



Brussels,

**NOTE FOR THE ATTENTION OF FSC**

**Subject: COVID-19 and the insurance sector – preliminary analysis of impact and possible measures**

*The present note is meant to support discussion at the conference call of the Financial Services Committee of 27 March. It does not represent an official position of the European Commission and does not intend to engage the responsibility of the Institution as such.*

**1. Introduction**

This note provides a very preliminary analysis of the impact of the COVID-19 pandemic on the insurance sector, and an overview of possible mitigating measures. The precise first impact of the pandemic will only be known when Q1 2020 reporting data is available; this note is based on discussions with EIOPA and Insurance Europe. Many of the possible measures are in areas also covered in the ongoing Solvency II review (calculation of balance sheet and solvency requirements; long-term guarantees package etc.), and raise the question of whether urgent action would prejudice the review, which will involve full impact assessment. There has been little call from the EU insurance sector for crisis measures (with the possible exception of export credit insurance), only reiteration of previous positions on the review of Solvency II.

**2. Impact of COVID-19 on the EU insurance sector**

**2.1 Vulnerabilities**

The insurance sector is potentially impacted by the COVID-19 crisis on both the asset and the liability side of its balance sheet (“double hit scenario” already stress tested by EIOPA). However, so far, the impact on the liability side (insurance claims) seems limited, partly due to existing pandemic exclusion clauses in many insurance policies. This fact risks having reputational consequences for the insurance sector in the medium term, but it mitigates the short-term impact of the crisis. However, the situation can rapidly evolve as the coronavirus continues to spread in Europe and insurers may adapt some terms and conditions of insurance contracts to accommodate the contingent

situation (e.g. expand health coverage). In general, specific business lines may be affected more than others (e.g. health, export credit insurance).

On the asset side, the impact on insurers is mitigated by the limited exposure of the sector to equities and the fact that many debt securities can be held to maturity. Nevertheless, solvency ratios will be hit. There is also a risk that stock market volatility and sharp spread widening may unduly incentivise insurers to de-risk their investment portfolio, via forced selling of risky assets at possibly unfavourable market prices. It should be noted that even before coronavirus, the prolonged environment of negative interest rates was already raising significant challenges for insurers, in particular life companies offering products with guaranteed rates of return. Fortunately, the EU insurance sector overall has a good solvency “cushion”, with the median solvency ratio of EU insurers over 200% of the Solvency Capital Requirement (SCR).

A majority of EU insurers can probably avoid falling below their SCR during the pandemic; however, there will be exceptions, and some insurers which are already financially weak or below SCR for non-COVID-19 reasons could even fall below the Minimum Capital Requirement (MCR), which prevents them from writing new business and raises the possibility of winding-up if not remedied within 3 months.

Some insurers may be faced with liquidity shortages in the short term due to increased outpayments on claims combined with a fall in new business in-flows, delays in policyholders paying insurance premiums, and possible redemptions of ongoing life insurance policies (in Member States where that is possible). In such cases they may have access to horizontal emergency measures in Member States such as loans (not covered in this note). It is not yet clear to what extent liquidity will be a real issue for EU insurers going forward.

## 2.2 Preliminary impact assessment results

EIOPA has performed a preliminary impact assessment of the coronavirus outbreak on insurers’ balance sheets. The impact has been calculated on the basis of the change in market conditions (mainly interest rates and equity markets) from December 2019 (latest Solvency II data, Q4 2019) and March 2020 (latest observation 18/03/2020). That analysis would show a drop (-34%) in excess of assets over liabilities and a drop in the median solvency ratio from 213% to 173%. This figure should be taken with caution because it not based on official data.

In its 2016 stress testing exercise, EIOPA tested the effect of a “double hit” scenario affecting, similarly to what market evidence is showing in these days, both sides of the balance sheet of insurance undertakings (i.e. decrease in asset values due to falls of financial markets and increase in technical provisions due to lower interest rates). The overall result of that exercise was a negative impact on the balance sheet of stress test participants of -28.9% of the total excess of assets over liabilities in the baseline, but still leaving the “assets over liabilities” ratio above 100% on average<sup>1</sup>.

