable
U.S. health insurers	Stable
Asia-Pacific primary life insurers	Negative
Asia-Pacific primary non-life insurers	Stable

Where Are The Pain Points?

The pandemic has had far-reaching implications for the global economy, disrupting supply chains; changing demand for goods, services, and commodities; and, most importantly, causing fundamental changes to the daily lives of people in the affected countries.

Insurers' creditworthiness is likely to be more affected by the stress on financial markets than through their insurance risk. The trifecta of unprecedented low or negative interest rates, credit deterioration, and a declining equity market will chip away at insurers' financial strength, particularly for life insurers, by eroding capital and earnings. If the situation worsens, or lasts for a prolonged period, we expect that these factors will lead to more rating actions.

The insurance-related risks, such as increased claims and top-line pressures, are less significant risk factors for the industry as a whole. That said, specialist writers of loss-affected lines and those dependent on face-to-face sales could experience earnings deterioration or reduced market presence, respectively, as a result of the pandemic.

Financial market volatility presents the biggest risk

Financial markets have reacted to the rapid global spread of the virus in recent weeks, with global equity markets down over 30% and corporate bond spreads widening significantly by 40%-120%, depending on the sector. For insurers across all lines of business, we are evaluating the potential for financial market volatility to inflict losses on capital or earnings via their invested assets. We consider that disruption to the financial markets is the most likely reason why insurers' creditworthiness will deteriorate.

Insurers' capital positions could be eroded as the global equity markets continue to decline and spreads on corporate bonds widen, or because these factors cause corporate downgrades or defaults to spike. We consider that the volatility observed in the equity and bond markets to date could, in many cases, lead to material losses if insurers are required to mark to market.

Capital buffers are a key strength for the insurance sector globally. For most insurers, we expect their current and projected capital and earnings to be sufficient to absorb material losses from the market shock. However, insurers that demonstrate weaker capital positions or run their business to tighter capital levels will be more at risk if the volatility continues. We are closely monitoring insurers that have significant exposure to the financial markets in their proprietary investment activities or, in the case of life insurers, through the products they offer to

policyholders.

Although most insurers claim to hold their investments for the very long term, many who report under U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS) classify most investments as "available for sale" and not as "held to maturity." As a result, when the market moves for a prolonged period, insurers have to recognize the valuation impairments. As the investment risk is asymmetric, non-life insurers bear all downside if their investments underperform. Even in life insurance, where investment profit and loss may be shared between the insurer and the policyholder, the insurer is generally left with higher risk than the insured. This is a major risk to the insurance sector and a key source of negative pressure on ratings.

In light of the significant declines experienced in the world's major equity markets in recent weeks, we are paying particular attention to insurers that have significant equity holdings. Similarly, we are tracking insurers' sensitivities to movements in interest rates and spreads and looking closely at those that have material holdings of bonds rated 'BBB' or below, as these variations in valuations of bonds or increased risk charges in the event of widespread rating transitions would lead to accounting losses and significant swings in regulatory solvency positions.

For life insurers in particular, we are also analyzing the potential for outsized losses due to the products they offer. Although product features vary across markets, many products offered by life insurers offer some form of guaranteed return to policyholders over the life of the policy. These products present an asymmetric risk to insurers because they must accept losses when policyholders redeem or surrender their policies in a moment when asset valuations fall below the guaranteed minimum amount of redemption or rate of return. This risk is heightened in times of financial volatility and can lead to losses in insurers' earnings and capital positions, especially if surrender rates spike.

We are considering insurers' exposures to financial markets on an absolute basis and in relation to current and forecasted capital positions, while also accounting for the effectiveness of hedging strategies and credible mitigating actions by management teams. Although it is not part of our base case, a severe and prolonged market correction could have more damaging implications for insurers' earnings and capital positions in 2020.

Insurance claims should be manageable

The human tragedy of this pandemic should not be forgotten. As of March 25, there had been nearly 425,000 confirmed cases globally, and nearly 19,000 deaths. The containment and social distancing measures being encouraged or enforced in many countries will lead to significant economic losses and a loss of livelihood for millions of individuals, especially if prolonged.

