IRSG

INSURANCE AND REINSURANCE STAKEHOLDER GROUP

Advice on Shared Resilience Solutions

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INTRODUCTION

The IRSG welcomes EIOPA's issues paper on shared resilience solutions for pandemics. It is a step in the right direction at this important and economically uncertain time. It addresses a key gap in insurance coverage which has become evident to many insureds right at the time of their greatest need. The gap is evident in the exclusions applying to pandemics in existing covers, and in the lack of Non-Damage Business Interruption (NDBI) products providing pandemic coverage in the market. The need for a solution to this issue is indisputable, since businesses are harshly affected by the sudden and steep decline in business activities, caused either by the pandemic itself, or by associated government measures to flatten the epidemic peak curve.

It is also understandable that such massive events, which severely affect overall economic activity and pose systemic threats, prevent the existence of a product offered solely by the insurance market. A private-public shared resilience initiative has the potential to be effective to enable a functioning solution to the NDBI impacts for pandemics.

FOCUS ON NDBI IN PANDEMIC

The paper starts with a general discussion of insurance risks in a pandemic but then focuses quickly on NDBI. It is understandable that NDBI would be a focus given the exceptional interest in this area but the paper would have benefited from a more holistic description of insurance coverage in a pandemic and its role, including life and health covers. The insurance market can provide useful and consistent solutions to the challenges raised by pandemic risks in these fields. It is important to note that future crises are unlikely to take the exact same shape as the current crisis and it would be unwise to assume that the same issue will apply in the same way for future events.

EIOPA must be conscious that the next catastrophic risk may not be a pandemic, and should at least consider the possibility that a shared resilience solution designed for pandemics may ultimately be called upon in some way to deal with the consequence of different types of catastrophic or systemic event.

We agree that the four steps of a shared resilience solution which are set out in the paper (risk assessment, risk prevention, product design, risk transfer), are appropriate. We also address the possibility of self insurance below.

CAPACITY AND INSURABILITY

On business interruption costs, the correct issues are highlighted. Lack of capacity is a key issue, and the inability of the insurance sector to cover this risk on its own underlines the importance of building capacity, which should be a focus of follow-up work at EU-level.

Perhaps as a consequence of this, the paper does not directly tackle the question of which pandemic risks are and are not insurable. For example, there is ample evidence that pandemic mortality risks are insurable whereas it is extremely challenging to insure business interruption pandemic risks.

Insurers must consider the impact of pandemic on various policy classes and when doing so should ask themselves "was the policy designed to respond in this situation?". Life and health insurance policies will be materially impacted which will impact financially (as well as operationally and on staff) on both insurers and reinsurers (though note potential offset from the impact on longevity/annuities).

The paper would have benefited from a more focused explanation of why insuring business interruption is extremely challenging. Apart from the fact that pandemic NDBI losses are neither random nor independent, their magnitude is simply not manageable from the insurer's solvency point of view. The uncontrollable aggregation of losses could be ruinous to the risk pool and, ultimately, to the insurance industry as a whole. The paper addresses detailed technical points (e.g. parametric vs non parametric covers) without having properly addressed this fundamental point. In addition, having a common understanding of which pandemic risks are insurable and have been covered during the Covid-19 crisis and which cannot be covered due to their strong dependency on government actions is paramount.

Extending this theme, it would be helpful for the paper to consider the technical aspects of insurability, with a view to overcoming the issues presented for each by pandemic events. This would mean discussing such issues as:

- The existence of large numbers of homogeneous exposure units enabling statistical estimation of claim costs
- The extent to which the cover is fortuitous, i.e. beyond the control of the insured
- Whether losses arising can be considered to be definite in time and amount
- Whether losses are non-catastrophic and measurable
- The economic feasibility of premiums

Each of these factors is impacted in particular ways by the features of a pandemic and societal responses which are put in place.

