Commentary

The Global Supply Chain Crisis Exposes the Limits of Business Interruption Insurance

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Key Highlights

- Global supply chains are increasingly pressured by both lower supply and higher demand for certain products owing to the pandemic.
- Most income loss claims resulting from the pandemic are excluded from standard BI and CBI policies. However, there is significant pressure on insurers to retroactively assume some of these losses, which were not adequately priced or reserved to serve this purpose.
- In our view, the short-term challenges relating to BI and CBI claims remain manageable given the strong capitalization and earnings performance of insurance companies.
- Over the long term, demand for supply chain insurance could significantly rise given inadequate protection from standard BI and CBI policies amid the coronavirus pandemic.

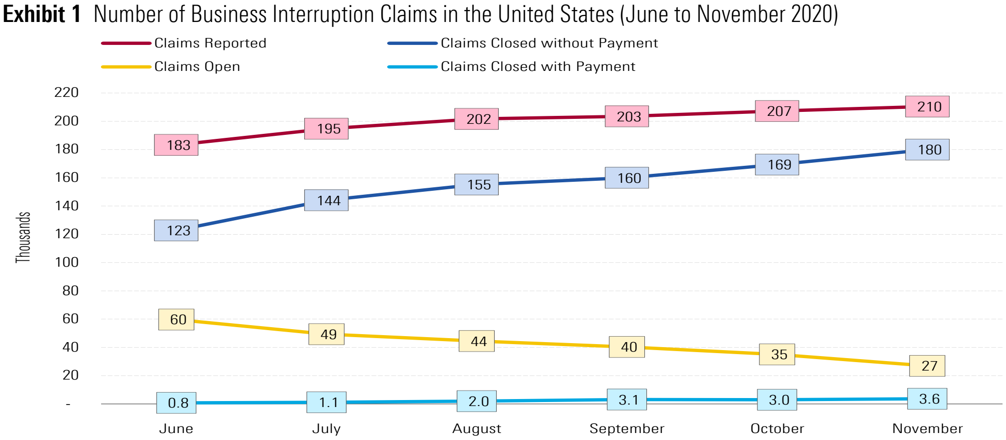
Overview

The Coronavirus Disease (COVID-19) pandemic has posed unique challenges for supply chains globally, causing an imbalance in both supply and demand. The introduction of lockdowns and social distancing measures, together with labour shortages, limited the supply of key products during most of 2020 and well into 2021. At the same time, consumers and businesses increased their demand during the pandemic for a wide range of products, straining global supply chains even more.

In this context, many companies turned to their insurance policies to try to recover some of the losses caused by the pandemic, particularly under their business interruption (BI) insurance. This is a type of commercial insurance that typically protects against losses from the suspension or reduction of operations caused by direct physical damage in the insured premises that result from a covered peril, such as fire or flood. Although BI insurance is aimed at covering losses arising from physical damage, the pandemic triggered a large number of BI claims in many countries, increasing litigation for insurance companies and creating a number of challenges as this product was not priced to cover pandemics.

Policyholders filed more than 210,000 claims related to BI coverages amid the coronavirus pandemic in the United Sates as of November 2020, with a total value of $1.3 billion (Exhibit 1).[1]

Exhibit 1 Number of Business Interruption Claims in the United States (June to November 2020)



Note: Data reported is cumulative.
Source: National Association of Insurance Commissioners.

1 National Association of Insurance Commissioners, COVID-19 Property & Casualty Insurance Business Interruption Data Call, 2020.

