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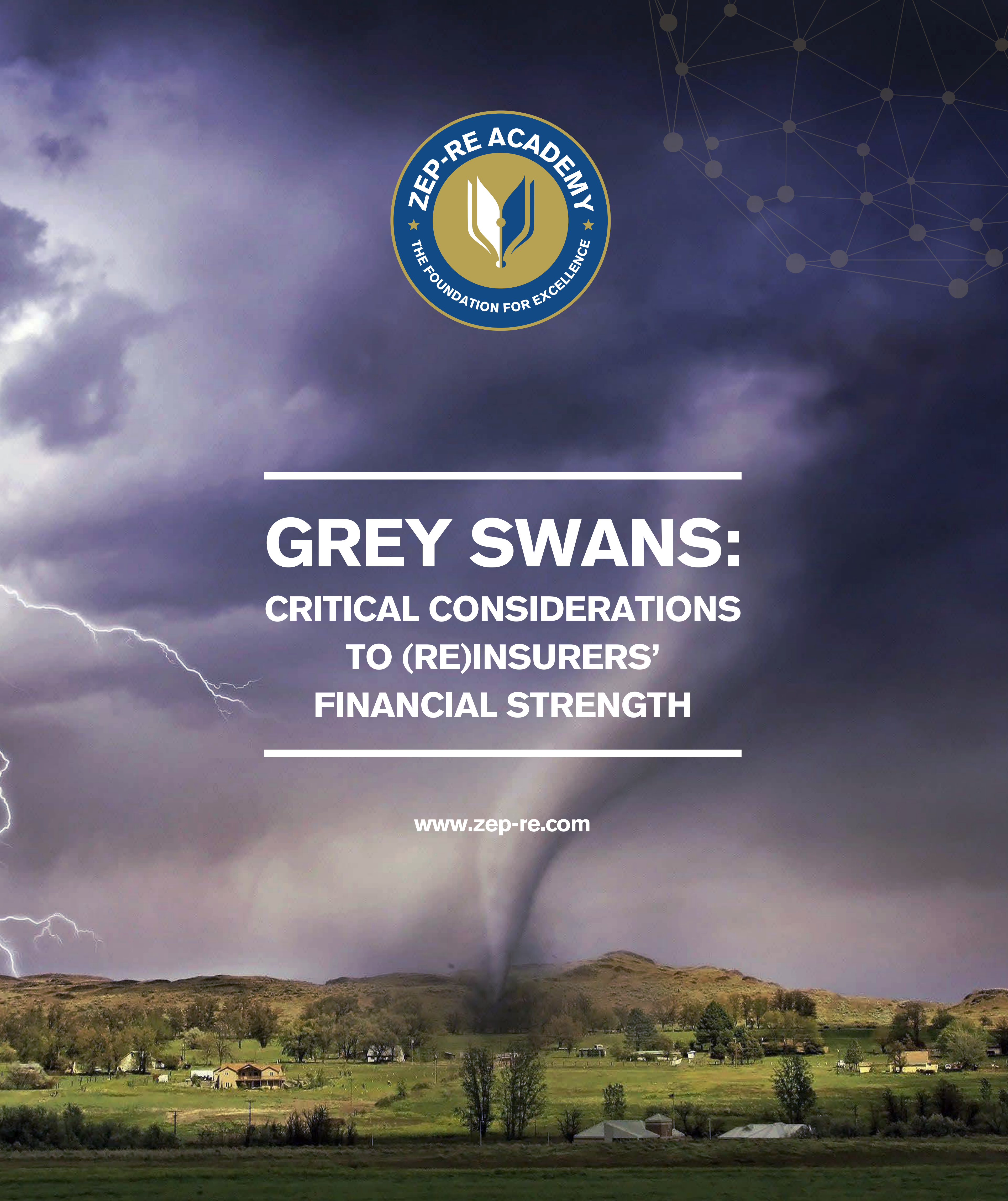

GREY SWANS:

CRITICAL CONSIDERATIONS TO (RE)INSURERS' FINANCIAL STRENGTH

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Introduction

Deniese Imoukhuede examines the impact of grey swans on the financial strength of the (re)insurance industry

The global business landscape has, over the past year, been plagued by the COVID-19 pandemic, a situation that has heightened political tensions, stalled economic productivity, caused mass insolvencies, and triggered high levels of unemployment. The economic and social disruption has been devastating, and no country, business, or individual has been immune to its impact.

