



**Market implications
of COVID-19 for UK life
insurers**

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Overview

In common with many segments of the economy, the life insurance industry is taking action in response to the effects of COVID-19. This report takes stock of COVID-19's effect on and implications for UK life insurers' share prices, solvency coverage and new business flows. It focusses on exploring in more detail the effect on Annuities, Unit-Linked and With Profits business. This report also takes account of likely regulatory focus points and areas of prima facie concern for supervisors.

Overall impact on UK life insurers

Life insurers are affected by falling asset values, increased volatility, falling interest rates, and increasing credit risks, which capital markets are experiencing due to the COVID-19 pandemic. At this stage of the pandemic, it is too early to be certain of how higher claims will affect the sector, both in terms of the level of excess insured deaths and the relative impacts on different lines of business. On the face of it we would expect the effect on insurers to be manageable in the short term, particularly for insurers with a mix of annuity and protection business. Factors such as socio-economic, underwriting, gender and smoker mix will all contribute to the overall impact of increased claims, from both mortality and morbidity exposed business. Uncertainties around mortality and morbidity rates are likely to persist to late 2020 and we may see insurers hold off moving to CMI_2019, which projects a marginal increase in life expectancies compared to the previous CMI model.

We also expect life insurers to see a sharp focus from regulators on the risks to firms and consumers created by COVID-19, although this will be balanced by some reduction in 'business as usual' supervisory interactions and relaxation of 'non-essential' regulatory processes such as reporting.

Impact on insurers' share prices

We have seen significant share price falls in the sector in the midst of the COVID-19 pandemic with some drops of more than 50% since the beginning of the year. In part, this reflects the equity market's view of uncertainty about the implications of the pandemic for life insurers; in general, life insurers have seen deeper drops in share price compared to general insurers.

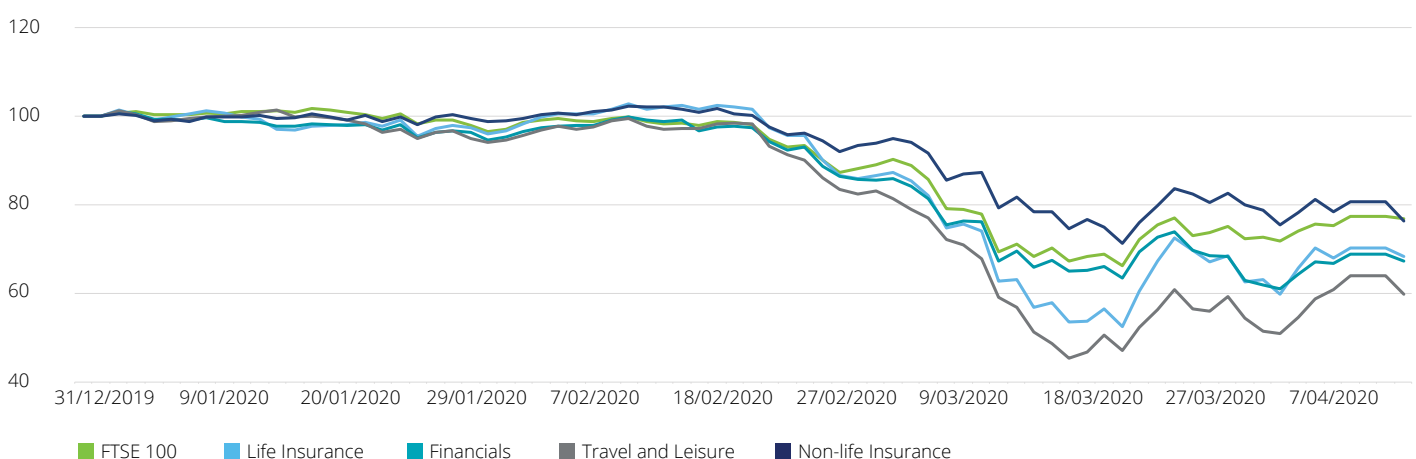


Figure 1- Sector Performance in the UK since 31 -12 -2019

Figure 1 shows that only the Travel and Leisure sector has experienced a greater share price fall than the Life Insurance sector to 7th of April. The recent partial recovery in share price may be due to information from some life insurers reporting continued strong solvency coverage.