Principle 1 on page 4 states that a shared resilience solution would require the sharing of costs and responsibilities across the relevant parts of the private and public sector in a meaningful manner. It must be recognised that, even if the private sector were to assume a very small percentage of the overall costs of such a solution, this would constitute a significant take up of risks for the insurance industry given the magnitude of the pandemic risk. This is recognised in the introduction, which states that current business interruption premiums would need to be collected for 100 years to cover only 2 months of business interruption costs, but should be brought out clearly throughout the paper.

MEMBER STATE AND EU INVOLVEMENT

The case for the involvement of Member States and the EU is strong. If the preparedness for large systemic risks materialising is not at the same level across Member States, nor will the recovery be; this undermines the Internal Market. Although national efforts are being made to repurpose existing schemes at national level (whether it be a pool, or a subsidized scheme) these solutions are both geographically and thematically limited. In this respect, EU's primary role supported by EIOPA would be to ensure consistency and coherence across the EU Member States.

RISK ASSESSMENT, PREVENTION AND ADAPTATION

Underlying all of the above is the sense that there should be more focus placed on the fundamentals of risk management in the four key elements and principles of the shared resilience solution put forward by EIOPA. The Three Lines of Defence model, recognised as a standard of Enterprise Risk Management (ERM), is a very strong tool for improving organizational resilience. ERM better prepares organisations to prepare for a large systemic event by building up robust capabilities to prevent, detect, respond to and mitigate these risks, and re-start activities.

The risk management community, which is uniquely positioned to assess how to manage a risk of the size of the ongoing pandemic, has identified self-insurance by corporates as a potentially viable approach for some. This would require greater financial capacity which could be achieved through reserving and balance sheet management to prepare for the impact of uncertain events. It would also be useful to consider a review of accounting rules to facilitate this possibility. In addition, the use of captive (re)insurance companies (regulated by Solvency II) can be an efficient risk management tool. This could provide a solution to corporates in that they can expand the scope of available insurance, consolidate and mutualise group risks, as well as offer added value to their customers.

However, most European businesses, including SMEs, will continue to demand insurance coverage to cater for the financial business interruption losses caused by catastrophic risks. The EIOPA Issues Paper therefore rightly suggests a resilience framework which would assure the inclusion of the private insurance sector. Beyond its financial contribution, this would primarily embed a high degree of technical expertise to assess risks and contractually transfer these at an adequate individual price. This incentivises good risk management, i.e. loss prevention, which supports societies with lower losses and creates a more effective and efficient way to use taxpayers' monies.

DATA SHARING AND RISK MODELLING

Section 3.1 outlines how lack of NDBI data and modelling capability presents an obstacle to writing these covers. It correctly acknowledges that these covers are very challenging to model because the main drivers of NDBI in a pandemic (government actions) do not lend themselves to being modelled. There is an implication that the covers could be written if these modelling deficiencies could be overcome. Even assuming that such covers are insurable, this understates a key point drawn out elsewhere in the paper that the costs of such covers when priced on a risk basis would dwarf current insurance premiums such that the purchase of such covers would not be economically feasible for small businesses likely to be most impacted by the pandemic. Affordability of insurance premiums is already a key issue, and it is likely that the provision of coverage in respect of all or some of the potential NDBI cost emerging from a pandemic would make insurance unaffordable. This must be a key consideration for the work on shared resilience solutions, i.e. how to mitigate the cost of pandemic related losses without making ongoing insurance premiums unaffordable.

Viewed from an SME perspective, this lack of data goes beyond the current scope of this paper, since there is no clear database that follow SMEs access to information on insurance in general. Note that SMEs databases regarding access to finance (ECB – SAFE)[1] and access to investment (EIB - IS[2]) already exist. The lack of access to a distinct insurance database for SMEs makes it more difficult, if not impossible, to design insurance policies that would fit the specificities of small companies in general, and of an NDBI product in particular.

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[1] https://www.ecb.europa.eu/stats/ecb_surveys/safe/html/index.en.html

[2] https://www.eib.org/en/publications-research/economics/surveys-data/eibis/index.htm?sortColumn=startDate&sortDir=desc&pageNumber=0&itemPerPage=10&pageable=true&language=EN&defaultLanguage=EN&tags=5bf8095afa70f13f9d3b51b3&ortags=true&orCountries=true

We support the idea of establishing an EU expert group, with clear deliverables and governance structures, to work on this area.

