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CORONAVIRUS AND FINANCIAL STABILITY RISKS FOR UK AND EU INSURERS

Carriers have proven resilient to the onslaught of the Covid-19 pandemic, but significant concerns remain

In July, the European Insurance and Occupational Pensions Authority (Eiopa) published its 2020 financial stability report for insurers and occupational pensions schemes in the EU, providing a quantitative and qualitative assessment of potential risks in the sector.

While the report acknowledges the industry was well capitalised to manage the initial effects of the coronavirus pandemic as a result of the risk-based approach adopted in the Solvency II regulations, it has identified a number of risks insurers will need to consider as the long-term implications of the pandemic continue to unfold.

The financial stability objective is largely two-fold: it aims to tackle systemic risks and maintain the resilience of the macroeconomic environment as a whole. In terms of materiality, the top challenges Eiopa identifies for insurers relate to investment and underwriting profitability, solvency position, exposure to banks and cyber risk. Unsurprisingly, coronavirus-related risks dominate the findings, given the sheer scale of the anticipated economic downturn remains unknown.

In terms of profitability risk, Eiopa says low interest rates, which are expected to remain as central banks try to sustain the economy, will drive down insurers' returns on investments. There is concern this risk will be compounded by reductions in loan and dividend returns, as the knock-on effects of a recession unfold. Both the Prudential Regulation Authority (PRA) and Eiopa warn the scale of certain risks, such as underwriting profitability, has yet to materialise. In the UK, the potential insurer liability for business interruption claims is as yet unknown – depending on the final outcome of the recent Financial Conduct Authority test case.

On the solvency side, the report identifies several effects of the Covid-19 outbreak that could weaken insurers' solvency positions, including falling revenues due to premium holidays and a surge in bad debts. The looming risk of rating downgrades due to market volatility is also expected to devalue insurers' assets – which could affect own funds positions and solvency ratios. In fact, the PRA report warns credit downgrades are a key challenge for life insurers' matching adjustment portfolios. To preserve their capital position, both regulators reiterate previous calls to defer all discretionary dividend distributions and share buybacks.

More generally, Eiopa highlights mass remote working arrangements have increased cyber attacks and this has put a further spotlight on cyber risk. The interconnectedness of the banking and insurance sectors could also cause a spill-over of the above risks.

Both UK and EU regulators have already taken steps to address some issues, including the relaxation of supervisory reporting and disclosure deadlines in March 2020 to facilitate business continuity for insurers and the introduction of state aid systems to backstop trade credit cover.

Eiopa also recommends firms adopt a prudent approach and mitigate the impact of Covid-19, including by identifying any affected products early on and considering proportionate remedial action to treat customers fairly. Firms will also need to closely monitor the evolving situation, update their risk and capital assessments and to take appropriate management actions to manage the impact on their balance sheets to meet the PRA's expectations. The autumn review of Solvency II, both at EU and UK level, will no doubt provide another forum for legislating on emergency measures to mitigate these risks.

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