Investment managers have also seen similar share price falls as insurers. For further information on the impacts on investment managers see our separate blog [here](#).

Insurers should continue to remain sufficiently capitalised in the short term

Although it is too early to know the potential impact of the COVID-19 pandemic, our expectation is that most insurers will continue to remain sufficiently capitalised post market shocks. For example, based on the sample of insurers in our analysis, we expect those insurers applying Transitional Measures on Technical Provisions ('TMTP'), using a Matching Adjustment and/or a Volatility Adjustment, or asset hedging (e.g. equity and interest rate), to experience reductions in their solvency coverage ratios of 20ppt to 40ppt¹ (in absolute terms) while insurers without such measures/mitigations, are likely to experience higher drops in their solvency coverage ratios. Considering that most life insurers are capitalised with substantial buffers in excess of the Solvency II requirement (with coverage ratios typically in excess of 180%), a drop of 20ppt to 40ppt still leaves most with solvency coverage ratios in excess of 150%.

Insurers have a number of potential management actions they can take to improve solvency and profits, as we discuss further below.

2019 dividend payments will be scrutinised by regulators

The PRA has imposed restrictions on dividend payments for large UK banks until end of 2020, and has [written to](#) insurers reminding them of the need to carefully consider policyholder protection before any dividend decisions are made. EIOPA has also [communicated the same message](#), urging insurers to "temporarily suspend all discretionary dividend distributions and share buy backs aimed at remunerating shareholders". Given the strong capitalisation in the Life Insurance sector, we expect insurers to have funds available, in principle, to continue with their planned dividend payments for 2019. However, as well as running potential reputational risk, insurers paying dividends are likely to attract regulatory scrutiny and

so should discuss planned distributions with the regulator in advance based on comprehensive stress testing and capital projections that demonstrate their sustainability. Suspension of 2019 dividends by other market players is possible if more insurers follow Aviva, RSA, Direct Line and Hiscox, who announced the suspension of 2019 dividends on 8 April 2020, citing as key reasons for the decision: prudence, sound risk management, policyholder and wider stakeholder interests. In our view, further regulatory intervention on 2020 dividends also cannot be ruled out.

Slowdown in new business levels likely

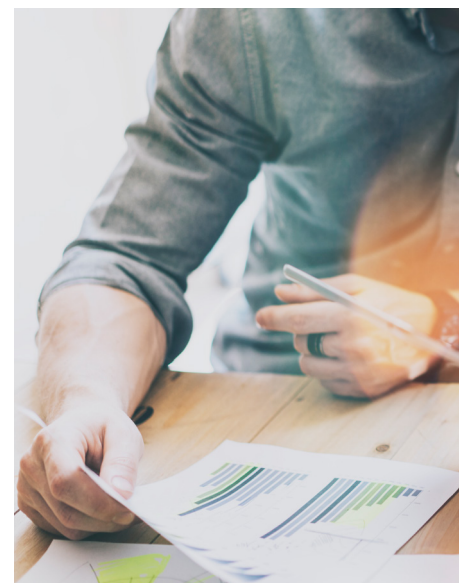
We expect weakened economic activity, combined with strict social distancing measures, to slow down new business levels for some products, particularly from broker led origination, although some insurers are experiencing increased demand for protection products. Demand notwithstanding, the additional strain on the NHS and medical practitioners is likely to lead to slower processing of new business policies for Protection business that requires medical underwriting, and we are aware of some insurers already pausing the sale of policies that require medical practitioners' input. Both firms and regulators are likely to be concerned by any slowdown that reduces availability of products and services to consumers, and for the majority of insurers any slowdown would have an adverse impact on profitability over time, albeit there may be some temporary solvency improvement. We expect the brunt of reduced new business levels to be reflected in Q2 results, but its effects are likely to be noticeable in full year 2020 results as the recovery will take time.

Regulatory scrutiny to intensify in some areas

Insurers' management action plans will be a key area of regulatory focus, including with respect to new business. The PRA and FCA have already issued statements on their expectations, including on payment of

dividends and variable remuneration, and on fair treatment of consumers, for instance where insurers choose to suspend a product on which a consumer may rely for continuity of cover. At key consumer touchpoints, such as product purchases, renewals, or mid-term changes, regulators will expect clear communication with customers on policy terms and how these may operate or be affected by COVID-19.

