THE PROPERTY/CASUALTY
INDUSTRY & COVID-19:
WELL POSITIONED AMID THE OUTBREAK

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March, 2020

On March 11, 2020 the World Health Organization (WHO)officiallydeclared COVID-19 a global pandemic. Two days later, U.S. President, Donald J. Trump, declared a national emergency. Countries around the world have been taking unprecedented action to slow the spread of the virus. These actions have already had a profound impact on businesses around the globe. The spread of COVID-19 and the unprecedented global response from leaders across all nations has wreaked havoc on economies. Simultaneous supply and demand shocks have sent investors into a selling frenzy. The question of whether the world falls into a global recession has transitioned from “if” to “when.” On Sunday, the Federal Reserve (Fed) cut short term interest rates to zero in an attempt to spur economic activity and restore investor confidence. As of this writing, the White House and the Fed are drafting a stimulus plan to the tune of $1 trillion. Despite this, major Wall Street indices are now off roughly 30% of their all-time highs.

Currently, there is no vaccine for COVID-19. Some experts believe that it could take over a year until a vaccine is available for worldwide distribution. Until that day comes, the healthcare industry will be strained as the number of cases continues to rise and patients seek hospitalization. Medical claims will spike higher than anticipated and the unfortunate loss of life will have a significant impact on life and health (L/H) insurers. No sector is shielded from the impact of COVID-19. Property and casualty (P/C) insurance companies will also certainly be impacted, but we believe that short-term losses will largely be mitigated by robust industry capitalization, conservative investment rules and prudent underwriting discipline, as we will discuss further in this publication. We believe that the P/C industry, in general, is well positioned to endure this pandemic.

Claims Activity

From a P/C insurance perspective, impacted lines of business will include event cancellation and business interruption insurance. Other lines, such as workers' compensation and directors' and officers' (D&O) insurance, may also be affected.

With the voluntary and involuntary closure of many businesses across the nation, many business owners may be wondering if insurance will cover loss of revenue. Typically, business interruption (BI) policies cover risks of material damage to property from events such as fires, floods and other natural disasters. A pandemic is a different type of interruption because there is no "physical" damage to the business. However, certain policies can extend coverage for circumstances whereby public authorities force closure. In some cases, coverage explicitly includes an infectious disease extension. It all comes down to policy language. However, following prior contagious disease events, particularly the so called 'Brid Flu' epidemic, insurers have generally only offered non-physical damage BI cover in very selective cases and with strict and conservative sub-limits as to the financial quantum of the claim and the duration of closure over which losses can be recovered. The provision of such cover tends to be weighted towards larger industrial group insurances, not the SME business generally targeted by smaller and mid-sized insurers.

Given the unprecedented level of government intervention to combat the economic risks posed by COVID-19, there is also the possibility that lawmakers step in and pressure insurers to retroactively cover BI risks. With past catastrophic events where this has occurred, insurers have stepped-up to the plate, to a degree, where policy conditions were vague, but in turn, portions of these losses were then recovered from reinsurance coverage to mitigate the impact on the insurer's balance sheet.

Around the world, major events are being cancelled or postponed. In some areas of the US, no more than ten people are allowed to gather

in one area. Event cancellation insurance may protect event organizers from loss of revenue or enable them to recover pre-paid expenses. Again, policy language matters here. Some policies can be general and offer coverage for any reason, while other policies may only cover specific reasons for cancellation. Event cancellation policies may also include extensions for contagious diseases. Such policies are generally issued by the major national and international (re)insurance companies and by Lloyds' syndicates. Smaller P/C insurers are generally not exposed to this liability.

Workers' compensation insurers have already reported increased claims activity related to COVID-19. Some insurers have stated that they are processing COVID-19-related claims on a "case-by-case" basis. Employees must be able to prove that work conditions made them more prone to infection. However, as the infection spreads, it will be more difficult to prove whether or not it was contracted outside of work.

The impact of COVID-19 is not limited to these lines of business. We will certainly see claims spill over to other lines of business in ways we may have not anticipated. For example, on the fringe of COVID-19-related P/C claims activity, are initial reports of directors' and officers' (D&O) claims for missteps by company management in response to the pandemic. Norwegian Cruise Line is facing a lawsuit from investors alleging that the company misrepresented risks concerning COVID-19.

