Covid-19 & (re)insurers' financial strength

Willis Re
Strategic & Financial Analytics
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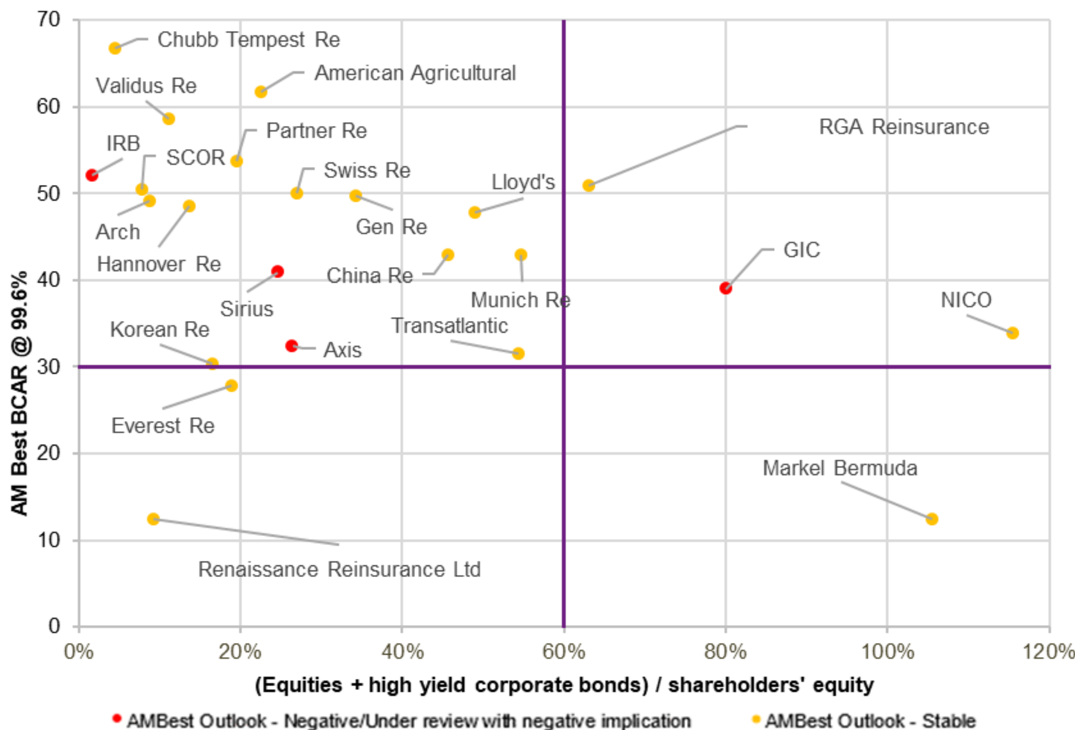
Summary

- Willis Re's Strategic and Financial Analytics teams continue to monitor the financial impact on the global (re)insurance sector due to the Covid-19 pandemic.
- Our current estimated hit to the global reinsurance capital base is approximately 5%. This is a much improved position versus the 20% hit cited in our 24 March publication, as investment markets have recovered, but it also demonstrates how sensitive (re)insurers are to investment market volatility.
- Strong starting points of capital strength continue to provide insulation. And, importantly, the reinsurers with the greater sensitivity to investment markets tend to also be the ones with the stronger current credit ratings. We provide a comparison of BCAR score and investment market sensitivity below.
- In the US P&C market, we estimate the drop in the industry surplus to be on the order of 7.2% and 5.5% after tax on a statutory and economic basis respectively. The impact on regulatory and rating agency capital positions will be more muted, given declines in required capital as well.
- Similarly, amongst the European (re)insurers, analysts estimate a drop in the Solvency 2 ratio from approximately 210% at the start of the year to about 190% as of the end of March (with a partial recovery no doubt in April) – in aggregate a still sound level.

Strong starting points of capital strength continue to provide insulation to the global reinsurers

The scatter diagram below contrasts the AM Best BCAR score (99.6 VaR level) of the global reinsurers to how geared their capital bases are to equity and credit. Comparing with our 24 March publication we have expanded the list of global reinsurers from 18 to 23 and isolated gearing to high yield corporate bonds (as opposed to all corporate bonds). The majority of reinsurers remain in the secure top left zone of high BCAR score and lower gearing.

BCAR score vs sensitivity[1]



Source: Willis Re and © A.M. Best Europe - Information Services Ltd. — used by permission.

[1] The BCAR scores above are for specific reinsurance entities. In some cases, the score may not represent financial strength at the ultimate parent group level. Holding company support would be factored into the final assigned rating. It is important to note that BCAR scores are only one input into AM Best's balance sheet strength assessment, and AM Best's ratings are also determined by other factors in addition to balance sheet strength.