Regulators will also focus on the practicalities of management action plans in the current exceptional circumstances. For example, re-assessing the ALM strategy may be difficult to do in an unstable market environment, and regulatory applications and approvals may take longer than usual. Importantly, where insurers are unlikely to be able to enact management actions as planned, regulators will expect boards to identify and understand the risks this creates, and to re-plan as necessary. Regulators will also be intensely focussed on the risks of pro-cyclicality, for example where deteriorating market conditions result in disposals which themselves cause further deterioration, and will constantly reassess whether the prudential regime, and supervisory responses to the crisis, are inadvertently creating pro-cyclicality risks.



¹ We have assessed the impact on insurers' coverage ratios using published market risk sensitivities and market movements since 31 December 2019. Due to a data lag, the impacts from property price movements have not been factored in. Demographic impacts have been excluded from the analysis due to uncertainty on the pandemic's effect on these factors.

Impact on different lines of business

Below we take a closer look at some specific implications of COVID-19 for Annuity, Unit-Linked ('UL') and With Profits business. We also explore key actions that management can take to protect these lines of business.

Annuities

From a market perspective, Annuity writers are exposed to widening credit spreads, credit downgrades and defaults, and, in some cases, the risk of falling property prices. All else being equal, as credit spreads widen, the Matching Adjustment ('MA') will provide some offset to the relative fall in asset values via a higher discount rate for annuity liabilities. However, the extent of this offset will depend on a number of factors, including whether or not the fundamental spreads (the part of the bond yield attributable to the cost of defaults and downgrades) remain constant under stressed conditions as the probability of defaults increases. While credit spreads are widening, we do not believe that fundamental spreads will materially widen in the short term as these are based on the 30 year long term average spread and were envisaged to change slowly over time. This will be beneficial to insurers in the short term as they will be able to take the majority of the spread widening through the MA and avoid the need to restructure portfolios in depressed market conditions.

Based on published sensitivities from a number of annuity providers applying the MA in the market, a 125bps (consistent with the flat average of the spreads in Figure 2) widening of spreads shows a reduction in coverage ratios of between 3% and 6%². This is a relatively modest impact due to the change in MA absorbing part of the credit spread widening.

Term (years)	AAA	AA	A	BBB
1-3	134	164	169	193
3-5	105	158	164	178
5-7	161	118	140	169
7-10	-	83	132	119
10-15	-	75	84	111
15+	52	67	79	99

Figure 2 - Spread widening in bps from 31 Dec 2019 to 31 Mar 2020 on UK corporate bonds

Given the pressures on the broader economy, credit downgrades in the corporate bond market are anticipated. Credit rating agencies appear to be downgrading bonds faster than in the 2008 financial crisis, and this risk is likely to materialise in the short to medium term. These downgrades will reduce the offsetting effects (i.e. higher discount rates) on the solvency position from the MA, as a fall in rating reduces the MA available from a given bond, therefore reducing the solvency coverage for affected firms. In the absence of any intervention by regulators, for example to remove the sub-investment grade cap on the MA, this is likely to lead to insurers rebalancing their portfolios to increase credit quality to previous levels. Regulators have not suggested such an action at this stage. However, as noted above, avoiding risks of pro-cyclicality is likely to be high on regulators' agendas.

Insurers are increasingly invested in more illiquid assets such as equity release mortgages ('ERMs'), Commercial Real Estate Loans ('CRELs') and infrastructure to back their annuity portfolios. Different illiquid assets will be affected in different ways, with the final impact on them dependent on how the economy recovers once the COVID-19 restrictions are lifted. The volatility in residential property prices (for ERMs) and commercial property prices (for CRELs) will be particularly relevant, and could increase no negative equity

guarantee (NNEG) risk for insurers holding ERMs. It is too early to be clear on what the longer-term impact on illiquids will be, but insurers should be considering a wide range of scenarios in respect of these assets.

We have seen some evidence of bulk annuity prices reducing primarily due to the widening of credit spreads, suggesting that these providers expect to earn a higher risk adjusted yield. However, this additional yield is at the expense of a higher cost of capital due to the increased allowance for credit default risk. Whilst pricing may have become more attractive for buyers due to increasing spreads, the impact on the market is less clear as insurers struggle to source assets in the current environment to back deals and sponsoring employers struggle to make good any funding gaps due to market falls.



