Commentary

P&C Insurance: The Conundrum of Business Interruption Coverage during the Coronavirus Pandemic

DBRS Morningstar
April 8, 2020

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Key Takeaways

- BI policies protect for the loss of income following a covered peril that precludes the insured from continuing regular commercial operations.
- Perils covered in BI policies typically include those that physically affect the premises of the insured, such as an earthquake, flood, windstorm, or fire.
- Most income losses following the coronavirus are excluded from regular BI policies. However, there is increasing pressure on insurance companies to retroactively assume some of these losses.
- A hypothetical scenario where insurance companies are forced to cover BI losses outside the design of original contracts would threaten the solvency of the industry on a global scale, as well as negatively affect its liquidity profile. This would generate downward pressure on the financial strength ratings of P&C insurance companies.

Overview

With the ongoing Coronavirus Disease (COVID-19) pandemic affecting many enterprises around the world, there is growing pressure on property and casualty (P&C) insurance companies to assume business interruption (BI) claims even if the original policies were not intended to cover pandemic losses. Forcing P&C insurers to cover losses they had not originally priced in or had no proper reinsurance in place for, could jeopardize the underwriting performance and solvency of the industry in the short term. Even if current contracts are ultimately enforced, we expect increased litigation costs to affect the profitability of P&C insurers in 2020 and 2021.

What Is BI Insurance?

BI — or more exactly, first-party BI — is a type of commercial insurance that protects against the loss of income that a business suffers as a result of a covered peril that triggers a suspension of its activity. Generally, this coverage is intended to restore the insured to the financial position it would have had in the absence of the occurrence of such disruption of commercial activities. In many countries, BI insurance is not offered as a stand-alone policy but instead is more often included as an endorsement of a property or physical damage insurance policy. A typical BI endorsement would cover lost profits, fixed costs, and extra expenses incurred during the affected period (normally up to a year). Contingent BI is an additional class of BI coverage intended to protect insured companies against the loss of income caused by the interruption of suppliers or providers as a consequence of a covered peril.

Originally, BI policies were designed to cover the loss of income caused by a peril covered under the property policy, such as a fire, earthquake, or flood. With time, BI coverage has been extended, in certain situations, to cover the loss of income even in the absence of physical damage to the premises of the insured. One example of this is when a civil authority limits the entry to the premises of the insured or forces its closure due to a covered event in the vicinity of the premises. For instance, in the aftermath of Hurricane Katrina in 2005, insurance companies were liable for BI losses of clients that were forced to close due to the curfew imposed by the Mayor of New Orleans, even if their premises were not directly affected by the hurricane.

BI Insurance and Pandemics

Following the severe acute respiratory syndrome (SARS) outbreak in 2003 that infected more than 8,000 people in 26 countries, insurance companies suffered millions of dollars in BI claims. This led to many insurers adding exclusions to standard commercial policies for losses caused by viruses or bacteria. Since then, insurers and reinsurers have implemented tighter policy wording to exclude losses caused by pandemics in most of their contracts, except for a relatively small number of sophisticated clients that would pay additional premiums for this coverage.

Given the ongoing impact of the coronavirus pandemic on business activity and daily life on an unprecedented global scale, it is not surprising that many commercial insurance clients are looking into their BI policies to determine whether this event is covered. Significant supply chain disruptions, mandatory or voluntary quarantines, social distancing measures, and restricted travel are having a direct toll on many businesses that have been forced to shut down their operations. For any business, these disruptions can cause immediate liquidity problems and material financial impacts, including loss of inventory, revenues, and profits, as well as massive layoffs. Additionally, routine BI claims often present proof and quantification challenges, and in the context of the coronavirus pandemic, these challenges are even greater, with the situation being complicated by some policies filled with individualized exclusions and endorsements.

Although insurance companies have improved their modelling capabilities to estimate potential losses under a wide array of catastrophic scenarios like earthquakes, floods, and wildfires, forecasting insured losses in a pandemic is not an easy task. For instance, the World Bank spent a large amount of resources designing the payout scenarios under the pandemic bonds issued in 2017 because modelling transmission speeds and fatality rates is extremely complex. This is one of the reasons why P&C insurers have avoided covering pandemics under their property and BI policies after the SARS outbreak. Another reason for not covering pandemics is that insurance companies usually prefer to assume risks that are diversifiable across their portfolio of clients; a global pandemic is clearly not a diversifiable event. The same argument also applies to reinsurance companies that, in turn, provide the last line of defence in terms of risk diversification on an international scale. Based on their limited exposure to pandemics, insurers and reinsurers, in most cases, have not priced this risk in their property and BI insurance policies, and more importantly, they have not reserved enough capital to cover such an event. As a consequence of the current dispute around the interpretation of pandemic coverage in BI policies, the insurance industry will continue to refine future contracts. For instance, Lloyd's of London (Lloyd's) just issued last month new virus-exclusion language (see the Appendix) that provides further clarity to new insurance policies underwritten in this market.