To combat ambiguity and accurately quantify it's underlying aggregate exposures for such events, P/C underwriters exhibit prudent underwriting discipline and policy language clearly defines which risks they will or will not cover. The vast majority of policies will explicitly include or exclude pandemic related losses. In cases where insureds have contagious disease extensions, losses will be largely mitigated by the utilization of policy sub-limits which would effectively cap a company's losses in COVID-19-related losses. In the aggregate, Cohen & Company expects the impact of COVID-19 on the P/C industry's underwriting results to be relatively limited.

Investments

Increase in claims activity is not the only concern for P/C and L/H insurance companies. Insurers, regardless of the types of risk they cover, are active participants in the global financial markets. As companies collect premium from their insureds, they invest the proceeds until a claim needs to be paid. The time between the collection of premium and when it is used to pay a claim is known as “insurance float.” The duration of the insurance float depends on the types of risk they insure. Prudent management teams will adjust the “riskiness” of their investment portfolio with their anticipated future claims in a process known as “asset-liability matching” or ALM. In general, P/C companies cover risks that are short duration (i.e., a 6-month car insurance policy) and L/H companies cover risks that are long duration (i.e., a 20-year term life policy). Each management team’s approach to ALM is different but is ultimately based on many underlying actuarial assumptions as well as risk and return expectations from their investment portfolio.

When “Black Swan Events” such as the spread of COVID-19, disrupt and upset “normal” market conditions (and more importantly, the assumptions built into an ALM approach), an insurer’s balance sheet can be strained. After one of the longest bull markets in history, both P/C and L/H insurers may have gotten comfortable with the historical risk and returns of the stock market. However, these companies may now be experiencing significant, unexpected, fluctuations in these assets.

The declining share prices are not the only problem for P/C companies. Given the short duration of the risks that they cover, P/C companies historically had invested in short maturity, high-quality bonds. However, since the global financial crisis in 2008, interest rates (and subsequently, bond yields) have remained near historical lows. In order to improve the yield on their investment portfolio, companies began relaxing investment standards and started purchasing corporate bonds with lower credit quality and/or longer maturities. Now, with the with the anticipated global slowdown, the risks associated with holding these bonds have greatly increased.

Concerns around insurance balance sheets are largely mitigated by the robust capital levels across the industry as well as access to third party capital (most commonly in the form of reinsurance, which in turn, is also extremely well capitalized). The industry in the US is conservatively regulated at both the state and federal levels. The National Association of Insurance Commissioners (or NAIC) is responsible for overseeing the entire industry across the nation and sets clear requirements outlining how much investment risk companies can take. Furthermore, the NAIC dictates exactly how much excess capital needs to be held to minimize the risk of an insurer's failure. Most carriers maintain capital and surplus comfortably above the NAIC's minimum requirements. Insurers that are rated by credit rating agencies, such as A.M. Best, are arguably held to even higher standards when it comes to quality of capital. As such, Cohen & Company believes that these shorter-term shocks to balance sheets attributable to COVID-19 will be easily absorbed by most carriers. In the event that the economy transitions into a prolonged period of low interest rates and low expected returns across asset classes, P/C companies can quickly shift focus from

