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Pandemic Risk Insurance: Challenges of Business Interruption in a Global Pandemic

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Background: Thousands of U.S. businesses have filed insurance claims for business interruption since the start of the COVID-19 pandemic, particularly where civil authorities have ordered businesses to shutter. The overwhelming majority of such claims have been denied, however, as standard commercial property insurance policies typically require an insured to demonstrate evidence of physical damage. Most policies also explicitly exclude losses related to viral contagion. Many of these claims disputes have ended up in the courts.

But... Lawmakers at the state and federal level have responded to these claims denials with several ill-considered legislative proposals. Bills that would vitiate contract language and require coverage retroactively for COVID-19 business interruption claims were introduced in more than 10 states in 2020, though none were passed into law. In May 2020, U.S. Rep. Carolyn B. Maloney introduced the Pandemic Risk Insurance Act of 2020 (PRIA), establishing a $750 billion reinsurance program that would have the federal government pay 95 percent of business interruption claims arising from a future viral contagion.

However... Both the magnitude and the extreme correlation of business interruption losses arising from a pandemic make them nearly impossible to insure. Rewriting contract language to require payment of claims that are explicitly excluded would jeopardize both the rule of law and the solvency of the global insurance industry. Disallowing virus exclusions in future policies could threaten the availability of coverage for business interruption altogether. While it is possible to structure a government backstop that could draw interest from private insurers, the details of any such proposal need to be closely scrutinized. Ultimately, the question should be raised whether insurance is actually the tool best suited to the problem.

KEY TAKEAWAYS

BACKSTOP WOULDN'T HELP MOST

Only about a third of U.S. businesses currently have business interruption coverage, calling into question whether a federal system to support business interruption claims would offer assistance to those firms that most need it.

Moreover, while backstop proposals typically would see business interruption claims triggered by public health emergency orders, the experience of the COVID-19 pandemic shows that economic dislocation can occur even in the absence of government-mandated shutdowns. As of October 2020, after nearly all states lifted shutdown orders, airport traffic remained down 60 percent from before the pandemic and OpenTable restaurant reservations were down nearly 40 percent.

The best argument for a public-private partnership is that insurers can help policyholders to mitigate risk. But importantly, the risk insured by business interruption coverage is attenuated from a given firm's risk of spreading infection to the public at large. The latter is covered by liability coverages, while workers' compensation insurance covers the risk that employees will suffer workplace infection or injury. Business interruption insurance instead covers the risk that a firm will have to cease operations.

Faced with pandemic conditions, there are political economy reasons to want to subsidize a firm's risk of business interruption. This would align the firm's own economic incentives with the public health goal of stanching viral transmission.

LESSONS FROM COVID-19

The experience of the Paycheck Protection Program (PPP) recommends that any federal program to provide assistance to businesses coping with a pandemic should be structured to encourage broad participation, with a strong bias toward enticing take-up by small businesses who lack access to bespoke insurance products like captive insurers. It may be valuable to leverage the distribution and payment-processing capacity of the insurance industry, but implementation of the program should not be limited to insurers and insurance brokers; banks, payroll-processing firms, credit card issuers, and other segments of the financial services also should be invited to take part.

The insurance industry's claims-adjustment process is too cumbersome and fraught with the potential for litigation to handle the volume of claims that a pandemic would trigger. A more appropriate mechanism for a targeted assistance program would be to employ a parametric trigger, under which payments would be made automatically once certain economic, public health, or civil authority parameters are satisfied. Should there be reason to foreclose beneficiaries from using the payments for certain purposes—such as executive compensation or buying back shares—these can be clawed back later through the tax code.

Another option is to let states create their own plans, with the U.S. Treasury standing as a backstop. An upside to this approach is it would limit the "run on the bank" danger that PRIA poses, in which states that suffer losses early in what proves to be a rolling contagion—such as New York during COVID-19—might deplete the fund before other states have an opportunity to access it.

LAWMAKERS SHOULD PROCEED WITH CAUTION

State and federal lawmakers are expected to revisit the issue of pandemic business interruption in 2021, with Rep. Maloney in particular expected to reintroduce her PRIA proposal. Consideration of such plans should follow a deliberative process, allow space for private innovation, and be conscious of the many unintended consequences of government action.

For more on this issue, see R.J. Lehmann's November 2020 testimony to the House Financial Services Committee.

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