In response, African governments have implemented measures to balance the broader impact of the pandemic on the economy and public health. Such measures have included oscillating between partial and total lockdowns, banning gatherings, and facilitating remote working - all aimed at encouraging social distancing and preventing cross-border contagion.

Despite these actions, African economies have not been impervious to the three-pronged economic shocks: "(i) lower trade and investment from China in the immediate term; (ii) a demand slump associated with the lockdowns in the European Union and OECD countries; and (iii) a continental supply shock affecting domestic and intraAfrican trade" (Organisation for Economic Co-operation and Development 2020, p.1). This culminated in a 1.9% economic contraction in 2020, the worst performance registered for the continent, as reported by the International Monetary Fund (IMF) in April 2021 (IMF 2021).

Although there is promise of economic recovery in many countries during 2021, the IMF anticipates that sub-Saharan Africa (SSA) will be the world's slowest-growing region, with an estimated growth rate of 3.4% compared with the global projection of 6.0% (IMF 2021). Furthermore, according to the IMF, SSA's economic productivity is expected to remain at pre-pandemic levels until at least 2025. This is due to the lack of access to vaccinations, the slow roll-out of immunisation programmes, and the general destruction of decades-long achieved socio-economic progress in these countries (IMF 2021).

The (Re)Insurance Industry

Against this backdrop, the (re)insurance industry has had to adjust to the dual economic and public health crisis through, among other strategies, the rapid adaptation to remote working protocols and new service delivery approaches to ensure continuity of operations.

Concurrently, the industry has employed conservative operational strategies, as far as possible, to safeguard its solvency and liquidity requirements.

Moreover, (re)insurance regulators, associations, and (re)insurance organisations have coordinated to sustain the industry's reputation by providing financial support to policyholders. This support includes flexible premium payment arrangements, insurance policy renewal extensions, and premium refunds or discounts on certain policies, such as motor and travel policies, following the reduction in exposures due to the implementation of lockdown measures that restricted movement.

The COVID-19 pandemic continues to pose challenges internationally and regionally to the (re)insurance industry's underwriting, investment, and operational risk management capabilities. The outcome has highlighted weaknesses, including how certain insurance contracts have been designed, as illustrated by the total COVID-19 pandemic-related losses of USD 37.4 billion registered as at June 2021. This figure, USD 37.4 billion, is based on data collated by the financial services advisory firm, PeriStratt LLC, and Reinsurance News, from the publicly reported results of several global-operating reinsurance companies (Reinsurance News 2021). These losses have arisen from several sources, including the grounding of world-wide aviation fleets, events cancellation, and life and health policies. Additionally, ambiguously worded business interruption policies have resulted in unexpected loss exposures, following the outcome of various class action legal cases contesting insurers' claims payment obligations.

Aside from underwriting, the performance of several (re)insurers has been affected by the high investment risk appetite employed to augment profits. This has resulted in considerable fair value losses, contributing to a massive deterioration in reported earnings and impaired solvency position in 2020. (Re)insurers are subsequently re-evaluating their investment strategies, along with their underwriting risk appetites.

Although economic recovery is anticipated, many unknowns remain as (re)insurers seek solutions to build financial and operational resilience, not only to the ongoing pandemic and its impact on competitive positioning but also against known and emerging risks. The pandemic has shown that it is imperative for the (re)insurers, in their day-to-day tackling of risks, to consider the "Grey Swan" events that could impair the ongoing viability of their businesses. These are known events that can have a significant loss impact, are considered unlikely to occur, but can have a ruinous effect on the financial strength of an organisation, much in the same way as "Black Swan" events. "Black Swan" events are rare and unknown outlier events of great magnitude and consequence that are unpredictable.