² Not all firms disclose whether a partial offset from the MA is allowed for in their sensitivity results.

Unit-Linked business

UL policyholders are directly affected by the market falls we have seen through a reduction in their asset values. For insurers that earn fees via a percentage charge of funds under management, the impact of lower asset values is a proportionate reduction in fee income. The loss of future charges will be dampened to the extent that such exposures are hedged. Where insurers have used unit-matching to 'hedge' their unit-linked equity exposure, they may still be exposed to market movements, depending on where the cash released through unit-matching has been invested.

The uncertainty in the market is expected to affect illiquid assets, and we are already seeing the gating of some open-ended property funds in response to this, restricting policyholders from accessing their investments in these funds. We expect significant regulatory scrutiny of liquidity risks during this period of economic uncertainty, for example in the form of increased ad-hoc information requests and reporting, and a focus on potential implications of liquidity risks for consumers.

The current market turmoil may see an increase in lapses (i.e. the proportion of policyholders withdrawing their funds) and paid-up (i.e. the proportion of policyholders who discontinue premium payments but whose funds remain invested) policies on investment linked savings business as policyholders look to restrict spending and access savings to get them through the crisis. Such policyholder behaviour will lead to a reduction in future fee income for insurers. Insurers are also likely to see pressure from regulators to treat policyholders at risk of lapse fairly and with due regard to any vulnerability created by COVID-19, in particular where lapse or surrender would not obviously be in the policyholder's best interest (for example, where policies contain guarantees). In

such circumstances, insurers may, for example, offer temporary suspension of premium payments where policyholders are unable to afford regular premiums due to temporary reduced employment.

With Profits

Similar to the movements observed for UL liabilities above, With Profits asset shares will reduce due to credit spreads widening, falls in equities and any future fall in property prices. The magnitude of this impact will depend on the exposure to these asset classes and the level of hedging that funds have in place; however, With Profits funds are usually backed by significant holdings in equities, corporate bonds and fixed interest assets and we therefore expect a reduction to asset shares from market falls.

The reduction in asset shares may increase the cost of certain guarantees such as cost of bonus. Greater equity volatility and a drop in interest rates will further increase guarantee costs (to the extent these are not hedged), weakening the solvency of the fund. However, in the case of guaranteed annuity options, the cost of guarantees could potentially reduce, as policyholders would convert a lower fund at the guaranteed rate. For products with limited guarantees, policyholders will bear the majority of the impact through the reduction in their asset shares and lower expected bonuses in the current environment, with interim bonus declarations being considered to reflect this.

Managers of With Profits funds have a range of actions at their disposal to protect the solvency of their funds, such as revising bonuses, changing asset allocations, changing target pay-out ratios and expanding hedging programmes. We have already seen some funds enacting such management actions. These actions can also be allowed for within the calculation

