TOWARDS COVERING **OPERATING LOSSES?**

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The whole world is going through a historic and dramatic period in many ways. We have had serious disruption of our daily lives: the closure of schools and non-essential activities, millions of people on short-time working, etc.

To deal with it, the authorities have implemented unprecedented support measures for businesses, dealing with full or partial unemployment, support from the State and central banks for a rescheduling of bank loans, the mobilization of emergency bank loans which companies may need because of the epidemic.

The impact on our economies is on a historic scale: for example, on April 14, the government estimated that France should experience in 2020 an 8% decline in GDP growth (Gross Domestic Product), a public deficit around 9% of GDP and a debt of around 115%. These will change but the direction of impact is certain. By comparison in France, GDP has only fallen significantly 3 times since 1950 and never by more than 3%.

To the health crisis is added, for an as yet unknown period, an economic crisis despite the measures taken at French, European and even global levels. While the crisis has been mitigated for some companies by the technological advances of recent years (telework, digitalization, etc.), many companies have seen their activity slow down or even stop overnight. On April 22, the government announced that one employee in two in the private sector was in partial activity and that 820,000 companies and associations had already used the partial unemployment scheme, five weeks after the start of confinement.

WHAT WAS THE IMPACT ON INSURANCE COMPANIES?

First, they were able to adapt to exceptional circumstances and mobilized to ensure business continuity and service to their policyholders by using, for example, video expertise in the event of claims.

With public State support, the main credit insurers in France also undertook to market on April 15 additional offers of credit coverage inter-company for French companies up to € 12 billion.

In a further positive development, insurers announced that they were taking a series of exceptional extra-contractual measures amounting for the most exposed and a global investment program in favor of small and medium sized enterprises at a cost of over € 3 billion.

Looking at claims, some insurers have seen a significant decrease due to confinement, particularly for motor and housing risks. Other portfolios are strongly impacted in terms of volumes (insurance whose premium volume is based on turnover for instance) or in terms of increased claims (cancellation of events for example or liability insurance).

And of course the sharp fall in the financial markets had a strong impact on the returns on financial investments, which weighs on the profitability and on the solvency ratios of many companies and insurance groups.

In this context, reflections on the establishment of an insurance scheme covering operating losses have started within the profession.

INSURANCE FOR OPERATING LOSSES IN EVENT OF CATASTROPHE

When the company (or professional) is faced with a claim due to material damage, business interruption insurance makes it possible to offset the effects of the reduction in turnover. The compensation paid is thus intended to put the company back in the financial position that would have been if the disaster had not occurred.

On the other hand, operating losses following immaterial damage (breakdown of the energy network, strikes, etc.) are, for the most part, not covered and the current health crisis generally falls within the scope of the contractual exclusions.

In these times of crisis, insurers are often under pressure from public opinion and the political world. In the United States, for example, some States plan to require insurers to pay for part of the operating losses resulting from confinement. In Germany, Bavaria has imposed an agreement to cover 10 to 15% of operating losses for a period of 30 days. In this context, some insurers are worried about being obliged to retroactively cover risks for which they have not collected premiums.

In recent decades, public policies have effectively been implemented in many areas, for influenza vaccination for example, for better management of the risks of natural disasters as well. Risk prevention plans (natural, technological, etc.)

