Commentary

Coronavirus Disease (COVID-19) Impact on Life Insurers More Likely to Result from Adverse Market Movements than Increased Claims

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Key Highlights:

- The impact on insurance claims is expected to be manageable, given the relatively low mortality rate for infected individuals.
- The adverse reaction of financial markets to coronavirus may affect insurers' profitability, including earnings generated from their investment portfolios.
- Insurers operating in higher-risk countries are seeing some disruption to their day-to-day operations.

Overview

The Coronavirus Disease (COVID-19) outbreak will likely affect life insurers in the following ways: (1) increased incurred claim costs, including death and disability claims, and drug costs, (2) adverse movements in the financial markets, including declines in bond yields, equity markets, and real estate, reducing profitability; and (3) business interruption and potential impact on revenues.

As coronavirus continues to spread across the world, its effects are rippling across financial markets and the global economy. The life insurance industry is no exception, particularly given the increasingly global nature of many insurers and their sizable investment portfolios. Although most countries have had minimal reported coronavirus cases so far, and consequently the impact on claim costs for life insurers is negligible to date, the impact on business operations for some global insurers has already surfaced, particularly for those operating in high-risk regions such as China, Iran, and Italy. Most life insurers expect to feel the impact of coronavirus on the financial markets because of the highly interlinked global economy.

Impact on claims depends on frequency of new cases in the location of the policies issued and the severity

There is the possibility, although relatively remote based on currently available data, that death claims may increase materially, particularly for firms in affected countries. Drug costs and short-term disability costs may also increase, depending on the rate at which coronavirus spreads. Most life insurers do not have a pandemic exclusion for their life insurance policies. Instead, risk is primarily managed using reinsurance. For example, an insurer may reinsure all policies with face amounts larger than $1 million, limiting their risk exposure to a pandemic scenario and the resultant spike in deaths.

Adverse market movements caused by coronavirus will likely affect net income meaningfully, depending on the investment portfolio composition

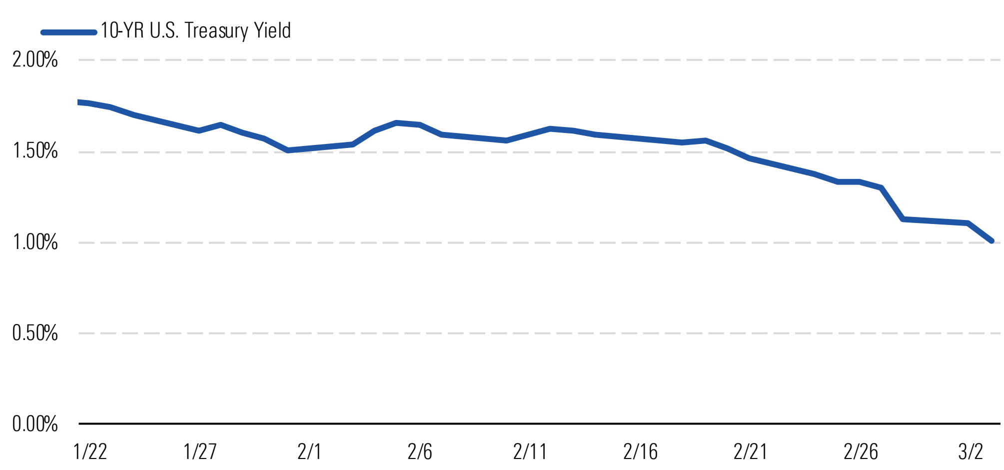
Because of the nature of the business, life insurers have large invested asset portfolios comprising mainly fixed income, but they may also include equities and real estate. As coronavirus continues to spread across the globe, financial markets have taken a negative view, resulting in a drop in bond yields as well as a steep drop in most equity markets.

Impact caused by a decline in bond yields:

Insurers worldwide have been operating in a sustained low interest-rate environment for several years now, and most have managed to maintain profitability despite the margin pressure that low interest rates can cause. To reduce their exposure to interest rates, many insurers have also implemented de-risking activities or hedging programs over the years. In general, insurers have also improved their capacity, as demonstrated by stress tests on interest rates, to handle additional declines of 25 to 50 basis points, and remain solvent. Nonetheless, a further decline in bond yields can affect insurers in multiple ways. Insurers generate income from their investment portfolios, which primarily comprise investment-grade fixed-income securities; therefore, any drop in fixed-income yields would reduce the income earned from the bond portfolio. Additionally, defaults on debt securities may also increase, particularly for insurers with more of their fixed-income portfolios rated BBB or lower or in private placements. In the medium to long term, a sustained low interest-rate environment will continue to adversely affect insurers as this reduces the investment income earned from fixed-income portfolios and increases regulatory capital requirements for longer-term liabilities. The impact of low interest rates on an insurer also depends on the magnitude and type of guarantees offered in the products, and the extent to which assets and liabilities are matched.

As an example of declining interest rates, Exhibit 1 shows the decline in the 10-year U.S. Treasury Yield since the beginning of the coronavirus outbreak. The decline in yields may be partially attributed to coronavirus.