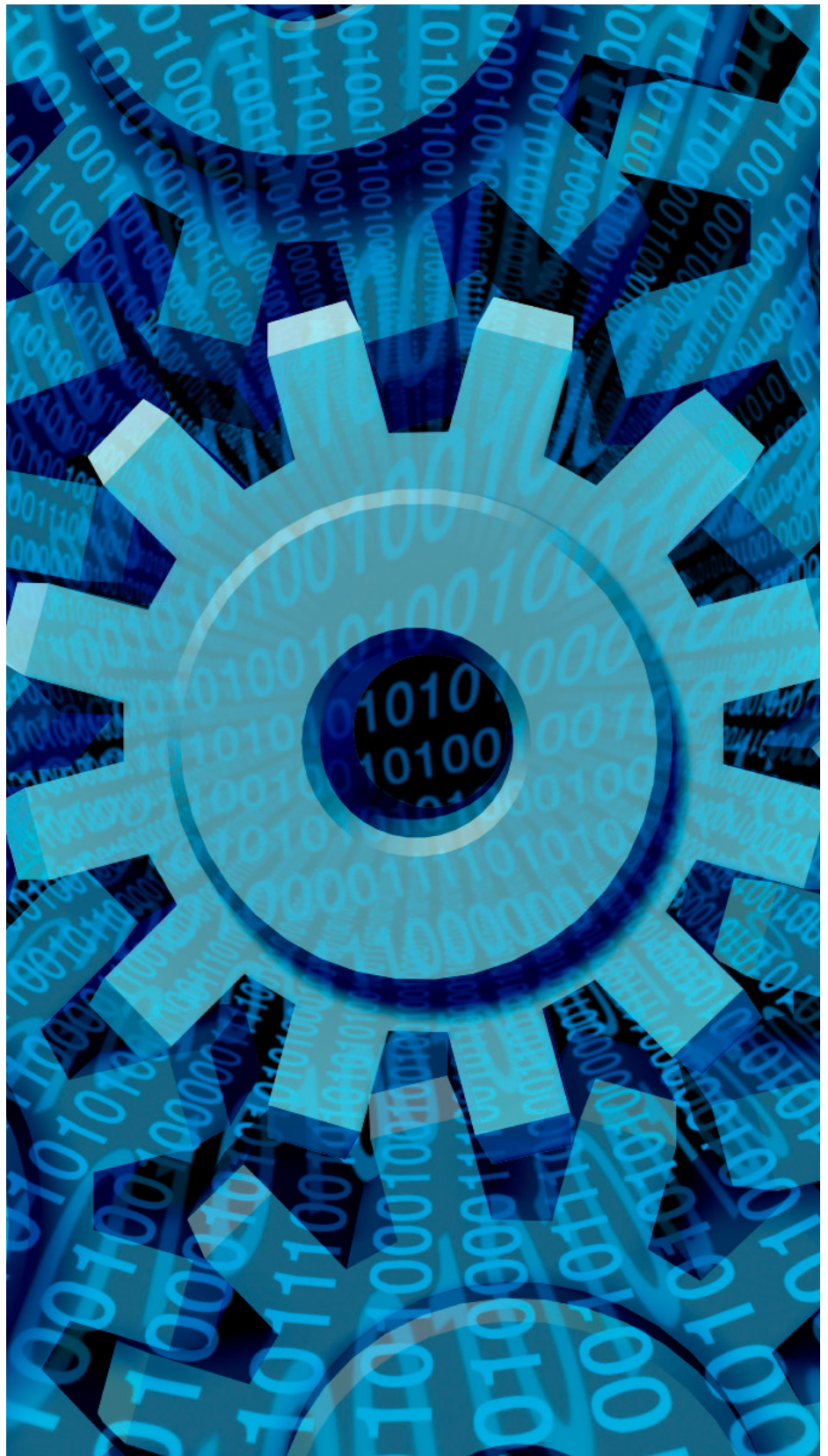
of the Solvency Capital Requirement ('SCR') through the Loss Absorbing Capacity of Technical Provisions. Therefore, while these market impacts may be material for With Profits funds, the management actions available and the ability to take credit for them in the SCR may dampen the effect on the solvency of these funds. The implementation of management actions may take longer in With Profits funds (than other lines of business) due to the rigorous governance requirements, and more significant management actions are likely to require the non-objection of the Regulator(s).

Conclusion

Whilst we have seen extreme market turmoil in recent weeks, insurers' share prices have seen a recovery of sorts, and solvency coverage ratios, while dented for some insurers, appear to be holding up within insurers' target capital ranges.

However, insurers are likely to need to maintain their operational resilience and solvency management strategies for some time, while meeting potentially complex and changing consumer needs as they deliver vital services to policyholders. Supervisors will, rightly, be focussed on outcomes during this uncertain and demanding period, and so insurers can expect flexible judgment and measured forbearance from their supervisors where this will assist their objectives of policyholder protection, financially sound firms and orderly markets. But they should also expect supervisors to pay very close attention to firms' resilience and to the solvency and operational risks created by COVID-19, some of which have been unanticipated, and to the treatment of vulnerable policyholders.

Globally, many insurers are at the stage of reacting to the difficult implications of COVID-19 for their people, shareholders and customers. Looking to the recovery stage, insurers will need to embed changes to give themselves a chance of sustaining them – some Chinese companies are now adapting as they move into this phase. Finally, insurers should, ultimately, expect more fundamental change in order to thrive in what we anticipate will be a dramatically different environment in terms of consumers, workforce and communities.



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