FRENCH INSURANCE MECHANISM FOR NATURAL DISASTERS

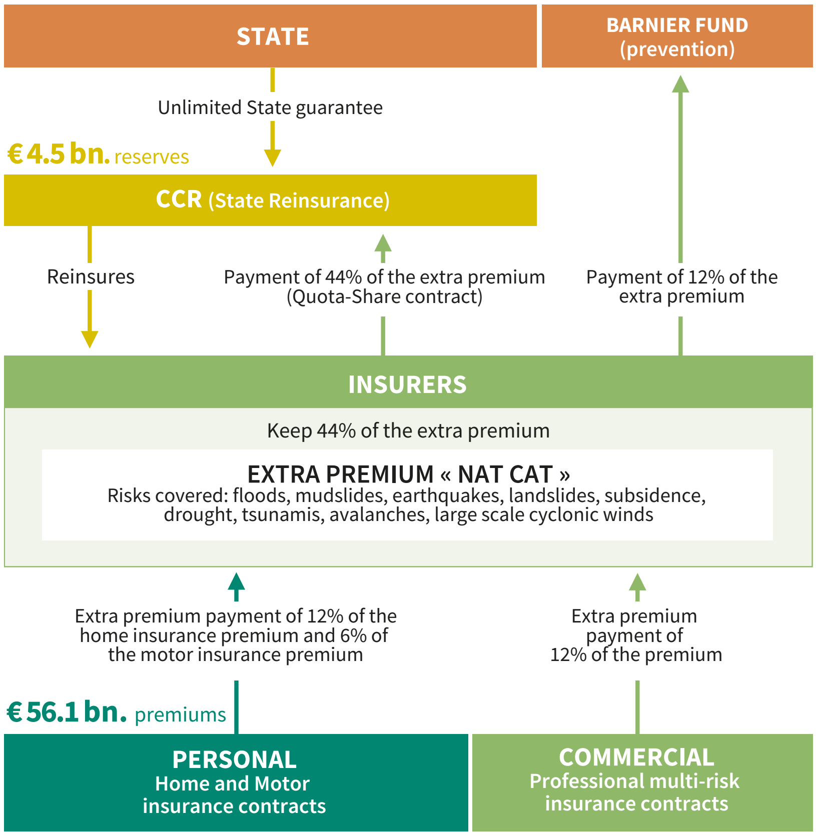
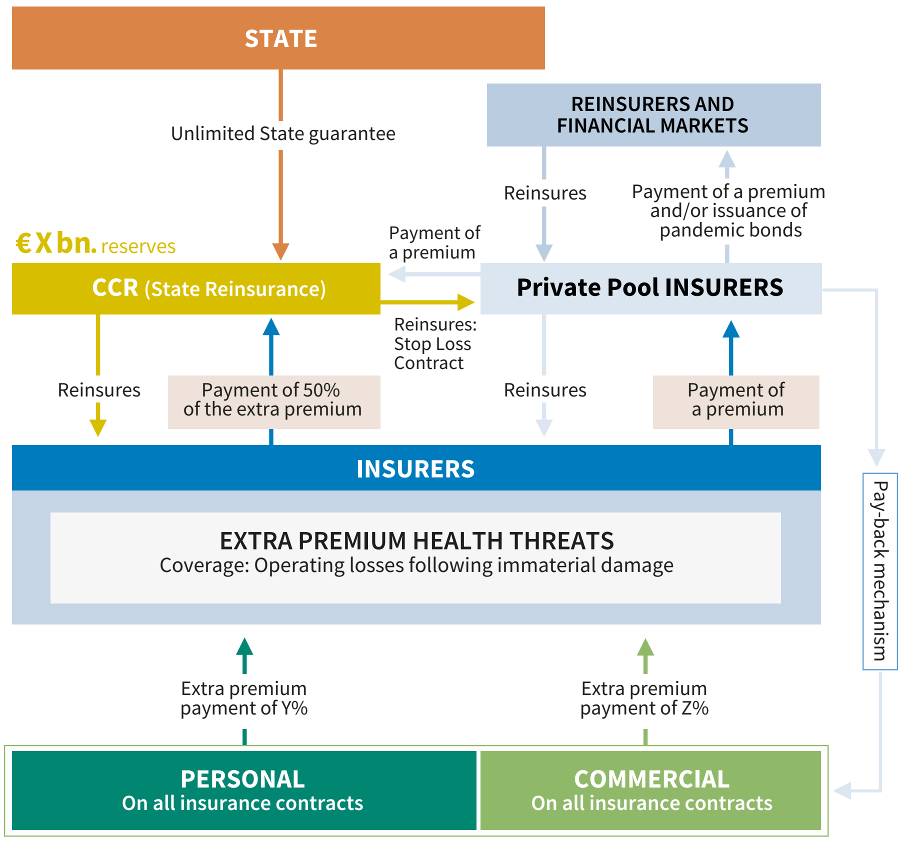


ILLUSTRATION OF A POSSIBLE INSURANCE MECHANISM COVERING OPERATING LOSSES



have been defined to try to prevent the unpredictable.

