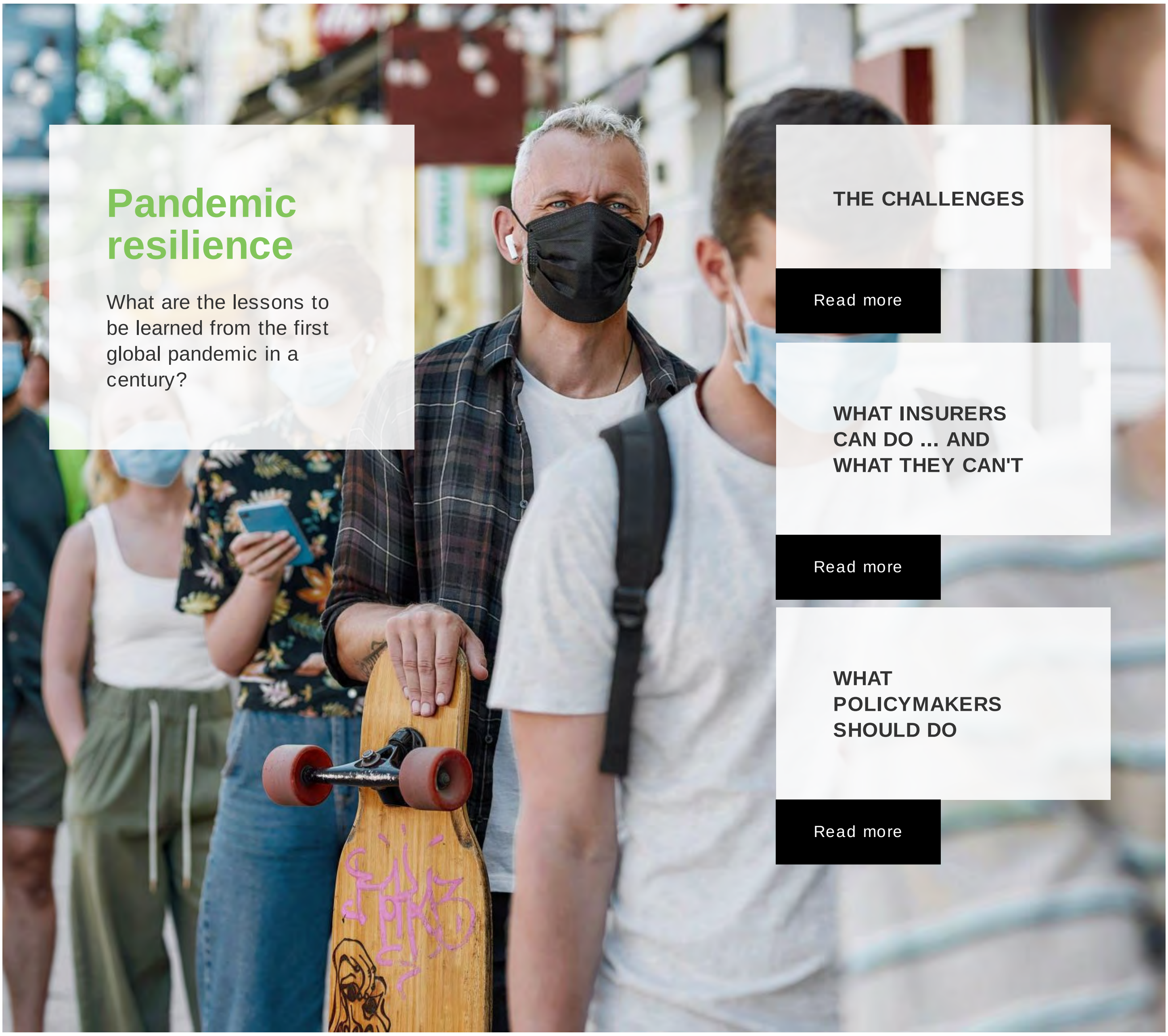

Pandemic resilience

What are the lessons to be learned from the first global pandemic in a century?

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Eighteen months on from the first reported case of COVID-19 in Europe and life on the continent is still far from normal. The challenges presented by the pandemic need little introduction. COVID-19 has devastated societies and economies the world over, leaving no sector untouched.

It is that size and breadth that makes pandemic risk different from other catastrophes. Whether natural or man-made, other catastrophic risks do not usually hit the entire world at once. And in the case of COVID-19 the economic losses have arisen not only from the pandemic itself but also from the government actions that have mitigated the impact of the virus but exacerbated its economic effects.

Estimated OECD revenue loss for one month of strict lockdown measures

Largest economic loss from a single event since 1970

Businesses across OECD countries faced an estimated **$1.7trn** in revenue losses for **one month of strict lockdown measures**.

