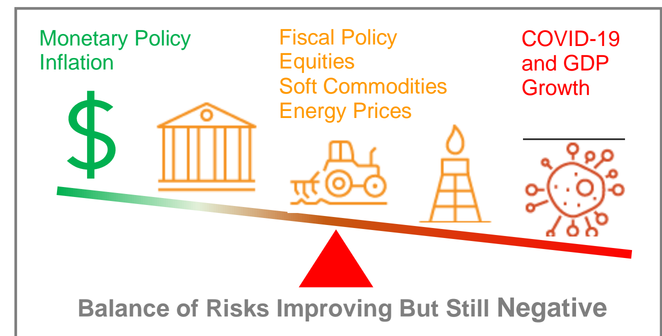
INSURANCE INFORMATION INSTITUTE

Q3 2020 SUMMARY | THE YEAR AHEAD

The COVID-19 pandemic continues to depress growth across the world. At the time of publication, the illness has claimed 870,126 lives and infected 26,383,872 people. Nearly every country in the world is experiencing negative growth and recession. Earlier hopes for a summer break vanished with the virus continuing mostly uninterrupted to spread around the world. Overall, benchmark GDP forecasts for 2020 and 2021 have been worsening over the last three months pointing to a deeper and wider impact by COVID-19 on global GDP growth than initially forecasted at the pandemic's onset. With a few notable exceptions, advanced economies have proven more resilient against the virus than developing ones. Forward looking growth proxies such as interest rates, government spending, equity markets and commodity prices are sending mixed to negative messages about growth in 2020 and 2021. Against this backdrop, the global insurance industry has continued to issue new policies, service existing ones, and process and pay claims. While the final numbers on the extent of the pandemic and recession's impact on the industry will not be fully understood until 2021-2022, early indicators point to flat premium growth in 2020 across the world and to significant differences in how the pandemic, monetary policy and the recession are impacting carriers and insurance lines in the U.S. versus abroad.

Growth and Inflation

In June the IMF lowered its baseline **global GDP forecast for 2020 to -4.9%**, down -6% from +2.9% in 2019, **and for 2021 to 5.4%**, down 0.4% from 5.8% earlier this year. The IMF baseline assumes that COVID-19's impact on the economy peaked in Q2 of this year. The IMF stress tested this baseline by assuming the pandemic continues into Q4 2020. Under that scenario, **growth in 2020 decreases to -7.7% and in 2021 to -1.9%**.



The OECD took a different approach than the IMF, skipped providing a baseline, and forecasted global GDP growth for 2020 and 2021 using two scenarios. The OECD's first scenario assumes the pandemic peaked in Q2 2020 and that there is no second wave. Under this scenario, **growth in 2020 is -3.5%** (down -6.2% from 2019's +2.9%) and **growth in 2021 is +2.8%**. The OECD's second scenario assumes a second wave in Q4 2020. Under this scenario, **growth in 2020 is -4.8%** (down -7.5% from 2019's +2.9%) ranging from -14% in the U.K. and Spain to -11% in the Eurozone; -9% in the U.S.; and -2% in Korea. Under the OECD's second scenario, **growth in 2021 is +1.5%.**

Our estimate is for **global growth to range between -5% and -8% in 2020 and between -1.5% and -3% in 2021**. This estimate assumes a vaccine becomes available in Q1/Q2 2021 in advanced economies and in Q3/Q4 2021 in emerging economies. Our updated estimate is lower than the -3% global GDP growth we forecasted in Q2 for 2020 due to the virus' higher-than-expected impact in the U.S., U.K. and Brazil. We continue to view the IMF's baseline and the OECD's first scenario as excessively optimistic and our updated GDP growth estimate for 2020 and 2021 is aligned with the IMF's second stress test and the OECD's second scenario for 2020 and 2021**.**

Monetary and Fiscal Policy

Global central banks kept benchmark interest rates mostly on hold in Q3 at an average of +0.6%, reflecting the limits of near-zero interest rates policies. To compensate, they engaged in expansionary monetary measures including mechanisms to bring non-sovereign fixed income onto their balance sheets even though most central banks remain arguably prohibited from directly purchasing such assets. For its part, global expansionary fiscal policy trended downward in Q3 compared to Q2 following COVID-19 infection rates across most of the world, with a few notable exceptions, including the United States. Perhaps indicative of improving confidence, benchmark government bond yields increased slightly in Q3 after dropping in Q2 but are still lower than in Q1 while credit spreads across investment classes narrowed in Q3 after widening in Q2.