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<sup>1</sup> After the application of the “double hit” scenario, the undertakings with an “assets over liabilities” ratio below 1 represented together 1.4% of total assets. Participants were not asked to recalculate the post stress SCR ratio (i.e. post stress own funds/ post stress SCR), so the only “solvency metric” used to assess the impact was the “assets over liabilities” ratio in the post stress scenario.

The impact of the coronavirus outbreak on insurers' balance sheets would thus seem to be comparable to the outcome of the 2016 stress testing exercise. The result of a stress test exercise needs to be taken with caution due to its non-regulatory nature<sup>2</sup>.

### **3 Possible mitigating measures**

#### **3.1 Measures already taken**

In its press release dated 17 March 2020<sup>3</sup>, EIOPA stressed that:

- it is particularly important that insurers are able to maintain services to their clients and stand ready to implement the necessary measures to ensure business continuity;
- recent stress tests have shown that the sector is well capitalised and able to withhold severe but plausible shocks to the system;
- insurance companies should take measures to preserve their capital position in balance with the protection of the insured, following prudent dividend and other distribution policies, including variable remuneration;
- notwithstanding existing tools and powers, EIOPA will continue to monitor the situation and will take or propose to EU institutions any measure necessary in order to mitigate the impact of market volatility to the stability of the insurance sector in Europe and safeguard the protection of policyholders.

Like all businesses, insurers are faced with business continuity issues in the current difficult working conditions. For this reason, on 20 March EIOPA adopted a Recommendation to national supervisors on the exercise of flexibility in the deadlines for the submission of reporting by insurers for the year end 2019 and Q1 2020, and also public disclosure (publication of Solvency and Financial Condition Report). More flexibility is recommended for the end-2019 reporting (8 weeks extra) than for the end-Q1 2020 reporting (1 week extra), as the Q1 2020 data is more relevant and urgent.

Currently, EIOPA calculates and publishes “risk free rates” on a monthly basis, and the Commission adopts them quarterly as an Implementing Act for the purposes of quarterly and end of year reporting. Given high volatility in interest rates, and that fact that certain supervisors are now asking their insurers for weekly reporting, EIOPA will start sharing with supervisors its risk free rates on a weekly basis.

EIOPA's Board of Supervisors has so far not decided on any other measures to be taken at EIOPA level or to be recommended to EU supervisors, though the situation is being monitored on a weekly basis and an initial exploration of possible exceptional measures has started.

#### **3.2 Measures available to supervisors without new legislation**

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<sup>2</sup> It was not a “pass or fail” exercise and subject to many simplified/proxy computations.

<sup>3</sup> [https://www.eiopa.europa.eu/content/eiopa-statement-actions-mitigate-impact-coronaviruscovid-19-eu-insurance-sector\\_en](https://www.eiopa.europa.eu/content/eiopa-statement-actions-mitigate-impact-coronaviruscovid-19-eu-insurance-sector_en).

### *Wider use of transitional measures*

Solvency II contains a **transitional measure on technical provisions (insurance liabilities)** which was introduced at the first application of Solvency II in 2016 to grant a smooth transition into the new system. Subject to supervisory approval, it is a “transitional deduction” to the technical provisions which permits to mitigate the effect of market movements degressively in the first 16 years of application of the new framework. This “deduction” can be recalculated when a material change in the risk profile has occurred (e.g. as of 31 March 2020), which has the potential to provide some capital relief during exceptional situations.

Currently the measure is applied in a few national markets for the portion of business which was written before 2016. The Directive does not prevent insurers not already using this transitional measure to submit a request for its application to the NSA at any time during the 16 years of application of the transitional.

