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COVID-19 effect on the Property-Casualty Sector

The below is an excerpt from the April 2020 Conning Commentary prepared by Conning's Insurance Research team.

Key Takeaways

» Reduced premium growth is expected from decline in economic activity, with a particularly negative impact on commercial exposure units.

» Economic slowdown will also work to slow the drivers of loss frequency in most lines (vehicle travel, retail traffic, work activity, etc.).

» Lines facing increased virus-related claims include business interruption and event cancellation coverages, particularly if regulatory mandates emerge to override standard policy exclusions.

» Premium collection may slow as insurers implement payment deferrals for individuals and small businesses, straining cash flow and increasing credit risk.

» Conning estimates a decline in the industry's investment portfolio of approximately 5%, resulting in a decline in economic surplus of approximately 9% (as of March 25).

» Continuation of positive commercial lines rate momentum is in jeopardy, with the reduction in capital and need for rate offset by weaker economic conditions.

Revenue effects

With recession a certainty, reduced economic activity will have a negative impact on exposure growth in most lines. Economic growth is the underlying fuel for exposure growth, and the hardest-hit industries include hotels, airlines, restaurants, movie theaters, sporting events, and convention centers.

At the start of 2020, the consensus expectation was for GDP growth of close to 2% for the year; now forecasts are quickly turning to flat or negative growth for the year. Forecasters are mostly uniform in their assessment of negative growth in the second quarter, with variability across forecasts as to the duration of the recession. It appears a recovery will look more U-shaped than V-shaped.

Economic growth conditions drive most of the direct and indirect exposure bases for most lines of business: sales, new construction, property values, vehicle mileage, wages, and office occupancy.

New light vehicle sales are slowing dramatically. Over the past two weeks, expectations have fallen from 16.9 million units for 2020 to 15.9 million units by mid-month (a 6% drop in one week). As a measure of sensitivity, at the depths of the 2008 recession, new light vehicle sales dropped by 40% between 2007 and 2009. Based on a vehicle fleet of 250 million personal vehicles, a drop in new light vehicle sales of 40% would lead to a reduction in personal auto exposures by 1%.

Forecast retail sales, projected at the beginning of the year to be up more than 3% for 2020, declined by 0.5% in February and will be more adversely affected by the shutdown in March and subsequent months. Restaurants and theaters are closed in most locations, creating essentially a 100% decline in revenue on a year-over-year basis for the next several weeks.

In addition, premium collection will slow as businesses and individuals struggle with cash flow. Allstate has seized on this issue, providing a two-month grace period for nonpayment of premiums—waiving the cancellation for nonpayment clause for a two-month window—a strong initiative that will pressure others to follow and possibly could pre-empt more draconian measures imposed by states or by the federal government. California and Washington have requested auto insurers implement a 60-day grace period for premium payments.

Reduced premiums will also be met with a slowdown in loss payments due to reduced loss exposure. The industry's cash flow (positive $87 billion for 2019E) could very well turn negative. However, the industry's liquidity position is strong with $67 billion in cash and equivalents as of year-end 2019. This amount does not include additional liquidity sources including bank lines of credit or access to the Federal Home Loan Bank. Nonetheless, liquidity varies widely by individual company, with smaller companies likely at a disadvantage.

Reduced payroll affecting workers' compensation

Job losses and reduced hours will cause reduction to wages and salaries, the exposure base for workers' compensation premium. Although hourly workers typically earn between 20% and 30% less than salaried workers, 59% of workers in the U.S. are hourly employees. In addition to reduced hours, there will be layoffs in the economic sectors hardest hit by crisis. The reduction in payrolls will affect workers' compensation premium in 2020 and 2021.

Initial unemployment claims were 3.3 million for the week of March 16 alone. In China, close to 5 million jobs were lost in a workforce of 450 million, according to official sources. Sectors expected to be most affected include travel and tourism, restaurant, entertainment, and transportation. The duration of the crisis will dictate the extent of payroll and wage levels. Employment forecasts track GDP forecasts and range from optimistic scenarios with return to growth in the third quarter to full-blown recession through next year.

The ILS market

The ILS (insurance-linked securities) or alternative capital market has operated largely on a business-as-usual basis (except for constrained secondary market liquidity), demonstrating the noncorrelated nature of this asset class versus nearly all financial markets. Further, assets backing the collateral requirements for these structures are typically invested in high-quality, liquid, and relatively short-term securities. While only a small portion of institutional portfolios, the ILS asset class will very likely attract additional interest among institutional investors.

Loss/expense effects

The slowdown in economic activity will actually work to put the brakes on the drivers of loss in most lines (vehicle travel, retail traffic, work activity, etc.). Large or sudden increases in virus-related claims are unlikely for the property-casualty sector, but business interruption (BI) coverage may be cause for concern. BI is typically not triggered under a virus scenario due to specific policy exclusions and requirements for a physical loss to have been incurred. However, consider recent developments:

» The New Jersey legislature debated a law to retroactively apply BI coverage, overriding specific policy language. The law has not yet moved forward, with various industry groups united in opposition.