Central banks moving forward with this policy regardless of growing government and consumer debt, is indicative of a major shift in how they perceive the relative risks of "free-money" and inflation. This shift was formalized in August when the U.S. Federal Reserve announced (statement / press summary) that it would no longer focus on maintaining inflation below 2% and instead would give more weight to maximizing employment while also recognizing that inflation below 2% can be as damaging as deflation. This major decision will have direct consequences across global central banks and accelerate the transition to a permanent environment where interest rates will be below, and inflation will be above their recent historical averages. This may lead to a systemic shift whereby real interest rates on major sovereign debt become and remain negative, narrowing spreads on all debt instruments down the risk curve, leading to higher valuations on equity assets.

Benchmark GDP growth forecasts for 2021, including the IMF and OECD baseline and stress tests, assume additional government spending in 2021 of approximately 5.15% of global GDP, **the equivalent of adding $16 trillion in global government debt**. It remains unclear whether there is policy or market appetite for such an increase in sovereign debt, especially at current record-low interest rates. Our analysis is that **the appetite for additional government spending to fight the pandemic is decreasing, dragging benchmark forecasts closer to their lower growth range**.

Equity Markets

For their part, equity markets recovered in Q2/3 pushing S&P 500 P/E ratios up 20% from their March low of 22% to nearly 30% by August. Rather than a disconnect with the larger economy, **the pace of the recovery in equity prices recovery may be linked to the nature of the COVID-19 economy rather than expectations of a faster recovery**. First, global central banks' stated policy of flattening the yield curve and ever-expanding mechanisms to increase their balance sheets, effectively leaves investors little choice than to move forward on the risk curve away from fixed income into equity. Second, the performance of stocks within specific sectors directly benefits from shifts in consumer behaviors during the pandemic and their impact on overall indices. Jefferies, the investment bank, highlighted examples such as companies providing goods and services related to courier, cloud and collaboration technology, security, gaming, and streaming media.

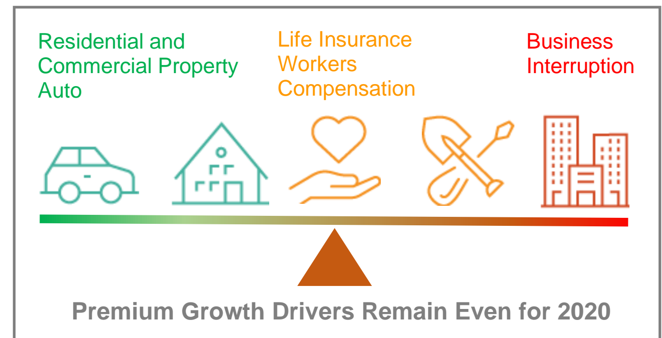
Commodities

The pace of the recovery in commodity prices trends is aligned with the IMF COVID-19 GDP stress tests forecasting negative growth into 2021 and possibly 2022. The IMF reported that since the beginning of the pandemic, out of the 25 most traded commodities, 21 experienced decreases in prices, and four were either flat or up. Commodities associated with industrial activity were the hardest hit, such as Brent (-59%), NG/LNG (-28%) and copper (-23%). Agricultural commodities fared relatively better ranging from soybeans (-5%) to Arabica coffee (+18%); the latter being the best performer of any major traded commodity.

GLOBAL INSURANCE OUTLOOK

Premium Growth Drivers

Global premium growth is expected to remain at best flat this year. Premium growth is related to economic activity, and as of Q3 2020 GDP growth for the world's 10 largest insurance markets is expected **to decrease by –6.99% in 2020, compared to our previous estimate of -4.9%**. COVID-19 and lower economic activity continue to hinder premium growth in property, workers compensation and auto, while a recent survey indicates that COVID-19 led to a reduction in life premium. It is too early to determine whether increasing take-up rates for warranty and indemnity, cyber and a surge of interest in captives will make up for the downward pressure of lower GDP growth and COVID-19 on premium growth across the industry.



