

COVID-19: What have we learnt from SFCRs of UK life insurers

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The spread of COVID-19 has had a profound impact on public health, but also on the economy. Both are expected to have implications for the operations, financial stability and business continuity of life insurers globally.

We have reviewed the Solvency and Financial Condition Reports (SFCRs) that were recently published by major life insurers in the United Kingdom to examine the disclosures made on the impact of COVID-19.

What do SFCRs say?

WHAT IS THE FORMAT OF DISCLOSURES?

On 20 March 2020, the European Insurance and Occupational Pensions Authority (EIOPA) published its [recommendations](#) on the implications of COVID-19 for supervisory reporting and financial disclosure, and following this on 23 March the Prudential Regulation Authority (PRA) published its own recommendations. While some delays in reporting deadlines were permitted, and insurers were not required to restate their end-2019 balance sheets, EIOPA recommended that insurers shall consider the pandemic as a "major development" and publish appropriate information in their SFCRs on the effect of COVID-19 on their business. EIOPA did not, however, prescribe the possible format or extent of such disclosure.

As a result, different approaches were taken by insurers to meet the disclosure requirements. They ranged from having dedicated sections for the impact of COVID-19, with both quantitative and qualitative assessment of certain scenarios, to having a few lines giving a brief description of the potential impact at much higher levels.

WHAT ARE THE MAIN THEMES?

The majority of the firms whose SFCRs we reviewed identified that the key impact from the COVID-19 on their life insurance business can be seen in three risk areas:

- **Insurance risk**, as a result of selling life protection products, income protection, critical illness or health-related insurance products
- **Market and financial risks**, as a result of the significant higher volatility and adverse movements in certain segments of the financial market

- **Operational risk**, as a result of business disruption, such as providing support to existing customers; or as a result of any delay in asset transactions due to information technology (IT) or process-related issues

We will discuss each of these three risk areas in turn.

Insurance risk impact of COVID-19

As the COVID-19 situation continues to develop, it may still be too early to confirm the exact impact it will have on insurance risk profiles. This seems to be a consistent view across all SFCRs.

“From an insurance risk perspective, based on current data, the impact of Covid-19 on the mortality for those that we insure is difficult to predict, although we are continuing to monitor the developing situation and potential range of outcomes.” — Legal & General

Insurers noted that they expected higher claims from life protection policies, income protection policies, critical illness policies and/or health-related policies.

Most insurers suggested that they had reinsurance cover in place which would reduce the financial impact of these additional claims. One insurer commented on the financial strength of its reinsurers, stating it expected that it would be resilient to the COVID-19 crisis given its reinsurers were well-capitalised and with a diversified mix of risks. Insurers with annuities on their balance sheets expected COVID-19 to be a factor, providing an offsetting benefit to the business as a result of fewer payments expected to be paid in the future.

We note also that the majority of the Solvency II sensitivities provided in the SFCRs were focused on market (or economic) risk rather than covering insurance risks.

Market and financial risks impact of COVID-19

The financial market in the UK, as well as in many other countries, has experienced significant movements since the end of 2019. We observed by end March 2020¹ a drop of about 100 basis points (bps) in the yield on 10-year Treasury bonds since the start of this year, and a 20% drop in the S&P 500 index in the US market. In the UK, the Bank of England moved to revise down the base rate by 65 bps in total, leaving the rate at its historical low of 0.1%, with long-dated swap rates falling by 50 bps+ over Q1, and we saw the freeze of the residential property market. Credit spread also widened significantly.

At the time of writing, equity and credit markets have significantly recovered since the end of March, and the preparation of most firms' SFCRs, though to different extents in different markets.

There is a general expectation of a decrease in insurers' solvency positions from COVID-19, but the impact will depend on many factors, such as the risks the firm was exposed to, the firm's specific asset and liability structure, the risk mitigation and hedging the firm had in place, and the effect of the Solvency II long-term guarantee (LTG) measures. The combination of these factors means that each firm's exposure would depend on its unique circumstances.

"COVID-19 has caused disruption to businesses and economic activity which has been reflected in recent fluctuations in UK and global financial markets." — ReAssure

The disclosure of the quantitative impact of COVID-19 in SFCRs varies by firm.

