European insurers during the COVID crisis

Interview of Petr Jakubik, Financial Stability Team Leader with the XPRIMM publication

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We are still going through one of the most challenging periods, with the COVID crisis putting at risk numerous businesses and creating unprecedented situations. In this context, financial stability is probably more important than ever in the insurance industry. What were, in your opinion, the most challenging effects of the COVID crisis in the insurance business?

The COVID-19 crisis has been indeed an unprecedented experience with many challenges for the insurance sector. Some of them were rather short-term, especially market shocks after the pandemic outbreak, while the others seem to have longer-lasting effects. The most challenging were risks that were new and where previous experience is more limited. Here I can mention lockdown-related events such as business interruptions or a significant increase in cyber risks. Unlike market risks, cyber is a new territory where the risk assessment models and available data are still quite scarce. Moreover, the long-term upward trend in this risk class driven by digitalisation and its further intensification by the COVID-19 crisis is rather permanent. The reason for that is that working from home will most likely stay in some form even when the pandemic is over. However, cyber risk also has to be seen as an opportunity for the insurance sector due to cyber underwriting policies, notwithstanding of course the need for appropriate risk management when offering such products.

Would you say that financial stability of the re/insurance industry was, even for a moment, at risk?

The market shocks experienced at the outbreak of the crisis in March 2020 were unprecedented, moving the yield curves to new historical minimums, putting pressure on profitability and solvency positions especially for life insurance. However, European insurers have been able to withstand this situation. In particular, the Solvency II regime helped them to better align capital to risk, build-up resilience and enhance their risk management practices. Moreover, (re)insurers industry as a whole entered the crisis with very high solvency ratios.

Are there elements that may threaten the industry's financial stability on a large scale?

The initial shock to financial markets with the COVID-19 outbreak has been followed by economic recessions triggered by lockdowns of economies to contain the pandemic. As the impact on the real economy was mitigated by extensive fiscal measures, some negative effects might become visible only when the introduced measures are phased out. Among them, potential increased unemployment and corporate credit downgrades might have a negative impact on the insurance sector. If these risks materialise, prices of equities, bonds and other assets could face losses. One of the key risk transmission channels for potential increased credit risk could be the interconnectedness between European insurers and the banking sector as banks are exposed to the expected increase in non-performing loans once COVID-19 related fiscal measures lapse. Moreover, financial market valuations seem to be overly optimistic, also supported by accommodative monetary policies. Having said that, tapering bond purchases and eventual interest rate hikes by central banks might possibly lead to financial market corrections.

Would say that at this point the industry has overcome the danger of a major failure under the impact of the COVID crisis?

The European insurance sector has overcome the situation due to the fact that it has entered the crisis in a good condition thanks in part to the Solvency II regime. Although the industry might still face some consequences of the crisis, such as potential financial market corrections or increased credit risk when certain protective fiscal measures run out, the likelihood of any major failure has significantly decreased. EIOPA is currently running an EU-wide insurance stress test that will provide further insight into insurers' vulnerabilities. Moreover, EIOPA will continue to monitor market developments to be able to address any potential financial stability risks that might emerge before they materialise.

What are your expectations for the next months – are there risks still at a worrying level?

Looking at the future, the critical element is the evolution of the pandemic. The main risks are related to macroeconomic situation. As mentioned earlier, we have to consider the risk of potential financial market corrections that could be caused by higher inflation, sovereign debt sustainability concerns, increased credit risk related to the phase-out of fiscal measures or risk related to the real estate market. On top of that, we also have to take into account emerging risks such as cyber and climate related risks.

Would you say that this period may be qualified as a stress test for the Solvency II regime? Are there any lessons learned from this special situation?

The recent period could definitely be seen as the first successful real-life crisis test of the Solvency II regime. While the EU economy is still subject to high risks, the end of the crisis will allow time to analyse the lessons learned. Some have already been reflected in the proposals for the Solvency II review, where EIOPA's approach focused on improving the existing regulation based on the experience during the first years of application and taking into account the changes in the current economic context. In this respect, EIOPA recommended in its opinion that supervisors should have additional powers, including a macroprudential toolkit to tackle systemic risks, such as restrictions on the distribution of dividends to preserve insurers' financial position in periods of extremely adverse developments. Moreover, the ongoing crisis highlighted the critical importance of coordinated approaches among the national competent authorities.

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