In this context, this paper examines the key top five risks that (re)insurance organisations need to consider as the industry steers away from the COVID-19 pandemic. These events can have a material impact on (re)insurers' financial strength, consequently threatening the health of the industry's market.

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TOP FIVE RISKS TO (RE)INSURERS' FINANCIAL STRENGTH

1. A NEW PANDEMIC EVENT OR A NEW MORE INFECTIOUS AND FATAL COVID-19 VARIANT
2. EXPOSURE TO MAN-MADE AND NATURAL CATASTROPHES
3. CHANGE IN THE RISK MANAGEMENT STRATEGY
4. INCREASED REGULATORY SCRUTINY
5. EMERGING UNDERWRITING RISKS

1 A New Pandemic Event or A New More Infectious and Fatal COVID-19 Variant

According to numerous experts, despite its rapid and global spread, the COVID-19 pandemic is not characterised as a “Black Swan” event. This is in consideration of the fact that numerous infectious outbreaks have regularly occurred since the 20th century. These include the Spanish flu (1918-1920), Asian flu (1957-1958), Severe Acute Respiratory Syndrome (SARS, 2003-2004), the Middle East Respiratory Syndrome (MERS, 2012-to present), and more recently, Ebola (2014-2016). Further, infectious diseases have long been considered to be a part of the global risk landscape due to the impact of globalisation; urbanisation; and increased wealth in societies, which has contributed to heightened consumption of meat products and consequently accelerated the transfer of pathogens to humans. All these notwithstanding, there has not been much progress in pandemic preparedness.

The media regularly reports on the ever-evolving COVID-19 variants, considered more infectious and potentially more fatal. Moreover, there is the likelihood of low vaccine efficacy regarding these emerging virus variants. Without equity in vaccinations programmes worldwide, it is feasible that a variant could evolve that returns the global pandemic status back to square one.
So, have reinsurers learnt their lessons from COVID-19 and built up resilience against further outbreaks?

Some of the critical lessons emerging relate to the following:

- **Capital Adequacy:** Although an unrealistic premise to expect (re)insurers to capitalise themselves to a level that can absorb all losses from the most extreme event(s), they should at least understand the event(s) that could potentially result in their ultimate demise. Accordingly, they should take reasonable action to reduce the likelihood and/or severity of the risk affecting the entity. The COVID-19 pandemic has shown its threat to business continuity, capital market volatility, creditworthiness, and led to unexpectedly high underwriting exposures, all of which can crystallise simultaneously. Given the current risk environment, reinsurers may need to examine whether a period of de-risking is required to support earnings and balance sheet resilience.

- **Underwriting Exposures:** (Re)insurers ought to examine their source of growth as they seek to expand in the high-risk environment.
Although life and health policies have been the fastest-growing segments of the insurance markets, they remain significantly exposed to the high-risk landscape as countries experience third and subsequent waves. Hence, insurance organisations need to evaluate the amount of growth and, consequently, loss exposures they can bear, then determine the mitigating actions required to support their solvency status. Such considerations must include whether it is possible to quantify their loss exposures in the event of a new variant or under a new pandemic event. Further thought is required on whether reinsurers continue to support insurers' ability to underwrite these classes and at what costs. Still, it is essential to determine whether reinsurers should employ a conservative risk strategy for sustaining their financial strength, thus supporting losses as they fall due, now or in the future?
The market has also been affected by ambiguity arising from loosely worded policies. This has hindered sufficient understanding of the full extent of pandemic-related loss exposures. Whilst measures have been implemented to tighten contract wordings across the spectrum of business classes, over time, as markets soften again, it is not inconceivable that reinsurers will return to the status quo as they seek to strengthen their competitive positions. A continuous review of the risks entities are taking on, along with associated responses implemented to maintain exposures at sufficient levels, is critical to ensure that potential losses are within the organisations' risk tolerances.

