MORNINGSTAR | DBRS

Commentary

Assessing the Impact on Life Insurers' Financial Strength Ratings as the Coronavirus Crisis Unfolds

DBRS Morningstar
April 15, 2020

Hema Singh
Vice President
Global Financial Institutions Group
+1 212 806 3275
hema.singh@dbrsmorningstar.com

Marcos Alvarez
Senior Vice President, Head of Insurance
Global Financial Institutions Group
+1 416 597 7553
marcos.alvarez@dbrsmorningstar.com

What Will Be the Impact of the Crisis on Life Insurance Companies?

The extent of the new Coronavirus Disease (COVID-19) disruption on the global economy in the long term is still unfolding. DBRS Morningstar will continue to update its rating assessments on life insurers as the situation evolves. In the current environment, we note that the global economic downturn and low-interest rate environment, as well as the heightened equity market volatility, credit default risk, and product risk, could all adversely affect life insurers' ratings. These factors have the potential to adversely affect insurers' asset portfolios, earnings, and capitalization.

How Will These Factors Affect Ratings?

DBRS Morningstar's rating assessments are based on the long-term prospects of life insurers, reflecting the long-term nature of their liabilities. We are focusing on the assessment of individual building blocks that could be adversely affected by the factors stated above, per our *Global Methodology for Rating Life and P&C Insurance Companies and Insurance Organizations*. In the short term, we are reviewing the factors in the building blocks that assess the risk profile, earnings ability, and capitalization scores (see Exhibit 1 below), and how life insurance companies are managing the headwinds from the disruption in the global economy and financial markets. The franchise strength and liquidity blocks assessments are not as susceptible to the current shocks; however, depending on the duration and severity of the impact of the coronavirus on the markets where the insurer operates, we will likely adjust the assessment of the remaining building blocks and factors.

Negative rating implications for an individual insurer would likely develop based on the combination of a material decline of a few factors, as shown in Exhibit 1, rather than a single factor. The building blocks are interconnected, so a change in one rating factor in one building block could also lead to a change in another building block. Looking forward, there will be greater pressure to restore the capitalization building block, as well as an insurers' ability to remedy any significant deterioration within a reasonable time.

Life insurers generally maintain some capitalization buffers above minimum supervisory levels, which will help to provide cushion against the headwinds insurers are facing. Additionally, their risk management frameworks have been enhanced since the global financial crisis of 2008–09. Life insurers regularly perform stress testing activities, including scenario analysis on mortality/morbidity assumptions, as well as interest rates and equity market movements. Meanwhile, some insurers have employed significant hedging programs or hold additional levels of capital buffers to mitigate some of these risks. We believe that these strategies will continue to help life insurers navigate the pressures in

the current environment in which they are operating but are unlikely to eliminate all risks. The cost of hedging activities will also increase under current market conditions. We consider that companies with low levels of capital buffers and significant exposure to equity market volatility through their asset portfolio or product portfolios offerings could see their solvency position deteriorate quickly during the coronavirus pandemic.

Risk Profile: Key Factors

- **Product Risk:** In this block, we evaluate the diversification of the product portfolio and underlying risk factors. There are concerns that mortality and morbidity claims could increase significantly if the spread of the new coronavirus is not contained. The risk to an individual insurer would also depend on geographic regions where the outbreak is more severe. For life insurers who have group and individual supplemental health products in their product portfolio, these products can be repriced annually, but life insurers could see increase claims in the current environment.

- **Credit Risk**: Life insurers invest for the long term in the fixed-income market given their liabilities are long term in nature. Generally, the majority of the general account portfolio is invested in fixed-income securities and is highly diversified across asset classes, industry sectors, and credit quality/ratings. A significant deterioration in the quality of the fixed-income portfolio could have an adverse impact on the credit risk assessment score. This could be caused by the emergence of significant credit losses on commercial mortgages and private loans if included in a company's investment mix or a material deterioration in the credit quality of the fixed-income portfolio resulting in an increase in the proportion of BBB or lower-quality assets.

- **Market Risk**: Equity risk arises through asset portfolios or product offerings with guarantees. Companies with high exposure to in-the-money product guarantees could be exposed to interest rate and equity market value sensitivities if hedges are not employed or high capital buffers are not maintained to mitigate these risks. Similarly, interest rate sensitivities arise when duration mismatches occur between the asset and liability portfolios, but can also be offset with adequate hedges in place or higher capital buffers. Currently, various market indices have experienced unprecedented volatility and, while this could likely pressure the market risk factor assessment, it could also adversely affect the earnings and capitalization block assessment.