### *Extension of the recovery period*

An insurance company below its SCR can continue its business provided that the situation is restored within 6 months, on the basis of a recovery plan. Upon request by a supervisor, EIOPA may declare the existence of an “exceptional adverse situation” and allow supervisors to extend the “recovery period” up to 7 years, for insurers which are not SCR compliant and are not able to restore compliance within 6 months (Article 138 of Solvency II<sup>4</sup>). For the time being, there are no requests from EU supervisors to EIOPA to declare such an exceptional adverse situation.

### *Other measures*

Some Member States have already introduced in their national legislation the possibility to suspend or limit the distribution of dividends to shareholders. Some Member States have already introduced in their national legislation the possibility to suspend or limit the right of policyholders to surrender their contracts on a temporary basis. Generalising such powers at EU level may require the use of a company law or contract law legal basis.

## **3.3 Measures requiring legislative changes**

Solvency II already contains a variety of measures to mitigate volatility, which are currently all under review in the context of the Solvency II review. EIOPA has developed draft advice and consulted publicly on it; the next phase is a “holistic impact assessment” before EIOPA submits its final advice. However, EIOPA has indicated that this will be delayed by approximately two months due to the pandemic. These existing measures include the following “countercyclical measures” to cope with adverse market situations:

- *Volatility Adjustment per currency*: this mechanism allows to mitigate the effect of spread widening on solvency position of insurers offering long-term guarantees. Its impact is limited when spread widening affects single (or a subset of) countries within the currency union (Euro).

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<sup>4</sup> This is not the same as an emergency situation according to article 18 of the ESA Regulations, which must be declared by the Council.

- *Volatility Adjustment per country*: this mechanism allows to mitigate country-specific spread crises, should the situation in certain countries significantly deviate from the Eurozone average. The trigger for the use of this adjustment was recently lowered in the context of the ESA review.
- *Symmetric equity adjustment*: this (partially) corrects the capital charge for equity risk during equity downturns. This currently has a ceiling and floor to its operation; widening or removing these could reduce equity charges more in times of stress (but increase them more at the height of the cycle).

The *risk margin* (a component of insurance liabilities on top of best estimate) is also under review in the Solvency II review. The cost of capital rate that is used to compute the risk margin is currently 6%. Industry stakeholders already asked in the context of the review of the Solvency II Delegated Regulation, to reduce it, but EIOPA did not identify sufficient evidence to support such a claim. The Solvency II review is looking at the broader calculation of the risk margin, beyond the cost of capital rate.

During informal exchanges, the insurance industry has highlighted some areas of the framework<sup>5</sup> where targeted amendments could further reduce pro-cyclicality during exceptional adverse scenarios, like the present COVID-19 pandemic. But they have not urged immediate introduction outside the timeline of the Solvency II review.

Solvency II does not contain full harmonisation as regards measures aiming to prevent future distress (i.e. “pre-emptive recovery planning” and “macro-prudential preventive measures”). Solvency II does not contain harmonised resolution powers/roles. These areas are also covered in the ongoing Solvency II review.

#### **4. International responses and accounting aspects**

Most of the international measures reported to the FSB are similar to the ones described in this note (liquidity close monitoring, delay of non-essential reporting, measures to protect policyholders from coverage disruption or lack of cover). However, the US states<sup>6</sup> have mentioned the existence of a fund of US\$ 8bn that could be used to provide support where needed as well as the use of state-level guarantees in case an insurer would default.

At this stage, stakeholders have not expressed concerns regarding IFRS in the context of the current crisis. Indeed, on the asset side, IFRS 9 is still not used by most insurance groups. Under the current standard – IAS 39 - the impact of drops in market values is limited, as an impairment is only recognised if the loss is significant and cannot be recovered (“incurred loss model”). On the liability side, as IFRS 4 is still in place (and not IFRS 17), the impact should also be limited but will also depend on the different national policies.

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<sup>5</sup> Including, in addition to the elements mentioned above, reforms to the Ultimate Forward Rate, and to limits on “Tier 3” to allow Deferred Tax Assets to be included in own funds.

<sup>6</sup> In the USA, insurance regulation is largely a state competence, with a very limited federal role.