» Two other states, Ohio and Massachusetts, are working on similar bills to have insurers retroactively provide BI coverage to small businesses.

» Congress is working on several bills that would provide BI coverage to qualified insureds, most involving the federal government covering loss payments.

For firms that participate in longer supply chains, the threat of suppliers not being able to provide inputs due to similar virus shutdowns will also not be covered. In these cases, it is contingent BI coverage that would otherwise cover disruptions by vendors.

Workers' compensation

The reduction in economic activity will affect workers' compensation insurance by reducing both premium potential and loss frequency. With workers asked to stay home for an extended period, the near-term opportunity for many types of workers' compensation claims is dramatically reduced. There may be losses directly linked to COVID-19 exposure. The main workers' compensation coverage question is whether a worker who was sickened (or died) from COVID-19 contracted at work has an occupational disease. Many states exclude "ordinary diseases of life." Ordinary diseases of life, such as colds, are illnesses to which the general public is exposed and could be contracted outside the workplace. There have already been 31 workers' compensation claims related to COVID-19 filed in Pennsylvania.

The direction of workers' compensation court rulings is to be more liberal in interpreting what constitutes an occupational illness, moving from a "peculiar risk" to an "actual risk" standard. This means that there may be coverage even if the risk is not peculiar to the workplace. Some states, including Washington, Michigan, and Pennsylvania, have declared that they will provide coverage to first responders and health care workers who are quarantined following COVID-19 exposure. We expect to see more moves by departments of workers' compensation and judges in the weeks ahead and vexing differences in approach and interpretation from state to state.

Event cancellation insurance

Event cancellation insurance is another area where claims will possibly spike, but coverage determinations will be on a case-by-case basis. The purpose of event cancellation insurance is to protect event revenues and related expenses against the risks of cancellation, postponement, etc., for circumstances beyond the control of the event organizer. Most policies offer broad all-risk coverage, while other policies are written so only specific causes or risks (e.g., extreme weather, terrorism, etc.) trigger coverage.

Event cancellation policies usually exclude infectious disease coverage, but coverage depends on the terms and conditions of the specific policy. For example, losses may be covered if an event is canceled that takes place in an affected region. However, the cancellation of an event may not necessarily be covered if the cancellation was not beyond the control of the event organizers or attendees.

On March 24, the decision was made to postpone the Tokyo Olympics until "no later than summer 2021." While the cost of postponing the games will likely be significant, they should be less than an outright cancellation.

Asset effects

The property-casualty sector began the year in excellent financial health. While in the best condition ever to weather adversity, the current environment will still strain insurer balance sheets, reducing insurer investment portfolios and, consequently, economic surplus levels.

Insurer portfolios experienced a double negative impact: the equity market declined along with corporate bond values, which moved in the opposite direction to Treasuries. While the bulk of the sector's invested assets are in high-quality bonds, nearly 20% are in BBB and high-yield bonds.

A simplified view of the industry's investment portfolio indicates the sensitivity to the industry's financial strength. The table below left is an estimated point-in-time view of the impact to values across asset classes and the consequent effect on invested assets.

As of March 25, 2020, we estimated a decline in value to the investment portfolio of approximately 5%, with the largest contributors being BBB bonds, high yield, and equities. Compared to the end of the year, we estimate economic surplus (note that, for statutory accounting, insurers carry most fixed-income securities at cost and not at market value) may be down as much as 9%. This is a point-in-time view, but does demonstrate the risk to industry capital. Financial markets recovered somewhat during the fourth week of March, reacting to extreme actions by the Fed (announcing it would buy bonds in unlimited numbers and backstop direct loans to companies), but significant volatility remains.

Insurer appetites for new investments range from opportunistic purchases to cash preservation strategies given the economic and cash flow uncertainty. However, with the ten-year Treasury having slid to a sub-1% yield, insurers will be challenged to rely on investment income increases to support profitability.

Estimated Impact to Property-Casualty Investment Portfolios

Asset Class	Allocation	Estimated Price Change, 12/31/2019 – 3/25/2020
Cash	1%	0%
Treasuries	8%	2%
Municipals	16%	(5%)
A-AAA Corporates	24%	(2%)
BBB Corporates	15%	(12%)
High Yield	4%	(20%)
Equities	8%	(24%)
Structured and Other	24%	2%
Total	100%	(5)%

Source: Prepared by Conning, Inc. Source: Bloomberg Index Services Limited. Used with permission. Bloomberg is a trademark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg") Barclays is a trademark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Neither Bloomberg nor Barclays approves this material, guarantees the accuracy of any information herein, or makes any warranty as to the results to be obtained therefrom, and neither shall have any liability for injury or damages arising in connection therewith. Past performance is not a guarantee of future results.

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