Insurers will face claims on life insurance policies, as well as non-life and health insurance policies. We anticipate that most insurers will be able to withstand the resulting losses

The fatalities and need for medical care will cause an increase in mortality and medical claims for insurers. However, to date, the observed fatality rate suggests that the increase in mortality-related insurance claims will have a limited impact on the global life insurance industry. For example, we performed hypothetical stress tests on the U.S. life insurance industry; based on the results, a moderate mortality stress similar to the 1957 Asian flu would result in $7 billion of additional mortality claims, equivalent to about 2% of capital in the U.S. life market. By contrast, a severe mortality stress based on the 1918 Spanish flu would result in $52 billion of additional claims, or 12% of capital (see "Amid Coronavirus Outbreak, S&P Global Ratings Looks At How A Hypothetical Pandemic Could Affect U.S. Life Insurers," published on Feb. 14, 2020)

Business interruption exposure is limited due to standard virus exclusion

The containment and social distancing measures first put in place in China and now being embraced more widely in Europe and the U.S. are hindering economic activity; dampening productivity; and, in some cases, causing factories or businesses to close.

Most standard business interruption (BI) and aviation policies only cover losses from physical events--this excludes infectious diseases (see "EMEA And U.S.-Based Re/Insurers Likely To Take COVID-19 In Stride", published on Feb. 24, 2020). Although this should limit commercial insurers' exposure to losses from this line of business, in the U.S. and Europe, we are seeing some political inferences as to whether BI policies should cover more. For example, legislation was to be proposed in the U.S. state of New Jersey last week that would retroactively override the standard exclusion for virus-related losses in BI policies written in that state.

In the end, the proposal was not discussed by the state assembly. However, legislation such as this would effectively put BI writers in that state squarely on the hook for these losses if the legislation passes. If similar legislative initiatives successfully proliferate to other jurisdictions around the world, commercial insurers could bear much of the brunt of the economic disruption from this pandemic. We are watching these developments closely and will be monitoring insurers that write significant BI covers.

Other non-life losses will be concentrated in niche writers

Border closures, restrictions on travel, and large public gatherings in many countries will also lead to a spike in claims on certain non-life lines of business, including, credit, bond, mortgage and travel insurance as well as event cancellation contingency policies. Although none of these lines of business are material in the global context--for example, contingency represents about 1% of premium written in the Lloyd's specialty insurance market--some niche or specialist writers focusing on these lines of business will suffer outsized losses.

Medical care coverage costs curbed where government support exists

In many countries around the world, national health schemes or explicit government funding commitments are expected to pick up the tab for the rising medical costs associated with treating COVID-19; this will limit losses for insurers.

However, in the U.S., where health care costs are typically borne by the individual and often passed along to private health insurers, an increase in medical care costs would have negative, but likely manageable implications for insurers. In a recent report, we estimate that in the event of a moderate morbidity stress scenario, the medical loss ratio (MLR) would increase to 88%-89% from an average of 85%, while in a severe stress scenario the MLR would increase to 95%-97%. In both cases, the market's earnings would be consumed and capital would be eroded (see "Morbidity Stress Test: How A Hypothetical Pandemic Could Affect U.S. Health Insurers," March 12, 2020).

Solvency ratio sensitivity is an issue for some hybrid issuers

Some insurers have issued hybrid capital instruments that have coupon deferral requirements tied to a regulatory solvency ratio. For these insurers, it is important to monitor the sensitivity of their regulatory solvency ratios to equity or credit spread movements. Investors in these hybrid

instruments could be at heightened risk of having their coupons deferred if an insurer's solvency ratio drops below such a contractual threshold. We may reflect this increased risk of coupon deferral to hybrid investors by widening the notching between the ratings on the hybrids and the rating on the issuer itself (see "Hybrid Capital: Methodology And Assumptions", published July 1, 2019).

We are closely monitoring the solvency ratios and their sensitivity to market movements for those issuers that have issued rated hybrids that include these mandatory deferral features. These are most common in EMEA and Bermuda.

Market access could be tested by the new financing conditions

The turmoil in the financial markets presents a risk to issuers that need access to the market for refinancing or new issuance. We anticipate that the largely investment-grade-rated insurance sector is unlikely to face this risk as acutely as speculative-grade corporate issuers. Nevertheless, most global equity markets have seen significant declines and, in many cases, spreads have widened by significantly over the past month. For instance, U.S. insurance spreads have increased over 40% since mid-February. As a result, a few U.S.-based insurers that successfully issued senior and subordinated debt earlier this month at favorable coupons had to pay more spread. Some insurers may turn to liquidity programs such as credit facilities or commercial paper programs to ease any pressures in this difficult environment. This could have short-term implications for leverage.