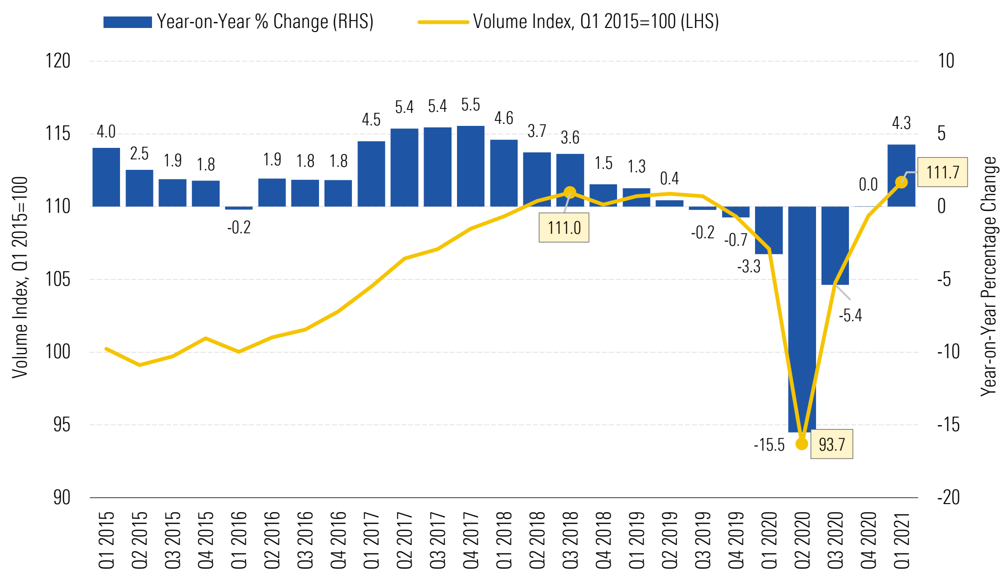
However, less than 2% of closed claims for BI losses submitted to insurers were paid in 2020, evidencing that pandemics were originally excluded in most insurance contracts. Moreover, U.S. insurers paid $420 million in BI losses as of the same date, which is very manageable for an industry with more than $800 billion in capital surplus, assuming courts continue to favour insurers on the interpretation of BI insurance policies. This is also similar for other countries, such as the United Kingdom and France where insurance supervisors have concluded that less than 4% of BI policies would result in losses related to the pandemic.[2] Nevertheless, this has not deterred policyholders from pursuing their claims in court, forcing insurers to face increased litigation costs and reputational damage.

In contrast to BI insurance, which by extension is not adequate for covering supply chain disruptions in a pandemic, commercial policyholders with advanced risk management programs utilized a specialized coverage called supply change insurance, which is underwritten by a small number of global insurance companies. Given its effectiveness during the pandemic, this coverage could become more prevalent in the future despite its additional complexity and cost.

The Busiest Season of the Year will Exacerbate Supply Chain Concerns

Although many industries already experienced supply chain issues before the pandemic, the current magnitude of challenges are unprecedented, as shown in Exhibit 2.

Exhibit 2 World Merchandise Trade Volume, Q1 2015 – Q1 2021



Sources: WTO Secretariat and UNCTAD.

Moreover, the interruption of the global flow of trade created an accumulation of shipping containers in certain ports. These containers must be shipped empty to wherever they are needed, increasing transportation costs and leading to higher prices of final and intermediate goods. With the reopening of most economies in the second half of 2021, the strong demand for finished products and raw materials

2 Organization for Economic Cooperation and Development, Responding to the COVID-19 and pandemic protection gap in insurance, 2021.

is straining global supply chains even more. There is increasing uncertainty regarding meeting consumers' needs during the fourth quarter, which is the busiest season of the year. Other disruptive events in 2021 have exacerbated the supply chain woes, including the massive winter storm in Texas in February, the blockage of the Suez Canal in March, and the cyberattack on Colonial Pipeline Company in early May, causing a six-day closure of a gasoline pipeline in the United States.

BI Insurance is not Designed to Protect Supply Chains Against Pandemics

Many large and medium-size companies have turned to their insurance providers and reviewed their BI and other supply chain insurance policies, hoping to recover some of the costs incurred as a result of the interruption of global supply chains. Generally, this coverage is intended to restore the insured to its original financial position before the occurrence of a disruption of commercial activities by a covered event, typically a physical damage of the insured premises. In many jurisdictions, 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).

Companies that rely on a limited number of suppliers or customers can also obtain a specialized BI protection called contingent business interruption (CBI). This is an additional subclass of BI coverage intended to protect companies against the loss of income caused by the interruption of suppliers or customers as a consequence of a covered peril. Unlike traditional BI insurance that compensates the policyholder for a loss resulting from damage to its own property, CBI allows a company to transfer the risk of certain losses to the property of a third party to its insurance provider. Typically, CBI insurance is triggered if: (1) there is direct physical loss or damage to the property of a supplier or customer; (2) the loss or damage is caused by a covered cause of loss; and (3) the loss results in a suspension of operations at a covered location.