Earnings Ability: DBRS Morningstar notes that earnings analysis is forward-looking, although we also use historical financials and other information in our assessment. In a period when an insurer is under stress, we will look at the insurer's ability to restore any deterioration in earnings over a reasonable period. As an example, we will assess the extent to which unrealized losses and adverse mortality and morbidity trends result in earnings strain. We will review the extent to which unrealized losses might be recovered in subsequent quarters.

- **Return on Equity (ROE)—Three-Year Weighted Average:** One of the primary downside risks in earnings is the exposure to a significant spike in mortality claims if the spread of the coronavirus is not contained. The low-interest rate environment will also affect earnings as a result of further compression in companies' investment portfolio spreads. Unrealized losses from the "available-for-sale portfolio" will

also put pressure on earnings. Pressure on earnings can also arise from a decline in fees, investment yields, and other revenue sources from noninsurance businesses. These factors may result in material deterioration of the three-year weighted-average ROE to a level consistent with a lower assessment for the ROE factors.

Capitalization: Key Factors

- **Capital Cushion and Ability to Deal with Stress Scenarios:** Overall, from a capitalization perspective, we see life insurers as better positioned now than when they were heading into the global financial crisis of 2008–09. Maintaining a healthy cushion over the supervisory target requirements increases an insurer's capacity to deal with stress scenarios. There will be greater emphasis on the ability of companies to restore capital levels if there were to be a material decline in capital buffers approaching minimum supervisory levels, as this could cause overall negative rating pressure.

- **Financial Leverage and Fixed-Charge Coverage Ratio (Three-Year Weighted Average):** Central banks have moved to ease the economic effects of the coronavirus by reducing interest rates, thereby making debt a viable option for raising capital or refinancing old debt at lower interest rates. We anticipate that companies will likely take advantage of this, which may affect financial leverage. A deterioration in financial leverage to levels over 35%, with three-year, weighted-average, fixed-charge coverage ratios dropping to less than 5.0 times, or a decline to levels consistent with a lower financial strength rating, could lead to negative rating pressure on the methodology grid scores.

- **Capital Flexibility:** Having a variety of capital options allows a company to raise capital in the most cost-efficient form, which is a positive rating factor in a challenging environment such as the one presented by the ongoing coronavirus pandemic. Capital flexibility can include retained earnings, common equity, debt, bank loans, hybrid debt structures, and preferred shares. Insurers may have to raise debt to strengthen their capitalization if earnings deteriorate significantly and/or reserve strengthening lead to negative retained earnings, and this would result in an increase in leverage ratio. Companies that are already highly leveraged may see their assessment drop for this category because of the negative impact on grid scores.

- **Capital Generation:** A material deterioration in net profits would affect retained earnings thus reducing internal capital generation. This factor is assessed over a period of time that would exceed a year because of the challenges presented by the fallout of the virus and associated economic disruption. In our assessment we will also review the steps insurers are taking in regards to maintenance and deployment of capital during a period of stress. Some factors could be adjustments in their dividends and share repurchases decisions. Public insurers have flexibility to adjust their dividends and share repurchase activities, while mutual insurers have flexibility to adjust non-guaranteed dividends credited to participating policyholders.

Exhibit 1: DBRS Morningstar Insurance Methodology Building Block Factors Most Likely to Be Affected by Coronavirus in the Short Term

Building Blocks	Factors	Impacted
Franchise Strength	Market position	✕
	Distribution channels	✕
	Diversification of businesses and/or products	✕
	Strategic and operational excellence	✕
Risk Profile	Product risk	✓
	Credit risk	✓
	Market risk	✓
	Operational risk	✕
	Risk management	✕
Earnings Ability	Revenue generation and profitability	✕
	ROE: Three-year weighted average	✓
	Combined ratios (P&C): Three-year weighted average	✕
	Income stability	✓
Liquidity	Liquidity resources and requirements	✕
	Claims predictability, frequency and severity	✕
Capitalisation	Capital cushion and the ability to deal with stress scenarios	✓
	Financial leverage	✓
	Fixed-charge coverage ratio: Three-year weighted average	✓
	Capital flexibility	✓
	Capital generation	✓

Source: DBRS Morningstar.