- **Business Continuity:** The pandemic forced organisations to adopt remote working, changing expectations of how, where, and when employees work and challenging how the organisations maintain their employees' culture, creativity, and motivation. Within the current uncertain risk climate, organisations will likely have to continue to adapt to some form of hybrid remote working, at least in the medium term, while governments continue to restrict movement in an effort to contain subsequent waves of infections.

In these circumstances, communication, alongside effective monitoring and management of work productivity, are key in supporting company culture. To sustain optimal productivity, (re)insurance organisations should continuously seek to understand the limitations and benefits associated with remote working, including mental wellness, access to affordable internet and telecommunication, the effect of home distractions, and long working hours. In addition, workplace health and safety protocols need to be examined and necessary action taken with regard to staff who cannot work remotely. Besides, the organisations need to review their succession plans since new variants, or a different pandemic could plausibly reduce resources significantly, hindering their service delivery.

Remote working has also forced staff to access files from remote servers using personal Wi-Fi networks, resulting in increased exposure to phishing emails, thereby heightening vulnerability to privacy and security risks. Although these are not new problems facing organisations, information technology (IT) departments need to consider how these vulnerabilities can present themselves and, in turn, implement new responses to address the possible risks.

2 Exposure to Man-made and Natural Catastrophes

Outside of a pandemic event, man-made and natural catastrophes remain a threat, whether earthquake, severe flooding, or terrorism. Above a certain level of losses, such events could impair the most conservative (re)insurers and the market in which they operate.

As with a pandemic event, (re)insurance organisations must consider events that could put them out of business and thus implement measures to reduce the likelihood and/or severity of the possible risks from such events. These mitigating actions require consistent collation of high-quality data to allow for modelling of potential losses under various catastrophic scenarios and taking action to reduce the modelled loss to an acceptable level.

Alternatively, organisations could undertake a reverse stress test, whereby they use realistic disaster scenarios to identify the threats that could render their entities insolvent and accordingly implement responses to manage the potential risks to an acceptable level.

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3 Change in the Risk Management Strategy

As the pandemic risk subsides, organisations are likely to return to a business-as-usual mindset. The longer-term consequence of the COVID-19 pandemic, although still unknown, may hinder a rapid recovery in economic and operating conditions. Under such a scenario, there is a risk that (re)insurers, intent on meeting their objectives, may be tempted to increase their risk appetites to levels not aligned with their risk-taking capacities and risk management capabilities. For example, in a drive to meet growth objectives, (re)insurers may be more inclined to grow into new risk segments without the sufficient skillset to support the associated underwriting. Alternatively, they could aggressively expand into new territories to close a premium gap. Such aggressive approaches typically result in deficit loss reserves, impairing the (re)insurers' balance sheets.

Furthermore, (re)insurers may seek to augment earnings by employing aggressive investment strategies that mismatch their liability profiles – either by amounts, duration, or currency. This is because underwriting profitability is likely to be affected by issues such as the pandemic-induced diminished growth prospects, at least in the medium term, and intense competitive conditions. This poses the risk of increasing volatility on the respective organisations' balance sheets by incurring substantial realised/unrealised investment losses. Additionally, the organisations are at risk of significant liquidity shortage to meet claims obligations while being exposed to credit risk associated with their holdings of illiquid investments. Credit risk has heightened since the COVID-19 outbreak.

Conversely, (re)insurers may become too risk-averse, depending on the regulation to drive the industry's development, the available insurance products, and the demand for the products. This may create the risk of inhibiting innovation within the industry, forcing insurance buyers to seek alternative solutions to protect their assets.

Therefore, (re)insurers must continue to align their risk management philosophies with their strategic plans to support risk-based decision-making.