Since our 24 March publication, equity markets in the US and Europe have recovered from YTD declines of approximately 30% to declines of approximately 15%. Corporate bond markets have also recovered, with investment grade bonds (ie BBB and higher) now approximately flat YTD. High yield bonds (ie BB and lower) have also recovered, but remain down YTD on the order of 10%. Our estimated hit to the global reinsurance capital has thus improved significantly, from approximately 20% as of 24 March to approximately 5% currently.

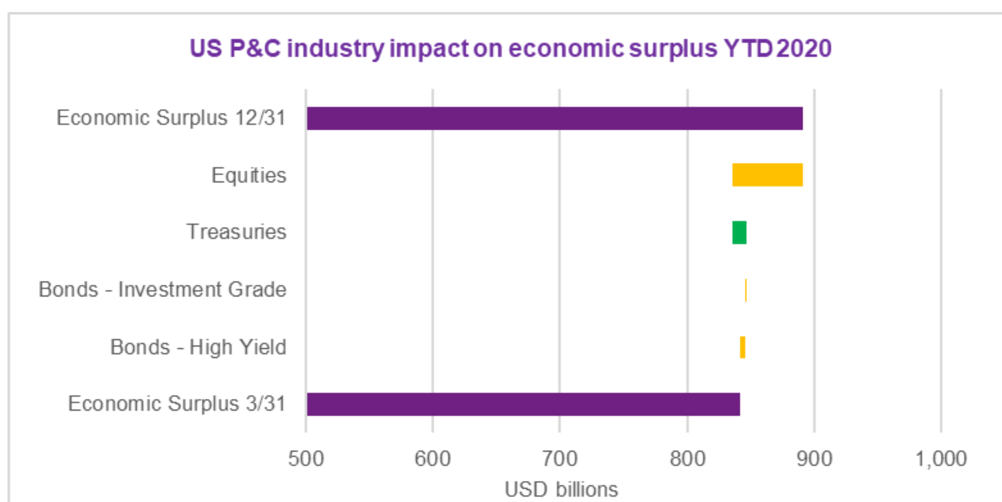
Muted impact on US regulatory and rating agency capitalization

AM Best and Standard & Poors have both affirmed their stable outlook on the reinsurance sector. However, AM Best has recently put a negative outlook on the US commercial lines sector. If the current scenario of a "manageable" Covid-19 pandemic with effective government fiscal response does not materialize, the agencies will undoubtably revisit their stance on the industry.

Both rating agencies will be performing "stress tests" on company level capitalization. But just as importantly, they will be looking for companies to provide updated and detailed financial scenarios and forecasts for 2020 and beyond given the new realities.

We estimate the drop in the US P&C industry surplus (available capital) to be on the order of 7.2% and 5.5% after tax on a statutory and economic basis respectively. Statutory results only carry equity and high yield bonds at market value. On an economic basis, treasuries and investment grade bonds are also marked to market.

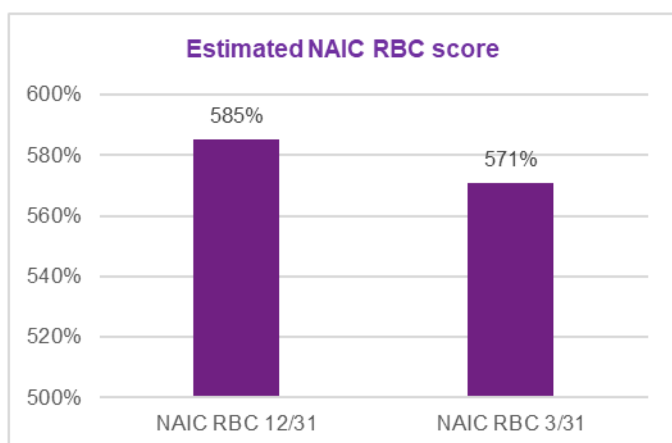
US P&C surplus level remains robust with YTD drop driven by equity market decline

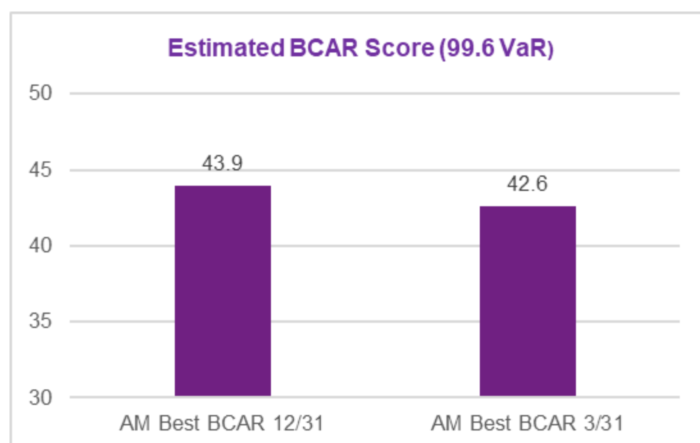


Source: Willis Re

It is important to note that reduction in solvency levels, or rating agency capital model scores, is lower than the above drop in available capital would suggest. This is because there is an offsetting factor of lower required capital for investment risk which is based on the reduced market value of these assets. The drop in equity markets in particular significantly reduces required capital as equities carry high capital charges in rating and regulatory capital models, eg greater than 40% at the 99.6 VaR level for AM Best's BCAR model. For context, our 31 March estimate for the average US P&C BCAR score at the 99.6 VaR level still comfortably exceeds the target of greater than 25 required for AM Best's 'strongest' category.