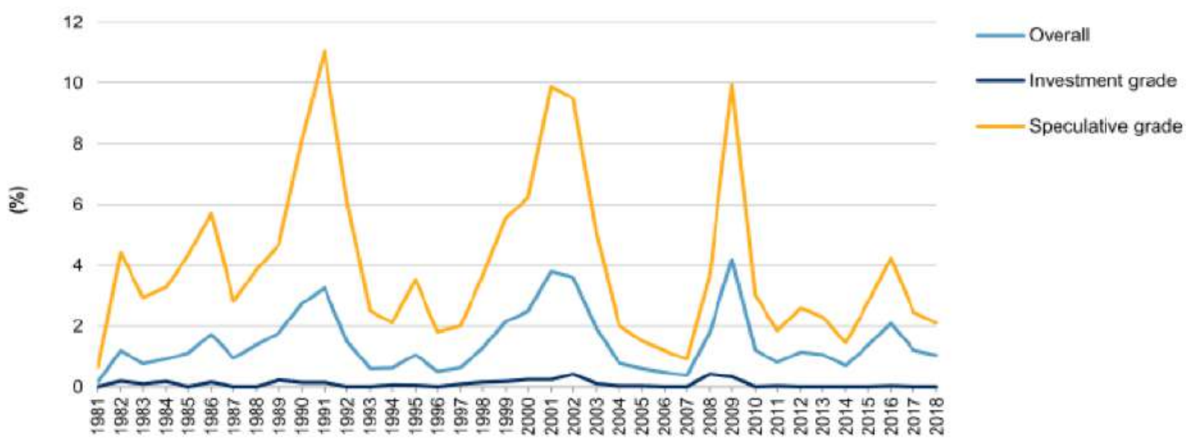
Historical Perspective

The insurance industry will be fighting a two-front "war" for the foreseeable future. Each "war" is taking place on one side of the balance sheet. Insurers are fighting increased claims activity on the liability side and declining asset prices on the other. However, from a historical perspective, the insurance industry is battle-tested and ready for the challenges ahead.

Insurance is vital for economic growth and protects financial stability against risk. Its origins date back hundreds of years. Although this is a re-emerging threat in our modern world, the industry has prevailed through countless natural disasters, economic cycles and global health crises and will continue to do so.a weighted average annual default rate of just 0.30% which compares favorably to the 0.66% for the rest of the financial institutions over the same time period. The energy sector saw the highest annual default rate, at 3.05%.

Chart 1

Global Default Rates: Investment Grade Versus Speculative Grade

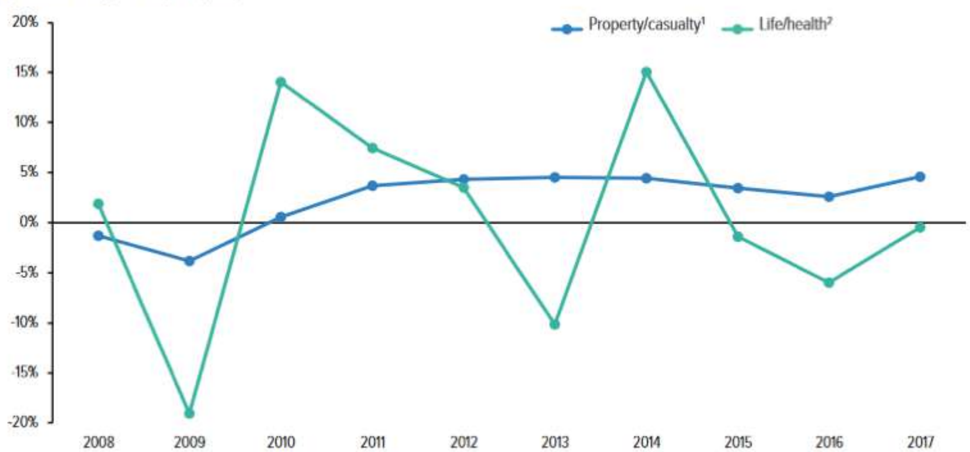


Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

Default rates for companies across all sectors have cyclical peaks that coincide with the general health of the economy. According to the same S&P study, the annual average default rate for non-financial companies climbed above 3.5% in the three most recent peaks (1991, 2002, and 2009). During those same peaks, the financial sector (which includes insurance) remained below 2%.

The increase in claims activity and the erosion of asset values will certainly drive down the industry-wide profitability and return measures. In addition, a decrease in global GDP growth will result in lower premium growth but the demand for insurance policies is somewhat inelastic, which should have limited impact on top-line growth. In the wake of the global financial crisis, in 2009, the U.S. P/C sector only experienced a 4% decline in net premiums written.

Growth In Net Premiums Written, Property/Casualty And Life/Health Insurance, 2008-2017
(Percent change from prior year)



[1]Net premiums written after reinsurance transactions, excludes state funds. [2]Premiums and annuity considerations (fees for annuity contracts) for life/health insurance companies.
Source: NAIC data, sourced from S&P Global Market Intelligence, Insurance Information Institute.

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Despite the volatility within the financial markets, P/C companies are generally well capitalized and maintain a healthy reserve of excess capital to meet policyholder and bondholder obligations. Insurers with limited capital buffers will be under more acute pressure. Now that interest rates have returned to zero, more pressure will be put on underwriting performance and rate adequacy. Fortunately, given the short-term nature of the risks they cover, P/C companies also have the ability to adjust rates on a more frequent basis to keep up changing claims activity as the industry adapts to the spread of the virus.

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Through Cohen & Company's PriDe program we look to support resilient small and mid-sized P/C insurers with debt capital, to maintain adequate capitalization and trade through the period ahead.

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