In the debate that is opening today on a widening of the coverage of operating losses, it will also be necessary to provide the preventative arm.

Regarding the establishment of coverage for operating losses following an epidemic, France, like other countries, has had strong experience in building such mechanisms in recent decades.

In 1982, following catastrophic floods during the winter of 1981, the compensation plan for natural disasters was created in order to respond to a lack of cover for natural risks in France.

Reformed several times since, this mechanism is based on several principles, among which: generalized cover for all natural hazards not covered by conventional insurance contracts, a single premium rate (set by the State), solidarity between territories, rules which define the triggering of the mechanism and an unlimited State guarantee in the event of exceptional claims.

In 2002, following the terrorist attacks of 2001, a system of insurance and reinsurance (Gareat) was created in France in order to address the shortfall in cover of the risks of damage to property related to the terrorism. Above a certain threshold of insured capital (currently set at € 20 million), insurers must join this structure. For this so-called '*Large Risks*' section, beyond a first line of co-insurance up to € 500 million, Gareat places an Annual Aggregate Excess of Loss reinsurance program up to a certain level (€ 2,600 million in 2018), supplemented by unlimited coverage with a State guarantee. In the UK, a similar system for insuring terrorist risks was introduced in the 1990s following a spate of large losses, some of which were uninsured.

These mechanisms have specificities linked to the nature of the risks covered, but have many common points, in particular: a compulsory nature, the principle of national solidarity, rates of extra premium, the principle of the intervention of CCR ('*Caisse Centrale de Réassurance*'), wholly-owned by the French State, and the unlimited State guarantee.

An emergency bill to create insurance for risks linked to serious health crises was tabled in the Senate on March 27 by Catherine Dumas and 70 other senators. It proposes to build a risk insurance scheme linked to serious health threats, along the lines of natural disaster risk insurance, to insure the economic world against future epidemics.

While there may be similarities in the structuring of the insurance scheme with the other schemes in force, the fact remains that fundamental differences remain. There are still questions about the scope and limits of coverage for health crises.

The bill defines health disasters as follows:

- 'The effects of serious health threats are considered to be operating losses which had as a decisive reason the restrictions or prohibitions on travel and meetings or the closings or restrictions on the opening of establishments decreed in order to prevent and limit the consequences of these health threats',
- 'The status of serious health threat is noted by ministerial decree which determines the zones and the periods when the serious health threat led to prescribe measures.'

If the consequences of confinement on the loss of operations are direct, post-confinement consequences are also to be expected, differentiated by sector of activity.

WHAT BASIS FOR FINANCING THE SYSTEM?

