

## COVID-19 and Insurance (3 of 3): Capital Conservation and Countercyclical Regulation

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Original post [here](#).

Insurance supervisors around the world outside the U.S. have urged companies they supervise to conserve capital during the COVID-19 crisis by limiting payouts to shareholders and bonuses to executives.

At the same time, many supervisors have sought to help insurers avoid procyclical behavior by mitigating the impact of volatile market swings on the value of insurance company assets and, in turn, on measures of their capital adequacy.

This blog describes such measures. Our online [spreadsheet](#) provides further details and links to country-specific actions. An earlier YPFS [blog](#) described measures bank regulators have taken to ease capital regulations during this crisis. YPFS blogs this week [discussed measures to help insurance customers](#) and [provide insurance companies with operational regulatory relief](#).

### 1. Measures to conserve capital

Insurers were generally well-capitalized going into the COVID-19 crisis. However, the lockdown recession could generate an unprecedented shock to their balance sheets in the long run. For that reason, supervisors in more than 19 countries have encouraged, but mostly not required, insurers to conserve their capital by curtailing dividends, other capital distributions to shareholders, and executive compensation, according to a [BIS brief](#). (Many bank supervisors have also done this, as we noted in an earlier [blog](#)).

For example, the UK's Prudential Regulation Authority (PRA) [sent a letter](#) calling on insurers thinking about distributing their profits to shareholders or executives to “pay close attention to the need to protect policyholders and maintain safety and soundness.” Of course, some existing contracts may make it difficult to withhold executive pay even if companies want to. Although the only tool the PRA really deployed here was moral suasion, it apparently was enough to convince some insurers to [pause dividends](#).

The [EU's supervisor](#) has urged insurers to “temporarily suspend all discretionary dividend distributions and share buybacks.” In a statement, it asked any insurers that believe they are legally required to pay dividends or provide significant variable pay for executives to explain their reasoning for doing so to their national insurance regulator. However, [insurers were not convinced](#) to modify or suspend their variable pay plans. The EU was not the only body looking to adjust variable pay plans; a [BIS brief](#) states that at least eight national and transnational insurance regulators asked insurers to modify their variable pay.

Italy's [insurance regulator](#) sent a letter to the industry requesting that its companies “adopt, at individual and group level, extreme prudence in the distribution of dividends and in the payment” of variable pay. [Austria offered](#) the “urgent recommendation to insurance undertakings to refrain from distributing dividends for the previous and current financial year as well as from share buybacks.”

India was also assertive in [its call](#) for insurers to “refrain from dividend pay-outs from profits pertaining to the financial year ending 31st March 2020.” Croatia’s insurance regulator took a more aggressive approach; it [banned](#) insurance companies from distributing dividends until April 30, 2021. However, it did not ask insurers to suspend share buybacks or modify variable compensation for executives, unlike some other countries in Europe.

The U.S. has been an exception. The NAIC has been silent on this issue, and no state has asked the companies it regulates to refrain from paying dividends, share buybacks, or paying executive compensation.

## 2. Measures to avoid procyclical behavior

Supervisors have also used a handful of tools, both automatic and discretionary, to discourage insurance companies from aggravating market stress during the COVID-19 crisis.

To be sure, insurance companies, as long-term investors, are less likely than banks or investment funds to sell assets in market downturns ([Timmer](#), 2016). They do not have to mark the value of their portfolios to market prices as frequently and they are less likely to face funding pressures that require them to raise liquidity in a pinch. As such, it is too early in the COVID-19 crisis to see significant market losses at insurance companies, and markets, for now, have recovered from their recent lows. Early on, [Thailand’s regulator](#) concluded in a stress test that its insurers were well-capitalized to handle potential COVID-19-related stresses.

Nonetheless, the international association of insurance supervisors has acknowledged that insurers could be prone to procyclical behavior, for example, in response to actions by rating agencies or supervisors ([Insurance Core Principles](#), 2019, p. 245). In particular, an insurer whose capital falls below a regulatory trigger may face restrictions that lead it to sell assets.

To address this procyclical bias in the rules, the Core Principles encourage supervisors to be flexible in applying triggers during market stress.

Supervisors have exercised such flexibility during the COVID-19 crisis. For example, supervisors in [Canada](#), [Europe](#), the [Netherlands](#), and [South Africa](#) have said they will allow more time for companies to restore capital levels that have fallen below supervisory triggers due to the crisis. Thailand’s Office of the Insurance Commission (OIC) [relaxed its capital adequacy ratio](#) for insurance companies in mid-March. Canada’s supervisor said it “considers the specific circumstances of the insurer and recognizes that the restoration of Capital Resources levels may take longer for some insurers when operating in a difficult environment.” The Dutch supervisor said it “takes into account the expected temporary duration of this exceptional situation” when evaluating health insurers’ capital.

Several countries have taken other ad hoc measures to discourage procyclical behavior during the COVID-19 crisis. [Canadian](#) and [Malaysian](#) supervisors have eased capital requirements for interest-rate risk. The [Swiss](#) supervisor said it would allow insurers to temporarily smooth yield curves to dampen the impact of market volatility on regulatory capital. When Korean insurers decided to help prop up domestic financial markets, [Korea’s supervisor](#) modified the risk assessment application system it uses to determine insurers’ liquidity ratios.

The [European Union \(EU\) supervisor](#) also has automatic stabilizers, introduced after the global financial crisis of 2007-09, that are intended to dampen the impact of volatile market prices on insurers’ capital ratios. These include the matching adjustment, the volatility adjustment, and

the symmetric adjustment for equity holdings. They are part of the EU's Solvency II framework for insurance supervision.

The matching adjustment and volatility adjustment allow companies to reduce the net present value of their liabilities in response to declines in the market values of their assets. When market-wide spreads rise above predetermined thresholds, the mechanisms allow companies to increase the discount rate they use to value their liabilities.

The two adjustments work differently. The matching adjustment is for insurers that offer long-term guarantee products, such as annuities, and hold assets to match the maturity of those liabilities. The volatility adjustment can be applied to an insurer's business more broadly and is intended to reduce the impact of large and sudden changes in market prices.

Solvency II also includes a symmetric adjustment for equity holdings. It requires companies to hold slightly more capital against their equity holdings after markets have risen, and to hold slightly less after markets have fallen.

These adjustments use market data provided by the European insurance supervisor. During the COVID-19 crisis, the supervisor increased the frequency of its reporting of these data inputs from monthly to weekly on [April 30](#), but reduced the frequency to biweekly on [May 19](#).

### **What issues still need more action?**

On May 6, the European Systemic Risk Board (ESRB) met and discussed the macroprudential aspects of their response to COVID-19. One of the key topics [it addressed](#) was the [impact of market illiquidity on insurers and the implications for financial stability](#). They argued that the tools for avoiding the procyclical behavior discussed above may not be enough to head off a run by holders of unit-linked insurance products, which are something like an insurance-investment product hybrid, "if the macroeconomic outlook worsens by more than is currently anticipated."

The ESRB noted that outflows from high-yield bond funds could put more pressure on the value of less liquid assets, or assets that have become temporarily illiquid, which insurers tend to hold. In such a situation, the ESRB said that the private sector and regulators will have to rely on central banks to maintain financial stability. A recent article by KPMG's Global Head of Insurance [stated that](#) the "EU's Solvency II regime is very sensitive to financial market volatility and movements in bond yields and credit spreads."