Related Research

- "Assessing Financial Strength Ratings of P&C Insurance Companies Amid the Global Coronavirus Pandemic," April 2, 2020.
- "Coronavirus: Likely Increases in P&C Insurance Claims in Certain Business Lines; Financial Markets' Volatility Will Affect Investment Portfolios," March 12, 2020.
- "Large Canadian Life Insurers: Strong Performance in 2019, but Coronavirus Weighs on 2020 Outlook," March 11, 2020.
- "Coronavirus Disease (COVID-19) Impact on Life Insurers More Likely to Result from Adverse Market Movements than Increased Claims," March 5, 2020.

About DBRS Morningstar

DBRS Morningstar is a global credit ratings business with approximately 700 employees in eight offices globally.

On July 2, 2019, Morningstar, Inc. completed its acquisition of DBRS. Combining DBRS' strong market presence in Canada, the U.S., and Europe with Morningstar Credit Ratings' U.S. footprint has expanded global asset class coverage and provided investors with an enhanced platform featuring thought leadership, analysis, and research. DBRS and Morningstar Credit Ratings are committed to empowering investor success, serving the market through leading-edge technology and raising the bar for the industry.

Together as DBRS Morningstar, we are the world's fourth-largest credit ratings agency and a market leader in Canada, the U.S., and Europe in multiple asset classes. We rate more than 2,600 issuers and 54,000 securities worldwide and are driven to bring more clarity, diversity, and responsiveness to the ratings process. Our approach and size provide the agility to respond to customers' needs, while being large enough to provide the necessary expertise and resources.

The DBRS group of companies consists of DBRS, Inc. (Delaware, U.S.)(NRSRO, DRO affiliate); DBRS Limited (Ontario, Canada)(DRO, NRSRO affiliate); DBRS Ratings GmbH (Frankfurt, Germany)(CRA, NRSRO affiliate, DRO affiliate); and DBRS Ratings Limited (England and Wales)(CRA, NRSRO affiliate, DRO affiliate). Morningstar Credit Ratings, LLC is a NRSRO affiliate of DBRS, Inc.

For more information on regulatory registrations, recognitions and approvals of the DBRS group of companies and Morningstar Credit Ratings, LLC, please see: http://www.dbrsmorningstar.com/research/highlights.pdf.

The DBRS group and Morningstar Credit Ratings, LLC are wholly-owned subsidiaries of Morningstar, Inc.

© 2020 Morningstar. All rights reserved. The information upon which DBRS ratings and other types of credit opinions and reports are based is obtained by DBRS from sources DBRS believes to be reliable. DBRS does not audit the information it receives in connection with the analytical process, and it does not and cannot independently verify that information in every instance. The extent of any factual investigation or independent verification depends on facts and circumstances. DBRS ratings, other types of credit opinions, reports and any other information provided by DBRS are provided "as is" and without representation or warranty of any kind. DBRS hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS or its directors, officers, employees, independent contractors, agents and representatives (collectively, DBRS Representatives) be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting therefrom, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of ratings and rating reports or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS or any DBRS Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. No DBRS entity is an investment advisor. DBRS does not provide investment, financial or other advice. Ratings, other types of credit opinions, other analysis and research issued or published by DBRS are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness, investment, financial or other advice or recommendations to purchase, sell or hold any securities. A report with respect to a DBRS rating or other credit opinion is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. DBRS may receive compensation for its ratings and other credit opinions from, among others, issuers, insurers, guarantors and/or underwriters of debt securities. DBRS is not responsible for the content or operation of third party websites accessed through hypertext or other computer links and DBRS shall have no liability to any person or entity for the use of such third party websites. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS. ALL DBRS RATINGS AND OTHER TYPES OF CREDIT OPINIONS ARE SUBJECT TO DISCLAIMERS AND CERTAIN LIMITATIONS. PLEASE READ THESE DISCLAIMERS AND LIMITATIONS AT http://www.dbrsmorningstar.com/about/disclaimer. ADDITIONAL INFORMATION REGARDING DBRS RATINGS AND OTHER TYPES OF CREDIT OPINIONS, INCLUDING DEFINITIONS, POLICIES AND METHODOLOGIES, ARE AVAILABLE ON http://www.dbrsmorningstar.com.