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Pandemic Planning and Recovery

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Pandemic preparedness, a subset of the "all hazard" planning process, is becoming more ingrained in American business culture. Every moment spent planning for a pandemic prepares a firm to better weather catastrophes large and small, from the loss of a hard drive to the loss of a key employee, to a large-scale natural disaster. Disaster planning is becoming a competitiveness issue, as vendors are being evaluated on their ability to continue providing services, not just price alone. This is, of course, consistent with enterprise risk management and the efficient frontier model, where investment decisions integrate risk and return into price.

Current research typically focuses on quantifying the effects of a pandemic. More emphasis needs to be placed on practical steps that should be taken to prepare for a pandemic, and, more importantly, how the insurance industry can position itself for recovery if a pandemic strikes.

1.1 Pandemic Planning

A full discussion of disaster recovery and business continuity planning is beyond the scope of this article. This piece addresses some of the aspects specific to the insurance industry. The broader discipline of enterprise risk management is active in this space, encompassing assets, liabilities and operations; obviously a pandemic affects all of these areas.

1.1.1 Protecting Brand Equity

Next to solvency, the greatest risk posed by a pandemic to the industry is the deterioration of the industry's brand—the breaking of the brand promise. This might take place at the industry level (for example, if the industry as a whole fails, even a strong performer will be lumped in with the rest of the industry) or at the level of a particular enterprise whereby the company fails to keep its promises and lags behind its peers. Some insurers have 100–year-old brands; companies should be making plans to survive not just financially but with their brand promise intact so that rather than having to spend time rebuilding their brand, customers would turn directly to them post-pandemic.

1.1.2 Communication

Companies need a communication strategy for before, during and after a pandemic, to both internal customers (employees) and external customers (policyholders, shareholders, rating agencies and regulators). Companies need to decide how to position themselves to respond to the event—or the media will decide for them. Given the speed and force with which events will unfold, prudent companies will not want to be responsible for developing strategies on the fly during an event or relying on the availability of their public relations firm.

To the extent they are available, solvency communications should be distributed to stakeholders long in advance. During the pandemic period, a company will want to communicate with its employees and customers regularly. The company will want to keep the channels of communication open and let interested parties know that it is staying abreast of the situation. Sample press releases should be prepared in advance for strategic points pre-, during, and post-pandemic.

From a broader perspective, society places a significant reliance on the accuracy and timeliness of the news. This is a reasonable assumption in normal conditions, but during times of upheaval, reporting in traditional news media

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will often lag behind actual events, at times significantly. It is clear that, in an event as broad and fast-moving as a pandemic, incidents will get ahead of reporters whose institutions will themselves be subject to the events at hand. In these conditions, there will be important aspects of the pandemic and its progression that they are not aware of; individuals on the ground communicating through blogs and Wikis may provide a better sense of the true situation than the traditional media.

It is important to be aware that early in the progression of the pandemic, official confirmation of incidences will be delayed, at times significantly. The delay and resulting undercount may make the progress of the disease appear to be less virulent than it actually is; at times there will be a wide disparity between probable, reported and confirmed cases. It is important to realize that during a situation like this, one must be skeptical about information while realizing important decisions will have to be made without access to perfect data.

1.1.3 Accounting and Solvency

Year-end reporting for companies might well occur in the middle of a pandemic. Valuation actuaries are well aware of the challenges they face under the best of times; it may not be possible to meet the requirements of an unqualified actuarial opinion during these conditions. Would reporting deadlines be extended? Would actuaries sign qualified opinions, and what would the response of rating agencies be? What might the regulatory response be to incomplete cash flow testing? How will life actuaries, lacking historical data on incurred but unreported (IBNR) claims, come to a conclusion as to setting their IBNR reserve? Will potentially insolvent companies be allowed to delay filing annual statements? What purpose would it serve to force premature judgment given the volatility in reserve estimates, asset values and statutory surplus? These and many other difficult issues would arise if a pandemic were to occur before or during year end.

1.1.4 Reinsurer Solvency

Reinsurers are not party to guarantee associations. If a reinsurer were to go bankrupt, direct writers would not be able to rely on other reinsurers to make up the difference. The burden is on the direct writer to fulfill its obligations; direct writers are ultimately responsible for their obligations.