Therefore, both BI and CBI products typically do not provide adequate protection for supply chain disruptions caused by a pandemic. Originally, BI and CBI policies were designed to protect against the loss of income caused by a physical peril covered under the property insurance policy, such as fire, earthquake, or flood. With time, BI and CBI coverages have expanded, in certain situations, to cover the loss of income even without physical damage to insured premises, such as in cases where the civil authority limits the entry to the insured premises or forces its closure. However, following the severe acute respiratory syndrome (SARS) outbreak in 2003, when insurance and reinsurance companies incurred millions of dollars in BI and CBI claims, the industry began to add exclusions to standard commercial policies for losses caused by viruses or bacteria. Since then, insurers and reinsurers have implemented tighter policy wordings to exclude losses caused by pandemics in most of their contracts, including BI and CBI policies.

Although the concept of CBI insurance is fairly straightforward, determining what is a covered cause of loss is rarely black and white. This has been complicated by certain court decisions in the U.S. and the UK since the beginning of the pandemic that favoured a more ample interpretation of covered causes under BI and CBI policies. In response, insurance companies have increased their actuarial reserves for future BI and CBI claims, which could pressure the profitability of the industry in the short to medium term despite having a relatively benign year in terms of insured natural catastrophe losses and increasing insurance prices in key business lines. The unexpected stream of BI and CBI losses and lawsuits relating to the coronavirus pandemic is a challenge for many insurance companies around the world. These products were not adequately priced and reserved in the first place because they were not intended to be triggered under the current circumstances. However, in our view, BI and CBI claim levels remain manageable given the strong capitalization of the industry and compensating factors, such as lower claims in other business lines because of the social distancing measures and quarantines implemented during the peak of the pandemic.

The Coronavirus Pandemic Could Increase Demand for Broader Supply Chain Insurance

In addition to BI and CBI policies, insurance companies have offered a broader coverage called supply chain insurance. This product is intended for a relatively small number of clients that need protection against disruption in their supply chains, not only caused by physical damage to the premises of key customers and suppliers but also by a wider range of events, including industrial accidents, labour issues, political upheaval and social unrest, the inability to enter premises, regulatory actions, and, in some cases, public health emergencies such as a pandemic. This type of coverage usually comes at a high price and is only available to clients employing advanced risk management tools and willing to partner with brokers and insurers to design a customized insurance program. Unsurprisingly, the coronavirus pandemic triggered claims under supply chain insurance policies but also highlighted the value of the product for many existing and potential clients.

In our opinion, global supply chain insurance policies, which are usually bought by large companies with relatively complex needs, could become more prevalent among a larger number of clients. The global supply chain challenges during the pandemic could open new business opportunities for insurance and reinsurance companies as corporations increase their demand for more comprehensive coverages and risk transfer tools. Swiss Re estimates that changes to global supply will generate approximately $63 billion in additional insurance premiums globally over the next five years.[3] We anticipate that increased demand for supply chain insurance and better modelling following the pandemic could bring new opportunities for global insurance companies serving large corporate accounts in the context of an enhanced multiline commercial relationship. If properly managed, this could improve the earnings profile of property and casualty insurance companies.

3 Irina Fan and Thomas Holzheu/Swiss Re, sigma 6/2020 - De-risking global supply chains, 2021.

Related Research

- *Outlook for Sovereign Ratings in the Wake of COVID-19*, November 1, 2021.
- *The Suez Canal Blockage Is Likely to Have a Limited Impact on the Global Insurance Industry*, March 30, 2021.
- *Covid 19: European Governments Have Moved Swiftly to Protect Availability of Trade Credit Insurance*, June 11, 2020.
- *P&C Insurance: The Conundrum of Business Interruption Coverage during the Coronavirus Pandemic*, April 8, 2020.

Note:
All figures are in U.S. dollars unless otherwise noted.

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