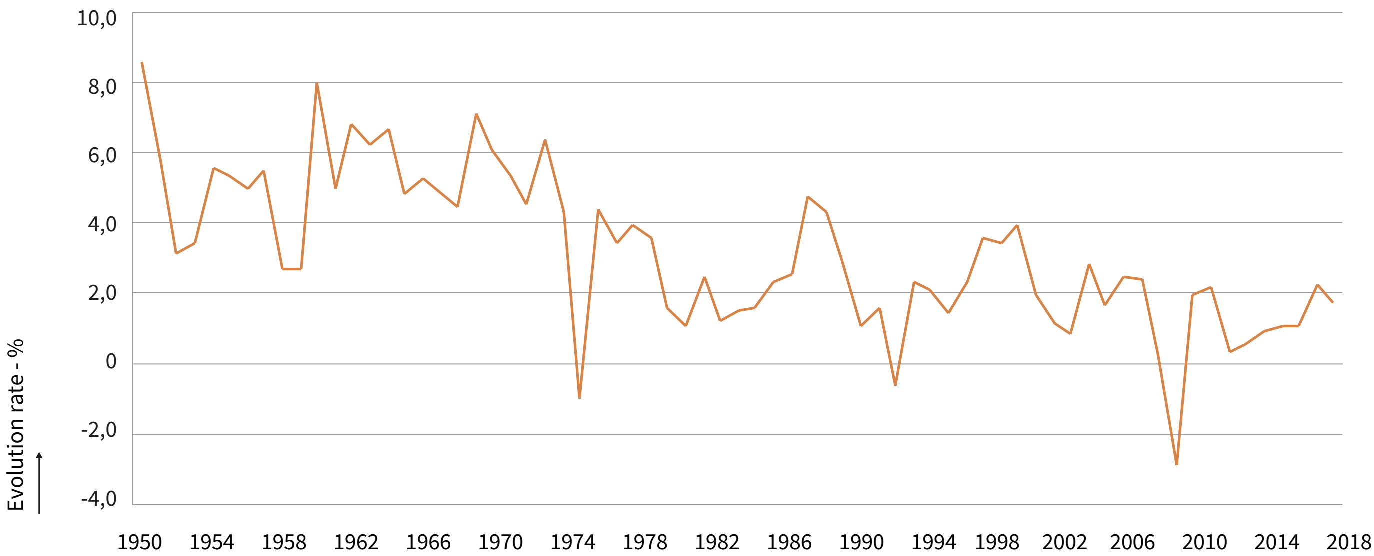
Given the potential amounts linked to operating losses, the question of the base to which a premium would be applied arises. The explanatory memorandum to the bill specifies that, as in the case of natural disaster risk insurance, the scheme insurance for risks linked to serious health threats would be financed by an additional contribution.

The scheme of the future regime remains to be drawn: will it be carried by CCR, which would have the ultimate recourse of the State guarantee, by a pool system of (re) insurers, or a combination of the two?

The future mechanism may also provide for the repayment of part of the premiums to the State in order to finance preventive measures (similar to the Barnier Fund for major natural risks) and the establishment of a centralized database.

In France, the claims experience relating to the non-motor Natural

FRENCH GDP EVOLUTION BETWEEN 1950 AND 2018 (GDP EVOLUTION RATE - COMPARISON YEAR TO YEAR IN %)



Disasters regime never exceeded € 3.3 billion in one year, and averaged € 977 million over the period 1982-2018, for a premium volume of € 1.67 billion in 2018 (source: CCR). The volumes involved for the health regime will be very significantly higher in the event of an epidemic, for lower frequencies of occurrence.

In the event of an unlimited State guarantee, taking into account potential losses, a stop-loss mechanism could supplement the system.

Other possibilities could be envisaged such as:

- Coverage through '*pandemic bonds*'. These instruments came into being a few years after the Ebola virus. Adopted by the World Bank in July 2017, they consist of raising funds from private investors so that they can then have significant financial resources to deploy health aid in the event of an epidemic. However, these instruments have recently come under fire from several critics (trigger criteria, deadline for releasing funds, etc.).
- Coverage through a fund which could be funded by a subsidy from the State budget, a system of premiums and the participation of insurance companies.

WHAT WOULD BE THE COST OF SUCH A MECHANISM?

The definition and the production of a quantitative analysis allowing to illustrate the mechanism and the impacts of the implementation of such a regime consist of delicate exercises taking into account the still very important uncertainties around a part of the epidemic.

One can imagine that a hypothetical COVID-21 would be less expensive than the current COVID-19 due notably to better anticipation. Thus, the future mechanism will probably have to be confronted with reality and therefore be evolving.

OUTLOOK

The experience of COVID-19 will probably trigger a new system for covering operating losses in the event of a health crisis. Faced with political pressure, it is likely to see the light of day in relatively short time.

The organization and parameters of this system remain to be defined, and, even if future health crises would probably require State intervention, given the amounts involved, this new regime would make it possible to better outline the role of the different parties.

Anyway, risk management systems will have to embed these systemic risks and their impacts on the organization of companies, as well as on strategic planning and risk and solvency assessment.

Finally, from our point of view, the thinking should go beyond covering pandemic risk, and also integrate other systemic risks such as Cyber risk for example.

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