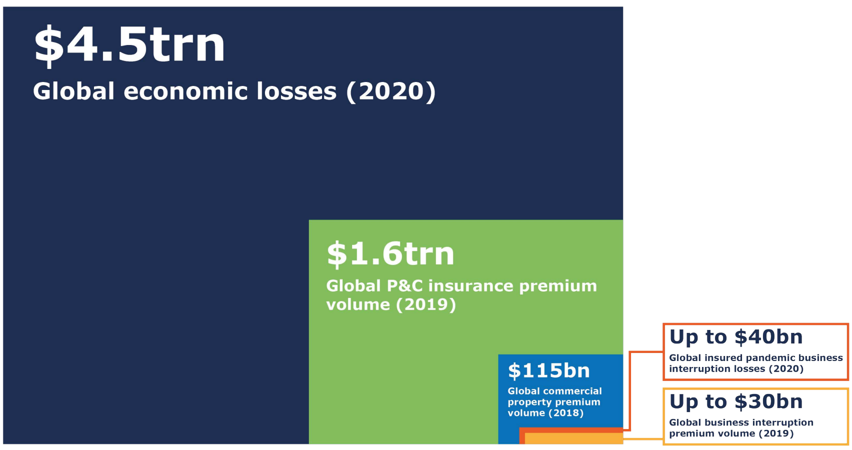
By comparison, the largest economic loss from a single event since at least 1970, the **earthquake that hit the east of Japan in 2011**, resulted in **$234bn** of losses.

(OECD, March 2021)

At the same time, COVID-19 has exposed massive protection gaps in the area of business continuity risk. The Geneva Association calculated in October 2020 that less than 1% of an estimated $4.5trn of global pandemic-induced GDP loss for 2020 will be covered by business interruption insurance.

It has also exposed the mismatch between pandemic-related economic losses and the risk-taking capacity of insurers. With annual business interruption insurance premiums of about $30bn, insurers would have to collect premiums for 150 years to cover the global output loss in 2020, according to the Geneva Association.

The global pandemic business interruption protection gap



All figures are estimates

Based on the World Bank 2020, McKinsey 2020 and contributions from Allianz Research

Source: "An Investigation into the Insurability of Pandemic Risk", The Geneva Association, October 2020

The COVID-19 pandemic also brought into the spotlight other areas in which resilience needs to be strengthened. Research by Bruegel published in July 2020 found that one in three EU households were unable to meet an unexpected financial shock even during regular times. And Interpol said in August 2020 that 59% of its member countries reported COVID-19-related phishing and other scams and frauds. Individuals and businesses therefore need greater resilience to cope with inevitable future pandemics. And greater public awareness and management of digital and cyber risks is needed.

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Insurability

Pandemic risk challenges the principles of insurability, but with significant differences depending on the area. Insurance for life- and health-related pandemic risks, for instance, is generally widely available and affordable, as the risks are not systemic and data is available that allows life and health insurers to model pandemic risk and price it accordingly. The Geneva Association expects underwriting losses for life insurers from COVID-19 to be significant but manageable and believes that pandemic risk poses "no fundamental insurability challenges" for health insurers (Geneva Association, October 2020).

On the other hand, as outlined above, the very nature of pandemics makes pandemic-related business interruption risks uninsurable by the property and casualty industry.

The issue here lies not just in the magnitude of the losses but in their global nature; risks that materialise everywhere and all at once prevent the diversification and pooling mechanisms that lie at the heart of the private insurance business model. This is why business interruption policies tend to only cover losses associated with physical damage. When non-physical loss is also covered, pandemic risk is usually excluded, with only limited cover offered to small numbers of policyholders in well-defined circumstances. Another difficulty is the fact that business interruptions are linked to government decisions, which cannot be foreseen.

Indeed, for a risk to be insurable a number of conditions need to be met. First and foremost, it must be possible to build a pool in which the risk can be shared and diversified at economically fair terms on the basis of which premiums can be calculated at affordable prices. The risk must also be definable, financially measurable and random, and there must be a reasonable large claims history and source of data from which to calculate the likelihood of the risk occurring. COVID-19 does not meet any of these criteria.