Some firms considered that their scenario and stress testing results carried out based on the year-end 2019 position would still be valid to provide an indication of how the business might be impacted by the financial market movements. They however acknowledged that, given the sensitivities were carried out by stressing one single risk factor each time, this would not inform readers of the report of the holistic impact.

One firm had developed bespoke stresses in respect of COVID-19 and applied them to its balance sheet to provide a more "real-life" feel on the potential impact on the capital position. Other firms had provided an estimate, in accordance to the actual market movement at end March 2020, of a range of the solvency positions within which they expected the actual result would land.

¹ Source: [Milliman London Market Monitor](#)

Some insurers have been taking actions to further reduce sensitivities to economic shocks since the crisis, as described in SFCRs and covered below.

EQUITY MARKET DECLINE

Following de-risking of the investment portfolios of life insurers, or at least those backing guaranteed returns, since the early 2000s, volatility in the equity market has a relatively limited impact on life insurers' capital positions. Indeed, certain firms reported no exposure to the equity market at all.

In addition, firms reported that they had reviewed, and in some cases reinforced, their existing hedging programs.

"We are also working closely with our asset managers to ensure that appropriate hedging arrangements remain in place during what is likely to be a prolonged period of increased market volatility." — LV=

CREDIT MARKETS

Many insurers have material holdings of corporate bonds backing guarantees, notably annuities. However, for UK life insurers, the impact of widening credit spreads in Q1 2020 was mitigated by the Solvency II LTG measures.

UK insurers with an approval to use the Matching Adjustment (MA) typically do not expect a material impact on their regulatory capital coverage ratios from corporate bond spread widening. This is because the MA provides an offsetting benefit through a reduction in the value of corresponding liability on the balance sheet if bonds maintain their rating.

Outside of the MA portfolio, the Volatility Adjustment (VA), where used, was expected to provide a similar but typically lower benefit: the VA for GBP widened from 15 bps at end 2019 to 50 bps by end March 2020. By end June 2020 the VA was back to 14 bps.

However, for MA firms, the prospect of future rating downgrades, particularly from investment grade to sub-investment grade, and the potential increase in corporate bond defaults would be expected to cause a more significant problem to firms in both capital and liquidity. This scenario has yet to materialise but is one that insurers are actively monitoring and testing.

"The Company has considered a number of scenarios for future downgrades and is carefully monitoring and managing the portfolio to limit any adverse financial impacts." — Pension Insurance Corporation

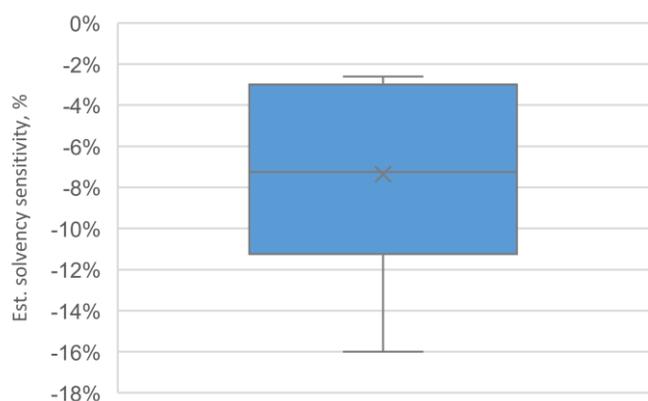
The PRA recently issued a [statement to insurers on the application of the MA during COVID-19](#), discussing issues such as the potential need to reconsider policies on sales of assets on downgrade and how to reconsider MA eligibility when loans are subject to payment holidays.

LOWER INTEREST RATES

The UK GBP risk-free rate had fallen by as much as 70 bps at the 10-year term, compared to that at year-end 2019.

Based on the sensitivity information provided by firms in their SFCRs, a lower interest rate would generally have a negative impact on a life insurer's regulatory balance sheet, in part as it typically gives rise to an increase in the Solvency Capital Requirement (SCR) even if the impact on Solvency II Own Funds or best estimate liabilities is hedged. This effect was typically more pronounced for insurers whose liabilities were more weighted to annuity business.