If bond issuances dry up for a significant period of time, insurers with bonds due to mature during that time could face some capital pressure if they cannot refinance them. Where instruments are up for call, insurers risk alienating investors if they decide against the call due to refinancing risk. Many insurers have taken advantage of low rates in recent years to prefinance upcoming calls, up to 12-24 months in advance. This will help them to alleviate the pressure of upcoming calls. We are closely monitoring the capital positions of issuers that have debt instruments approaching a call or maturity date.

Top-line pressure could follow where sales channels are shut down

For some insurers, business generation relies heavily on face-to-face interactions between agents and customers. These companies, which include bancassurers and many life insurers in Asia and Latin America, are likely to see a slowdown in sales because social interactions have been curbed as part of government containment measures.

Asian and Latin American insurers that use door-to-door sales are likely to be most affected; we expect to see significant top-line declines in 2020 in markets like China, Hong Kong, and Singapore, particularly in the first half of the year (see "Chinese Insurers' Earnings Will Erode Amid Coronavirus Outbreak", published on Feb. 4, 2020). Concerns over human-to-human transmission of the virus will likely mean that Hong Kong's cross-border sales to Chinese visitors will see a sharp slowdown, reducing overall premium revenue. This combination contributed to our downgrade of Hong Kong-based MetLife Ltd. last week (see "MetLife Ltd. Downgraded To 'BBB' On Deteriorating Business Position; Outlook Developing," published March 13, 2020).

Insurers Appear Resilient, But Situation Is Moving Fast

The scope and scale of the coronavirus pandemic has caught many by surprise. This is not unexpected as it is unprecedented in modern times and has been exacerbated by the interconnected global economy, increased human mobility, and stretched supply chains.

We believe we have identified the channels through which this evolving event could erode insurers' creditworthiness. Capital market exposure across almost all asset classes will be the most vulnerable channel, and the one most likely to trigger negative rating actions. Although we don't anticipate widespread downgrades, the companies that are most exposed to the financial market volatility could see targeted downgrades or outlook revisions.

Developments continue to emerge rapidly and we are constantly monitoring insurers that have significant exposure to these risks. We will continue to provide updates to the market as material developments occur, or our views change.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak between June and August, and we are using this assumption in assessing the economic and credit implications. We believe measures to contain COVID-19 have pushed the global economy into recession and could cause a surge of defaults among nonfinancial corporate borrowers (see our macroeconomic and credit updates here:
www.spglobal.com/ratings
). As the situation evolves, we will update our assumptions and estimates accordingly.

Related Research

- Global Macroeconomic Update, March 24: A Massive Hit To World Economic Growth, March 24, 2020
- Hanwha General Insurance Co. Ltd. Outlook Revised To Negative On Group's Weaker Profitability; 'A' Ratings Affirmed, Feb. 25, 2020
- MetLife Ltd. Downgraded To 'BBB' On Deteriorating Business Position; Outlook Developing, March 13, 2020
- Alandia Forsakring Abp 'A-' Ratings Placed On CreditWatch Negative After Negative Underwriting Performance, March 17, 2020
- Morbidity Stress Test: How A Hypothetical Pandemic Could Affect U.S. Health Insurers, March 12, 2020
- EMEA And U.S.-Based Re/Insurers Likely To Take COVID-19 In Stride, Feb. 24, 2020
- Amid Coronavirus Outbreak, S&P Global Ratings Looks At How A Hypothetical Pandemic Could Affect U.S. Life Insurers, Feb. 14, 2020
- COVID-19 Credit Update: The Sudden Economic Stop Will Bring Intense Credit Pressure, March 17, 2020
- Chinese Insurers' Earnings Will Erode Amid Coronavirus Outbreak, Feb. 4, 2020
- Latin American Banks Will Cope With Coronavirus Fallout But At The Expense Of Asset Quality, March 24, 2020
- Mexican Insurers' Solid Capital And Liquidity Help Counteract Impact From COVID-19 Outbreak,

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