Obstacles to insuring pandemic risk

	Business interruption	Mortality	Health
Randomness/independence of loss occurrence	●	▲	▲
Maximum possible loss	●	▲	▲
Average loss per event	●	■	▲
Number of exposure units	●	▲	▲
Information asymmetries	▲	▲	▲
Insurance premiums	●	▲	▲
Cover limits	●	■	▲
Public policy	■	■	■
Legal restrictions	■	■	■

● Prohibitively high barrier to insurability ▲ Manageable barrier to insurability ■ Insignificant barrier to insurability

Source: "An Investigation into the Insurability of Pandemic Risk", The Geneva Association, October 2020

Contract clarity

What has become clear as a result of the COVID-19 pandemic is that, in a number of markets or cases, there is some form of misunderstanding about insurance; firstly, about the basic principles of how insurance works by spreading the losses of the few among the unaffected many, as outlined above, and, secondly, about the cover provided by individual policies. The insurers and reinsurers concerned are therefore reviewing their contracts to ensure absolute clarity over what is and is not covered under their policies.

COVID-19: the insurance sector's response

Cover for related risks

In terms of reducing financial fragility and improving digital and cyber resilience, insurers continue to offer long-term savings and retirement income products and provide risk management advice and insurance policies to cover the risks of greater online interactions by businesses and individuals.

Risk expertise

Understanding and acknowledging the insurability challenges must be the point of departure for any discussion of solutions for covering the risks of future pandemics. There is an emerging consensus around the fact that if insurers are to play a role, it will be one of collaboration with governments, with the latter assuming the majority of the losses.

Nevertheless, beyond the financial aspects, the insurance industry can draw on a long history of risk management, as well as established claims-handling procedures and channels of communication with policyholders. The sector has extensive experience in addressing protection gaps for risks such as terrorism or natural catastrophes through public-private partnerships with national governments in many EU countries and beyond. Whether there is scope for a role beyond the purely administrative and advisory — in assuming a portion of the losses — remains to be seen. However, there is no doubt that the industry has a part to play when it comes to increasing pandemic resilience, and is keen to play that part.

At European level, Insurance Europe is involved in discussions on future pandemic risk solutions, notably by taking part in a workstream organised by the European Insurance and Occupational Pensions Authority to explore the options for and feasibility of shared resilience solutions.

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Pandemic prevention, vaccination procurement, virus testing and tracing, and strengthening public health systems are all essential elements in increasing resilience against future pandemics, thereby reducing the extent to which businesses would have to interrupt their activities should another pandemic materialise in the future. However, they fall outside the remit of this article with its focus purely on insurance-related issues.

Look ahead to future pandemics

A gradual return to normal life must incorporate lessons learnt from the experience of COVID-19 and, as European societies begin to reopen, the discussion around resilience will become increasingly important.

Governments — and insurers — in some EU member states have begun to explore public-private partnerships, drawing on experience of schemes to cover other, albeit different, risks, such as terrorism or natural catastrophes. These initiatives have not moved beyond national level and this is noteworthy because, despite their global nature, pandemics have a strong national component in terms of the extent and evolution of the disease, government responses to it and the resilience of healthcare systems.

Since the maximum possible loss from certain pandemic risks is uninsurable by the private insurance sector alone, as explained above, governments will need to get involved as “insurers of last resort” in any risk mitigation schemes, while still drawing on the significant expertise of the private insurance sector.

Correct the flaws in Solvency II

Policymakers must also draw lessons from the crisis in their current review of the European insurance regulatory framework, Solvency II. While it has many very good features, Solvency II does not correctly capture the real economics and risks of insurers' long-term business. This leads to an overestimation of capital requirements and excessive volatility in the solvency measures. These flaws were particularly visible in the first months of the COVID-19 pandemic, which triggered high market volatility. Those flaws could have pushed insurers into unnecessarily procyclical behaviour if the high volatility had persisted. The issue of volatility is already known and is part of the current review of the prudential framework because it pushes insurers away from long-term products and long-term investment. It is fundamental to address this in order to avoid measurement flaws in the regulation creating unnecessary problems for the sector and barriers to investment.

COVID-19: the insurance sector's response

In mid-2020 the European Commission brought consumer and business representatives together with those of the financial services industry to discuss the relief measures offered to customers affected by COVID-19 and the government lockdowns. Insurance Europe and its members endorsed the resulting best practices, which very much reflected the actions European insurers had been taking since the start of the pandemic.

Often on a case by case basis, these actions have included: agreeing to delays, deferrals or waivers of premium payments; switches to different tariffs; and policy cancellations or suspensions. And many insurers — nationally and individually — have taken a broad range of goodwill actions including: offering temporary extensions of cover and services; offering support for the economy through, for instance, trade credit or investment schemes; contributing financially to health and research initiatives; making medical and charitable donations; and relaying governments' mental and physical health messages.

Like other industries, insurers also faced the operational challenges of shifting the sector's combined workforce of over 900 000 employees from office to home. Overwhelmingly, the European industry has weathered the storm — maintaining solvency and continuing to provide services to customers on the back of strong business continuity planning.