What would it mean to direct writers if a reinsurer were to enter bankruptcy? If it were a smaller reinsurer, it probably would not have much impact in the overall scheme of things. Once the company were declared insolvent, reserves and surplus would be allocated between all claims equally—be they pandemic-related or claims that would have been expected during the normal course of events. Because statutory reserves have some redundancy, reserves would likely extend further than anticipated.

A failure in one of the top reinsurers, however, would be a very different thing, with ripple effects throughout both the industry and global capital markets. Cash flow would be a problem: while a failed reinsurer might ultimately be able to honor a high percentage of its liabilities, it would likely take many courts in many jurisdictions many years to ultimately decide on its disposition. This could lead to a liquidity crisis for some. Reinsurers and direct writers alike might find it in their best interests to invoke the "too big to fail" rule and find a mechanism to stabilize the company and calm markets.

1.1.5 Other Issues

There are specific business practices that put the industry at risk. One of the biggest ones is fraud. If a severe pandemic were to occur, all aspects of our public recordkeeping systems would be overwhelmed. It is not unreasonable to suspect that, in some areas, this might provide a window of opportunity for fraud on an organized scale.

Public officials in 1918 were overwhelmed with paperwork. Society is far less prepared today to deal with the specter of unrelenting sickness and death than it was in 1918.

Another feature that may put the direct life insurance industry more at risk is the fact that there are many small, regional companies. Insurance is regulated at the state level, which is one of the drivers of the fragmentation. Public health records from 1918 show the impact of the flu varied greatly by city and region. Thus, for companies whose exposures are relatively localized, some may escape relatively unscathed, while others may be more seriously impacted. Results for national companies whose books of business are more geographically diversified would be less volatile. Note also that, barring action within the NAIC, the regulatory response to the event would certainly be uneven, impacting companies from different domiciles differently.

1.2 Recovery

What might recovery look like for the insurance industry? A moderate scenario produces little more than a bump in a road to be driven around or bounced over by the vast majority of the insurance companies. However, a severe scenario would pose great challenges for the industry on top of the difficulties faced by society at large. But even under a severe scenario, it can be assumed that more than 99 percent of the U.S. population will survive, so not having a strong recovery plan in place will put firms at a disadvantage vs. competitors. And although this article has not addressed implications for society at large and for the global supply chain, recovery will be taking place in an extraordinarily challenging environment.

1.2.1 Globalization

Over the last 15 years there has been a marked increase in foreign insurers purchasing companies in the United States to gain entry into this important market. Likewise, U.S. companies have invested capital in all the major markets in the world. It is difficult to say what will happen to capital flows post-pandemic. Certainly, capital searches for the best return. However, human capital, which is critical to making financial capital yield an ROI, may not be as mobile post-pandemic as pre-pandemic.

Despite the industry's best efforts and those of global emergency heath providers, many expatriates will undoubtedly find themselves stranded in foreign countries for weeks or months without access to the kind of support and medical care they are accustomed to. To the extent that this core group of expatriates is burnt out and chooses not to renew their assignments, it may be some time before a new generation steps up to take their place.

Cultural memory is short, but it might well take half a decade or more to rebuild this team of foot soldiers, yielding a competitive advantage to companies that are able to respond more nimbly deploying human and financial capital. Companies that rely on flexibility and a decentralized command structure will likely fare better during and following a pandemic than companies who rely on a more hierarchical command and control structure.

1.2.2 Consolidation and Convergence

In comparison with other major markets in the world, the U.S. market is very diffuse, both in terms of consolidation and in terms of the sheer number of insurance companies. Just as companies that were already under regulatory scrutiny might be pushed towards insolvency by the stress of a severe pandemic,[1] companies that were not under observation but had an

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1 Toole, Jim, "Potential Impact of Pandemic Influenza on the US Life Insurance Industry," Society of Actuaries, May, 2007, p. 10.

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RBC ratio of less than 300 percent might find themselves under regulatory scrutiny. These weakened companies would be looking for capital, and companies with capital would be looking for investment opportunities to round out their portfolio. Guarantee associations and regulators may well be eager to push weakened companies into the arms of willing suitors to get potential liabilities off their balance sheets.

Much has been made of financial services convergence over the past decade.[2] The difficulties that the insurance sector faces during a pandemic might well convince fence-straddling banking executives that insurance risks are best left alone. Banking portfolios will certainly face their own challenges in weathering the financial impact of a pandemic.