Returns on Investments

Concerns about lower long-term interest rates are increasing as global central banks have pushed rates even lower during the pandemic. In a recent survey, about 33% of U.S. carriers now assume flat long-term benchmark rates, while 50% of carriers reported having changed, or are in the process of changing, their investment strategy. These changes are likely to accelerate now that the U.S. Federal Reserve officially changed the focus of its monetary policy and central banks around the world follow. **The impact of structurally lower long-term interest rates on asset allocation is likely to be more significant for U.S. insurers than for their foreign counterparts for two reasons**. First, U.S. carriers tend to hold more fixed income and less equity than their counterparts in other advanced or emerging economies. Second, U.S. carriers face significantly lower domestic interest rates than their counterparts in emerging economies.

Life Insurance

LIMRA reported in June that applications dropped at about one-third of the 47 U.S. life insurance companies that responded to a survey about the effect of COVID-19 on applications submitted face-to-face. Applications submitted through call centers and the mail also dropped, but only at about one-seventh of companies surveyed. Not surprisingly, applications submitted online or via mobile rose in 1 out of 4 surveyed life insurers. To keep writing new business, many life carriers have adjusted their underwriting to replace paramedical exams with older lab reports and physicians' statements. Because some state regulators have requested that insurers extend the grace period on premium payments, about 3 of 4 carriers responded that they have doubled or tripled grace periods on premium payments. However, with interest rates reaching new lows, some carriers lowered the maximum age at which their will offer life policies to 70 years old or suspended the sale of 30-year policies. **The negative impact on U.S. life carriers is likely to be more significant than on their advanced economy counterparts, but lower than on their emerging market counterparts**. This is due to smaller or wider social nets for long-term disability and differences in how COVID-19 impacted different age groups in the U.S., other advanced economies and emerging markets.

Residential and Commercial Property

Global carriers are expecting a reduction in non-catastrophic losses on residential and commercial dwellings, the extent of which has yet to be reported to different local and national regulatory bodies. For residential, ongoing occupation of premises by residents should lead to an increased ability to monitor, prevent and mitigate the impact of water leaks, mechanical breakdowns, fires and other hazards. For commercial, reduced economic activity should lead to reduced use of premises by employees and lower machinery utilization, increasing the efficacy of risk mitigation and prevention. **The positive impact on U.S. residential and commercial property carriers is likely to be more significant than on either their advanced economy or emerging market counterparts** due to the longer duration of shutdowns in the U.S. as countries such as Korea, France, Germany, Japan and China reopened before the U.S..

Business Interruption (BI)

The U.K.'s Financial Conduct Authority (FCA) published its final guidance on Business Income Interruption (BI) insurance in June 2020. The document identified key policy language, the interpretation of which should support or reject BI claims. These include: the non-physical damage clause; loss substantiation; notifiable disease exclusion listing or not listing COVID-19; geographic requirements; and scale of disease presence. The implications of the guidance will now be tested in the courts with the FCA moving forward in June against 8 insurance companies including Hiscox and Zurich. The eight-day trial focused on policy language; whether public health measures were government requirements or suggestions; and how, in the event of claims, insurers should calculate losses; such as by including or not including government payouts. A decision is expected by the end of September. In Ireland, litigation between FBD over the carrier's refusal to pay COVID-19 BI claims is expected to go to court in October. The court will hear the case on the heels of Ireland's central bank decision in August to issue a supervisory framework for COVID-19 BI claims requiring that unclear wording be interpreted in the most favorable manner possible for the insured. **Though it is too early to determine, the emphasis in the U.S. on the sanctity of contracts sets a better framework for further discussions between carriers, insureds and regulators than in Europe.**

Workers Compensation (WC)

Workers compensation (WC) differs greatly within and across countries. That said, carriers offering WC-like coverages outside the U.S. are taking a comparable approach to their U.S. counterparts when it comes to linking COVID-19 infections to a worker's workplace or occupation. Both within the U.S. and globally, higher unemployment is reducing payrolls and premiums collected. The OECD's next annual insurance report will provide insight into the financial impact of COVID-19 on a range of coverages including WC; private and public health; and public unemployment benefits. Putting aside the pandemic's specifics, in our estimate **for a comparable incident, carriers abroad face losses 40% to 90% less than in the U.S.,** largely resulting from those countries' social net programs, including but not limited to healthcare.

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