

## Green paper

### Supporting the economy to better cope with the consequences of future pandemic events

The corona pandemic has severe consequences for the global economy - and the next pandemic is probably only a matter of time. Against this background, an expert group of the German insurance industry examined new possible hedging strategies potentially able to better support economic sectors affected by a pandemic. Because social systems and financial aid packages are organized at national level, these considerations initially refer to the national framework. The upcoming discussions in Europe nevertheless have to show whether a linkage of national systems would be feasible.

There is a worldwide consensus that the financial consequences of a pandemic cannot be insured in the private sector<sup>1</sup>. The current pandemic and its containment have brought significant parts of public life and the economy to a standstill. It is not possible to spread this amount of risk within a collective and over time. A risk based "pandemic insurance premium" would be prohibitively high. However, a supporting system could well be considered which allows the insurance industry to quickly channel liquidity from the newly created vehicle to its corporate customers.

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<sup>1</sup> Press release on the "Business Continuity Protection Program (BCPP)" submitted by the US insurance industry on May 21, 2020, which refers to the sole distribution of purely government funds by insurers: "Pandemics simply are not insurable risks; they are too widespread, too severe, and too unpredictable for the insurance industry to underwrite".

The current situation has made clear that many businesses face bankruptcy in case of an infection wave (epidemic or pandemic) without rapid government support. The insurance industry comes forward with a proposal of a system that could mitigate the economic consequences of future infection waves by partly replacing governmental ad hoc aid in case of a limited event.

Basically, two models appear suitable for this task:

- Model A: A pure capital collecting entity that builds up a capital stock over time with flat-rate levies and pays (largely flat-rate) benefits in the event of an infection wave. The target size of the capital stock would primarily be determined by the question of how many days / weeks the system could provide aid before the reserves are exhausted. Furthermore, this time period depends on infection scenarios and the level of pay outs.
- Model B: A more risk-oriented system, characterized by the likelihood of a loss, in which businesses pay in for a specified loss to be compensated ("target"). Thus, each business decides for itself on the amount of pay-out it would like to get in the event of an infection wave. To achieve this, the business pays a fee to the capital collecting entity, which is based on a so-called return period (one loss in X years), which would have to be determined when setting up the system.

The necessary funds could flow into the models from potentially affected companies themselves or via direct insurers, reinsurers and the capital market (bonds). However, both models also require substantial government involvement to keep the inflows of funds into the system affordable.

Given the expected adverse selection, it can be ruled out that the capital stock in Model A will be built up solely by voluntary payments by individual businesses. Hence a compulsory system will be required. For example, payments by the businesses to the capital collecting entity could be linked to certain insurance products. Government funds would then complete the capital stock.

In model B, companies would pay directly to get a compensation of a certain amount that matches their business situation and size. In order to keep the payments within an acceptable range, these would be based on a high return period of the pay-out case - e.g. 100 years. If the pay-out case occurs earlier, the government would supplement the capital stock.

The system would be triggered by the WHO's declaration of a pandemic event, as well as the political declaration of a (regionally confined) epidemic event by the Federal Government and the Robert Koch Institute (Ger-

many's public health institute). Otherwise, a significant likelihood exists that the system would not be triggered within the time span of a "generation". This would be highly harmful for acceptance in the business sector.

Beneficiaries would be the businesses which have contributed to the capital stock of the system and which have been closed for general prevention (sanitary containment measures). It remains open for discussion whether businesses that are not forced to shut down but in fact can no longer carry out their economic activity should also receive pay-outs.

In order to play a substantial role in coping with the pandemic costs, a system would need funds in the order of tens of billions of Euro. In case of a regionally limited epidemic event, a fund of this size would potentially be sufficient for all pay-outs. In a pandemic, a limited time gap should be applied to give the government much needed space for analysis and decision-making.

Funds that can be supplied to the models by primary insurers and reinsurers – and the same applies to the risk appetite of the capital market – should be based on established levels of capacities (Extremus AG limits for terrorism risks, private venture limits for nuclear risks). However, from the insurers' point of view it is crucial to also involve the capital market especially via catastrophe bonds (so-called cat bonds). If an event were to occur, the cat bond issuer could use the nominal value of the bond to help finance the pay-out.

The specific design of the bond is important for its acceptance in the market. Here, the distribution of risk between the issuer and the investor is of key importance. Generally, the coupon of such a bond is positively correlated with the amount of risk held by the investor.

Regardless of how a system is designed in detail, it should be taken into account that the insurance industry has both the expertise and the resources to manage (claims) payments in future infection waves. There would be no need to hastily set up public payment facilities if insurers were to take on the role as service providers. Existing customer relationships would make identity checks easy so that fraudulent behavior could be prevented effectively. At the same time, the promptness of the payments would enhance the effectiveness of the financial support.

Berlin, 5<sup>th</sup> of June 2020