Exhibit 1 10-Year U.S. Treasury Yield Since Coronavirus Reported by WHO



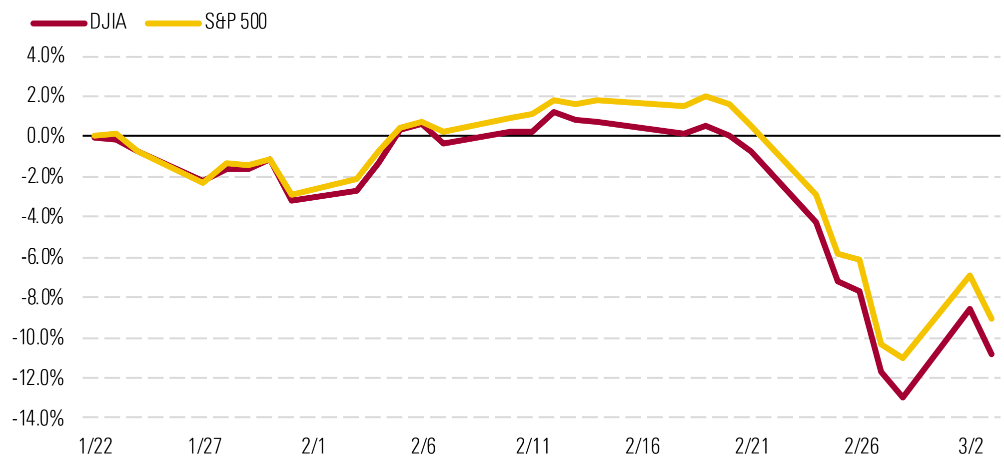
Sources: DBRS Morningstar, Bloomberg.

Impact caused by equity market declines:

The impact of a sustained decline in equity markets is slightly more straightforward. Life insurers typically hold a proportion of their investment portfolio in primarily public equities, typically to back their longer-term liabilities. Any decline in the value of these equities will result in an unrealized loss position. A decline in equity values will also have a negative impact on fee income earned on managed assets, particularly for insurers with significant wealth management operations or large segregated fund portfolios.

Exhibit 2 shows the decline in the S&P 500 and Dow Jones Industrial Average stock indices as an example of a general decline in stock indices globally since the beginning of the coronavirus outbreak.

Exhibit 2 S&P 500 & DJIA % Change Since Coronavirus Reported by WHO



Sources: DBRS Morningstar, Bloomberg.

Impact on real estate portfolios:

Some life insurers also have real estate, commercial or residential, on their books. The value of real estate investments may either increase or decrease, depending on the duration of coronavirus. Reduced interest rates can inflate real estate values in the near term; however, a prolonged recession would likely result in increased unemployment rates, adversely affecting office occupancy rates, reducing rental income earned, and increasing delinquency levels.

High likelihood of continued disruption to business operations, particularly for insurers in high-risk regions

Currently, coronavirus' impact seems to stem mainly from disruption to normal business operations rather than increased life insurance claims. For example, in China, quarantine measures have disabled some agents from selling, which may affect sales. Conversely, sales may ultimately improve as more people may see the value in life insurance.

Domestic players operating in lower-risk countries such as the U.S., Canada, and the UK are seeing minimal, if any, impact on their day-to-day business operations thus far, given the low incidence of coronavirus cases in these regions. Nevertheless, across the board, companies are generally vigilant in monitoring the spread of coronavirus and have placed a greater emphasis on this issue, including minimizing its impact on operational issues. Most companies have some sort of business continuity plan in place to minimize business interruptions. Because of improved risk management processes that companies have implemented in the past decade, early intervention and risk monitoring is more advanced than in the past.

Improved enterprise risk management programs in place compared with pre-crisis era

Over the past few years, nearly all life insurers have improved the comprehensiveness of their risk management policies and procedures. There are currently more developed risk management procedures in place and better monitoring of current and emerging risks. The 2008 financial crisis encouraged a movement toward developing a proactive approach to managing risks rather than limiting risk exposure after the fact. There has also been increased emphasis on early monitoring for risks that are less easily quantifiable, such as operational risk and emerging risks. Business continuity programs have also improved.

The total impact of coronavirus depends on its duration and the extent to which it spreads across the world. Currently, the severity appears to be manageable with a lower mortality rate than prior pandemics, including SARS and Ebola. There is little precedent, and using prior scenarios to estimate the impact of coronavirus may not yield accurate results because of the highly interconnected and increasingly global nature of the world. The economies of various nations are also much more interlinked, which may make it more difficult to constrain the economic impact of coronavirus within borders. The increasing importance of the Chinese economy and that of other emerging Asian countries to total global economic growth is also higher than before, increasing the risk of global rather than only local recessionary impacts, which potentially causes a ripple effect that may reach countries without incidences of coronavirus. Therefore, we continue to take a cautious approach when trying to determine the impact of coronavirus on the life insurance industry.

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