4 Increased Regulatory Scrutiny

With the COVID-19 pandemic hitting consumers and small businesses hard, regulators have increased activity around the insurance industry, grappling to ensure market stability, safeguard consumers, and facilitate the development of the industry's market, alongside offering some relief to the industry. Internationally and regionally, priorities have changed as regulators have also had to adapt to the new working conditions and the challenges this poses to effective communication with the industry on how to proceed in the pandemic.

At the forefront have been concerns over the industry's business continuity plans and the potential impact of such plans on policyholders and employees. These concerns include the unfair treatment of customers regarding their ability to access insurance products and submit claims, and employee safety and operational resilience.

In this context, some regulators have required insurers to activate their continuity plans in view of the severity of the pandemic, and in some cases requiring submission of the plans to review for suitability. In certain territories, regulators have directed the industry to digitalise through the provision of online platforms that facilitate the selling of insurance products, paying of premiums, and settling of claims, to support continuity during and after the pandemic. While noting the adverse impact of lockdown measures on consumers' financial stability, some regulators have also directed the industry to support lengthy grace periods for premium payments and make good on COVID-19 claims settlements. This is so despite the limited capacity of the industry to handle these claims of unknown quantum.

In some jurisdictions, there has been a focus on oversight of the prudential soundness of the industry, with regulators implementing more rigorous requirements. These include the need to provide periodic reports on the outcome of stress tests meant to examine the organisations' ability to withstand COVID-19 related losses in relation to their solvency position, liquidity, and general operational resilience. Conversely, other supervisory authorities have employed more lenient approaches in their regions, allowing their insurance undertakings to maintain a temporary shortfall in capital requirements as they weather the pandemic storm.

Even as markets take stock of the lessons from the pandemic, the industry will likely have to contend with more supervisory scrutiny as regulators progressively engage a more proactive approach in strengthening the industry's financial and operational resilience. One potential outcome of such scrutiny would be the need for the industry to adhere to further compliance and governance requirements, taking up a lot of management time that is arguably required to run the business. An additional consideration is the need to invest in information technology to support the growing regulatory reporting requirements.

In addition to higher regulatory costs of conducting business as industries move to a risk-based operating approach, lack of clarity and the risk of regulators adopting conflicting standards could affect (re)insurers' business models, profitability, and capital levels. Further, the potential for regulatory protectionism, through the ring-fencing of assets by local regulators, could hinder the insurance model of diversification and capital deployment.


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4 Emerging Underwriting Risks

In the wake of the socio-economic disruption caused by the COVID-19 pandemic, new premium pools are being developed as the global supply chain restructures and diversifies to prevent over-dependence on a single revenue stream. Besides, the rapid acceleration to digitalization, prompted by the global lockdowns, has forced industries to embrace the move online, creating new efficiencies and streamlining processes.

This, though positive for the (re)insurance industry, also brings emerging underwriting risks that cannot currently be fully assessed and quantified but which could affect the viability of an organisation's strategy and impair its financial strength.

The very nature of emerging risks means that the landscape is constantly evolving, making these risks difficult to identify and quantify. Examples of pandemic-related drivers emerging into the underwriting risk landscape include technological advances, scientific findings associated with the long-term impact of the COVID-19 pandemic and the vaccine, new economic and environmental developments, and social developments.

Traditional actuarial approaches used to quantify these risk exposures may not be effective.

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In summary

(Re)insurers can derive many lessons from the past year. However, rather than preparing for the last crisis, they should apply the transferable lessons from the pandemic to a range of complex, emerging threats to build financial and operational resilience to enable them to face the next crisis.

While many businesses have innovated and adapted to the rapidly changing landscape, not all have, nor will all, benefit from the expected economic recovery. Businesses must now be ready for a potentially disorderly disruption during the recovery period and beyond.

To build and maintain resilience, organisations need to continuously review their risk management approaches to identify the "Grey Swan" events that could impair their viability. This will enable them to respond effectively and, therefore, successfully navigate the risks and opportunities ahead.

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