GOVERNMENT RESPONSES

We note also the extent of differences in approaches used by governments to contain the virus through population restrictions, e.g. school closures, restrictions on opening of hospitality businesses, travel bans, workplace closures, lock-downs, etc. These differences are likely to lead to very different economic effects from country to country, both at a macro-level and at the level of individual business sectors. This in turn could lead to very different NDBI costs country by country, which could not be predicted in advance due to the uncertainty attaching to individual government responses.

BUNDLING

Section 3.3 states that pandemic insurance would benefit from more diversification and therefore be more feasible if bundled with other products. Attaching pandemic insurance covers to commonly contracted insurance products, e.g. fire and property, would increase take up across the business spectrum leading to diversification across sectors. Taking this pandemic as an example, we have seen different economic impacts across sectors, with some very negatively impacted but some benefiting. At a macro level, NDBI pandemic risk is non-diversifiable since economic agents are affected at the same time.

TARGETING

Paragraph 3.3.2. explores the option of targeting NDBI products at SMEs, and describes pros and cons of such an option. The majority of theoretical literature and empirical evidence agree that the size of the company is positively correlated with the company's resilience, namely the bigger the company, the more resilient it is in crisis situations. As a recent OECD paper[3] concludes "*These*

[3] https://www.oecd.org/coronavirus/policy-responses/coronavirus-covid-19-sme-policy-responses-04440101/

various impacts [of the pandemic crisis] *are affecting both larger and smaller firms. However, the effect on SMEs is especially severe, particularly because of higher levels of vulnerability and lower resilience related to their size.*". Thus, NDBI products should not only be targeted at SMEs, but there should also be a mechanism that would protect smaller enterprises (i.e. micro and small) at an even higher level. Creation of access for SMEs to an insurance database, which could categorize data across the three different SMEs sizes (namely micro, small, and medium) would provide a clear mapping of the specificities of these categories, allowing the creation of better and potentially different insurance tools for enterprises of different sizes.

IMPORTANCE OF CLEAR COMMUNICATION AND POLICY WORDING

Clear and regular communication to customers of the coverage which they have purchased, e.g. scope, triggers, exclusions, is essential to avoid surprise at a time of need. This could also address in simple terms the reasons why certain risks might be uninsurable. Many insured entities have been taken by surprise at the exclusion of losses due to pandemics from their policies. This aspect of the NDBI problem, and its rectification for future events, should be addressed by EIOPA.

Most SME policies are focused on property damage and only have basic cover for BI as a consequence of property damage. But some policies also cover for BI from other causes, in particular infectious or notifiable diseases ('disease clauses') and non-damage denial of access and public authority closures or restrictions ('denial of access clauses'). In some cases, insurers have accepted liability under these policies. In other cases, insurers have disputed liability while policyholders considered that it existed, leading to widespread concern about the lack of clarity and certainty. It is crucial that EIOPA clarifies key issues of contractual uncertainty for as many policyholders and insurers as possible. For example the UK Court judgment says that most, but not all, of the disease clauses in the sample provide cover. It also says that certain denial of access clauses in the sample provide cover, but this depends on the detailed wording of the clause and how the business was affected by the government response to the pandemic, including for example whether the business was subject to a mandatory closure order and whether the business was ordered to close completely.

There should be greater clarity on product wordings. Where the same words and phrases are used in different contracts, there should be a consensus among professionals about what those terms mean, so that consumers can be reassured that two policies that look the same on paper cover the same risks. So we would need to improve advice processes and non-advised buying processes to help clients understand both the insurable and non-insurable risks they face and what they can do about each one. The advice should be provided in the context of the reasonably anticipated insurer and government approach to pandemics and other systemic risks, including any shared resilience solution. If the government clarifies the risks it is prepared to cover, the market can be clear on how it will cover the risks that it is capable of covering.

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