1.2.3 Bankruptcy Surge Capacity

Insurance bankruptcies are particularly complicated due to the long-term nature of the liabilities and regulation at the state rather than the federal level. In a normal year, the National Organization of Life and Health Insurance Guaranty Associations deals with no more than a couple of insolvencies. Under a period of economic stress, there may be as many as a half dozen. However, under a severe pandemic scenario, it may be anticipated that a substantially greater cohort of companies would find themselves in a position where their statutory liabilities exceed their assets. Some companies might be required to shutter their doors after the first wave of a pandemic, while others might hang on but be put under by a second wave. A drop in asset values would only exacerbate the situation.

Given the administrative burden and length of time that it takes to work out an insurance bankruptcy in normal situations, consumers could lose value or suffer unnecessary delay in benefits payments during a period of significant financial and emotional stress. It is in the interests of both regulators and the industry alike to ensure measures are put into place both to provide flexibility and to streamline the process.

1.2.4 Regulation

The regulators' response to an ongoing pandemic emergency will play a significant role in how the event ultimately impacts the industry. The industry is highly regulated, but statutory guidelines are inflexible and assume incremental changes over time; they are not constructed to respond effectively to the impact of a severe pandemic.

The accounting and solvency issues previously discussed are better considered in advance than in the heat of the moment. There is no "emergency powers" act enabling insurance commissioners to waive certain statutory requirements at their discretion or based on discrete triggers. If model legislation were introduced that at least considered and covered some of these situations, it would give guidance to states as to how to respond. Individual state legislatures could then decide if, when and how to implement the model. Without a model response already considered, insurers will face a hodgepodge of uncoordinated and potentially conflicting regulatory responses. This will no

2 Toole, Jim, "Financial Services Convergence: Big Bang or a Whimper?" The Actuary (U.S.), Vol. 2 Issue 6, January, 2006.

doubt open the door for expensive litigation, taking away resources from claims and ultimately policyholders.

1.2.5 Non-guaranteed Elements

Much of the life insurance in force in 1918 was participating. Nearly all companies cut or stopped their dividend payments in 1918. Although many of the products in force today have non-guaranteed elements, it remains to be seen whether they would provide enough flexibility to address the needs of a pandemic.

First, changes would need to occur in a timely fashion. Changes in non-guaranteed elements would need to be created and implemented, and in some jurisdictions filed and approved in a regulatory environment severely stressed by the impact of the pandemic. Weaker companies may already find themselves in a difficult position as policyholders surrender products for policies with stronger companies; changes in non-guaranteed elements might exacerbate the trend.

It is important to note that, in calculating new non-guaranteed elements, the assumption is that it reflects expectations of future conditions (e.g., mortality); changes are not intended to recover past losses. Companies that need cash in the short term to stay afloat will not find changing non-guaranteed elements an attractive option, although it certainly will be one of the tools to rebuild capital over the long term.

1.2.6 New Business

New business production will be impacted during and after the pandemic. Interest in life insurance products will surely rise even as the industry will be taking steps to mitigate the risks assumed. Distribution, products and capacity will all be at issue, and companies will need to take steps to plan new business strategies in advance.

Different distribution channels will no doubt be treated differently, depending on the degree of control that the companies have over the channel and the extent to which their respective financial interests are aligned. Brokers will likely find themselves at a disadvantage to agency forces during a pandemic. Although the expense of agency distribution is a perennial thorn in the side of the industry, the agency force is typically more effective in serving as a first line of defense against fraud. Companies may reduce up-front commissions to both reduce strain and encourage selection. Direct marketing may well receive a boost with little increased risk to the company, as benefits are usually limited to the return of premiums in the first two years.

It is apparent that certain product types will be hit more heavily than others due to a combination of factors including face amount, reserve, reliance on reinsurance and overall economic status of the individuals buying the insurance. Joint and last survivor products may well be hit particularly hard, as a 1931 study indicated higher co-morbidity once the disease was introduced into a household. Writers of term insurance will likely be more at risk than writers of universal or whole life.

Finally, production capacity will also be an issue. Underwriting resources may be unavailable during a pandemic and in short supply for some time afterwards. Some direct writers may be short on capital, and reinsurers may also lack capacity, a critical one-two punch for capital intensive products. Thus, products with lower up-front commissions, statutory reserves and RBC requirements will likely be favored. ✦

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