Potential Credit Impact of Forcing P&C Insurers to Cover the Coronavirus under BI Policies

The discussion is quickly revolving around whether the coronavirus is a covered peril under BI policies. However, the answer is probably no in most cases with standard insurance policy language. This has caused tremendous pressure on insurance companies in some jurisdictions to cover BI losses even if they were excluded in the original wording. Lawmakers in New Jersey, Massachusetts, and Ohio are considering forcing retroactive policy changes to cover coronavirus BI claims. We have also seen some public officials in the United Kingdom calling for similar measures.

Because the number of potential claims under such hypothetical retroactive changes would be extraordinarily high in the current environment, we estimate that this would have a material adverse impact on the capitalization of the industry globally, and it could cause a liquidity crunch for some companies facing an unexpected surge in BI losses. This would generate downward pressure on the financial strength ratings of P&C insurance companies, particularly those that focus on commercial lines, where BI coverage limits tend to be materially higher. There would also be uncertainty about whether reinsurance companies would regardless cover BI losses related to the coronavirus when they never intended to. This would leave direct insurance companies in a very precarious situation that could make them not viable within a very short time, unless there were to be a government backstop similar to that provided by the *Terrorism Risk Insurance Act* in the United States. Yet another unintended consequence of retroactively forcing coverage of BI claims is that clients might find this product too expensive in the near future or unavailable altogether because insurance companies will have to price in the potential risk of being forced to cover BI losses outside the language of their policies.

Even without a scenario where insurance companies are forced to cover BI losses outside the original contracts, we estimate that many companies will face increased litigation costs around this particular coverage. This is compounded by the fact that BI policies tend to be tailored to the specific needs and the nature of the commercial activity of the insured clients, which leaves interpretation of these contracts up to the courts of law in many cases. Although we expect that existing BI contracts will be ultimately upheld and that the overall claims and loss ratios for most business lines will be manageable for the P&C insurance industry following the coronavirus, increased litigation costs will adversely affect insurance companies' profitability in 2020 and 2021.

Related Research

- *Coronavirus Disease (COVID-19) to Trigger Pandemic Bonds*, March 3, 2020.
- *Coronavirus: Likely Increases in P&C Insurance Claims in Certain Business Lines; Financial Markets' Volatility Will Affect Investment Portfolios*, March 12, 2020.
- *Assessing Financial Strength Ratings of P&C Insurance Companies Amid the Global Coronavirus Pandemic*, April 2, 2020.

Appendix: Lloyd's LMA 5393—Communicable Disease Endorsement (March 25, 2020)

1. This policy, subject to all applicable terms, conditions and exclusions, covers losses attributable to direct physical loss or physical damage occurring during the period of insurance. Consequently and notwithstanding any other provision of this policy to the contrary, this policy does not insure any loss, damage, claim, cost, expense or other sum, directly or indirectly arising out of, attributable to, or occurring concurrently or in any sequence with a Communicable Disease or the fear or threat (whether actual or perceived) of a Communicable Disease.

2. For the purpose of this endorsement, loss, damage, claim, cost, expense or other sum, includes, but is not limited to, any cost to clean up, detoxify, remove, monitor or test:
2.1. for a Communicable Disease, or
2.2. any property insured hereunder that is affected by such Communicable Disease.

3. As used herein, a Communicable Disease means any disease which can be transmitted by means of any substance or agent from any organism to another organism where:
3.1. the substance or agent includes, but is not limited to, a virus, bacterium, parasite or other organism or any variation thereof, whether deemed living or not, and
3.2. the method of transmission, whether direct or indirect, includes but is not limited to, airborne transmission, bodily fluid transmission, transmission from or to any surface or object, solid, liquid or gas or between organism, and
3.3. the disease, substance or agent can cause or threaten damage to human health or human welfare or can cause or threaten damage to, deterioration of, loss of value of, marketability of or loss of use of property insured hereunder.

4. This endorsement applies to all coverage extensions, additional coverages, exceptions to any exclusions and other coverage grant(s).

All other terms, conditions and exclusions of the policy remain the same.

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