Estimated drop in US P&C RBC and BCAR scores is lower than the decline in available capital would suggest



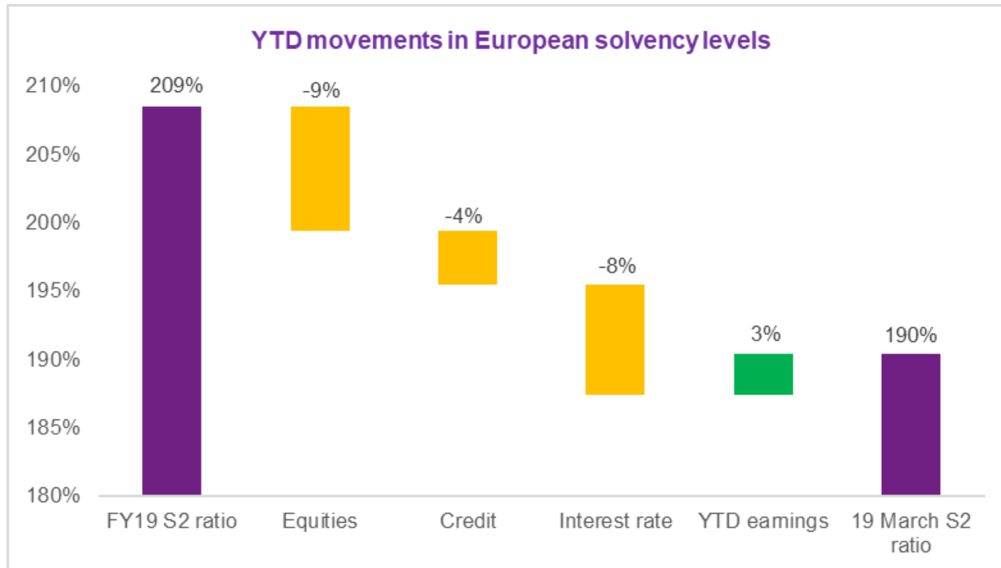


Source: Willis Re

European solvency ratios have declined noticeably but in aggregate remain robust

Amongst the European (re)insurers, both life and non-life, analysts estimate that Solvency 2 ratios fell from approximately 210% at the start of the year to roughly 190% as of late March. Given the recovery in markets in April, this picture will have improved (but not fully back to the end-2019 level). It is important to remember that under Solvency 2, a decline in risk-free interest rates (ie rise in the value of government bonds) is a negative for most companies' solvency positions. Although the major Europeans' solvency ratios remain strong for the most part, dividend payments have been temporarily suspended by some companies following regulators' calls for prudence.

Solvency remains strong for European insurance sector but exposed to further stresses



Source: Willis Re, based on a consensus of equity and rating agency analyst estimates.

Looking forward

Although average sector solvency positions and rating model scores remain healthy, some companies will have seen material erosion of their capital buffers. Rating agencies and regulators are engaging with (re)insurers to ascertain how well their impaired balance sheets can withstand further shocks. Sources of further potential asset hits include sovereign or corporate bond downgrades (or possibly defaults), and a decline in property values. US statutory accounting normally does not mark bonds to market, but this would be required when a bond drops into the non-investment grade category. There would also be a compounding effect in the event of corporate bond downgrades as required capital in rating and regulatory models steeply increases for lower credit grades.

While it is not in the scope of this bulletin to address coverage and liability issued related to Covid-19, there are significant potential underwriting implications to consider as well:

- First, the ongoing economic slowdown will likely reduce premiums as macroeconomic metrics steeply decline. Although exposure may reduce as well helping to manage current year results, this may not universally be the case.
- Also, as paid losses are driven by prior years' writings, and current year collected premiums will likely decline, there may be cash flow and liquidity constraints for some companies.
- Companies will also potentially face reinvestment risk particularly if seeking risk free or low risk investments.
- Given the heightened financial pressure, counter-party risk may be more high profile.
- Given the potential cashflow shortfall and liquidity issues, companies will likely defer capital return strategies such as dividends and buybacks. Also, this may put pressure on companies with significant debt leverage and low interest coverage, and the ability to refinance or raise capital may be difficult until capital markets stabilize.

Although average capitalization remains robust some companies may need future support to solvency, particularly in the event of further stresses. Reinsurance can be an important tool to bolster solvency or rating agency capital scores. To find out more, please contact your client advocate or reach out to our experts.

How can we help?

Willis Re's Strategic & Financial Analytics teams advise clients on strategic and capital management issues. To find out more, please contact your local client advocate or reach out to our experts.

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