FIGURE 1: UK MAJOR LIFE INSURERS' SOLVENCY RATIO SENSITIVITY TO -0.5% (PARALLEL) SHIFT TO INTEREST RATES



Some firms operate a dynamic hedging policy where they hedge best estimate liabilities, or International Financial Reporting Standard (IFRS) technical provisions, in normal circumstances, but switch to hedging their Solvency II Own Funds' SCR ratios if risk tolerances come close to being breached.

Firms are expected to review the effectiveness of their hedging frameworks and the alignment with their approved risk appetite after the crisis by utilising what they have learnt from the times of the market stress, following the [Prudent Person Principle \(PPP\)](#) requirements.

OTHER MARKET IMPACTS

The majority of insurers with significant exposure to inflation are generally well-hedged through swaps. However, as inflation break-evens (for measuring future expected inflation) actually fell in Q1 2020, some firms will have experienced an increase in the margin call from inflation swaps, with a knock-on effect on the liquidity demand of the business.

COVID-19 has created significant uncertainty in the UK's real estate markets, both residential and commercial. Any direct or indirect investment in either property market may suffer as a

result of the epidemic. There could also be a liquidity issue, if the assets in consideration could not be sold in a timely manner, or rental collection was significantly delayed, to generate the required liquidity for the business, as well as MA eligibility issues (as discussed above).

The currency market has also been extremely volatile. However, typically hedges had been put in place to protect the firm's GBP position. As with inflation, the main issue for firms may therefore have been liquidity demands associated with a weak pound performance relative to peers creating pressure on liquidity risk management.

“Market volatility in the second half of March 2020, in reaction to the developing COVID-19 pandemic situation in the UK, led to a significant temporary increase in the Group's collateral requirements, which have now subsequently largely reversed. The Group experienced collateral calls for an additional c. £500m, which it was able to meet from existing available liquidity balances and facilities.” — Just PLC

Operational risk impact of COVID-19

Operational continuity and resilience was a key concern for most insurers.

Following the UK's government announcement of the "lockdown" in late March and most people having to work remotely, insurers' infrastructures, such as IT systems, was subject to an unprecedented stress. This includes the ability to continue to support existing customers; to sell new business; to pay claims, and to carry out asset transactions. As a result many firms have enhanced their IT capabilities and improved their infrastructures, to be better suited for a COVID-19 "new norm."

COVID-19 also had an impact on certain key projects such as business transfers.

“Due to the rapidly changing situation with Covid-19 (coronavirus), the Group and L&G jointly approached the High Court to seek a delay to the transfer until the situation is more stable. The judge confirmed his agreement to this request on 25 March 2020. Both parties concluded a delay was in the best interest of customers and employees allowing the business to fully concentrate our efforts on continuing to provide the best possible level of service to their customers during this challenging time.” — ReAssure

Looking forward

The current COVID-19 pandemic has been a test for many insurers on their abilities to navigate a crisis. Many lessons have been learnt which could potentially trigger exercises to review existing frameworks that firms have put in place. They may include:

- Business strategy
- Risk appetite
- Business continuity strategy, including IT infrastructure
- Product structure
- Reinsurance arrangements
- Management of financial risks, including liquidity risk
- Hedging strategy, including basis risk and execution
- Strategic asset allocation
- Investment policies, including asset portfolio quality and resilience to risk events
- Underwriting and pricing
- Demographic and economic assumptions

Conclusion

Insurers typically considered that it would be difficult to quantify the exact financial impact caused by COVID-19 in their SFCR disclosures.

Most insurers considered that their capital positions and operational resilience remained strong at this stage. Having said that, the prospect of significant rating downgrades and a potential increase in defaults has not gone away and this scenario could create a larger issue for UK life insurers.

Insurers will also need to consider the potential medium-term and long-term implications of the [extraordinary economic responses to COVID-19](#) from central banks and governments.

Liquidity risk management has also been put under the limelight, strengthening the importance of firms having robust [liquidity risk management frameworks](#).

We expect to see a significant improvement to most insurers' operational resilience resulting from the COVID-19 crisis, and their ability to weather the next storm if and when it may come.



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