WALKERS

COVID-19

What Are the Likely Effects on the Bermuda Re/insurance Market?

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Introduction

We live in truly unprecedented times. As the spread of the COVID-19 virus continues, so does the contagion of the virus' effects on the global economy. Many businesses, large and small, have been forced to shut their doors, unable to continue operations in these days of self-isolation and social distancing. Many will never re-open, despite historic, multi trillion-dollar COVID-19 disaster funding packages in the US, UK and elsewhere. Aside from the human cost of the pandemic, the pervasive reach of the harmful economic effects is almost unimaginable. Recessions will follow across the globe. Very few will be spared some pain.

This article examines the economic effects of the pandemic on the Bermuda re/insurance industry.

Bermuda Re/insurance Market

Bermuda is a high severity, low frequency market and calls itself the "World's Risk Capital" having carved out over the last 35 years a reputation of "payer of last resort". The Bermuda re/insurance industry has paid billions of dollars in claims arising from the most severe natural catastrophe events and largest man-made disasters, for example 9-11. One might therefore presume that losses arising from COVID-19 – predominantly business interruption ("BI") – will fall to the world's insurance and reinsurance markets to indemnify. This may or may not be true.

Coverages

Bermuda's re/insurance market is made up principally of excess property (i.e. first party losses) or casualty (third party liability) insurance, specialty lines, reinsurance and retrocession and Insurance Linked Securities ("ILS").

As many commentators have already written, the principal claim insureds will want to make will be for economic losses arising from BI caused by COVID-19, as a result of closures, the disappearance in customer orders or supply chain disruption. Such coverage would be provided in commercial property insurances or, conceivably, under Commercial General Liability ("CGL") policies, of which the Bermuda Form Excess Liability Policy is a version.

Commercial property insurance generally provides a promise to pay for actual loss of net business income sustained by a necessary suspension of operations during a period of restoration. That suspension of operations must be caused by direct physical loss, damage or destruction to property. The restoration period refers to the process of rebuilding, repair or replacement of the damaged property.

Similarly, the Bermuda Form Policy (current versions XL004, or CHUBB005) provides an indemnity for an insured's liability for damages on account of, among other things, property damage which is physical damage to, or destruction of, tangible property, including a loss of use of that property, or the loss of use of tangible property that has not been damaged, arising from damage to other tangible property.

On the above analysis, BI will not therefore be covered in the vast majority of cases by commercial property and casualty insurance, because, while destructive, the virus does not cause physical damage to anything but human beings and their finances; it does not cause physical destruction to property and, as such, cannot normally give rise to BI.

Furthermore, in commercial property and casualty lines, as well as contingent coverages like event cancellation or travel insurance, a robust communicable disease / epidemic exclusion is commonplace. The re/insurance market learned its lesson from previous health emergencies like MERS, SARS, Zika and Ebola, meaning that any losses arising from COVID-19 would be likely expressly excluded. Other exclusion-type of clauses in play are: (i) force majeure clauses, which allow a party who would otherwise be in breach of a contractual obligation to be exculpated by reason of the happening of a force majeure event, or 'Act of God' which this epidemic likely is, and (ii) lay off provisions in employment contracts, which provide employers the ability to pause an employment relationship for a temporary period (four months in Bermuda) rather than opt for full redundancy. Consequently, COVID-19 is not covered by many insurance or other contractual arrangements we routinely participate in and the losses from this event are being absorbed by insureds, like you and me.

With the above said, it is conceivable that insurance coverages without express exclusions might allow losses for "silent-COVID-19", by which losses arising indirectly from the virus find their way in to coverages otherwise not intended to cover those losses. As we saw with silent-cyber losses, which bled in to financial lines policies for many years, it is likely that silent-COVID-19 losses will creep somehow in to commercial property, or casualty coverages especially. By comparison, however, it took 17 years for the market to produce a cyber exclusion, whereas the insurance market has responded instantly to this crisis by insisting on COVID-19 exclusions, with many insurers walking away from 1 April renewals if such exclusions are not accepted.

What is in no doubt is the US plaintiff bar's ingenuity in devising new claim theories, using reptilian litigation strategy to force an emotional reaction from juries to make unexpectedly high awards. Those increased awards could conceivably hit Bermuda's higher attachment points and continue the economic contagion to the Bermuda insurance market when one does not expect it. An aggravating factor is the contraction of Bermuda insurers' capital buffers in line with the drop in financial markets' values. Fitch have revised its outlook for the global reinsurance market and US P&C market to negative, citing "impacts on near term performance and the credit quality of insurers." We will have to wait and see if these factors will together make any negative impact on the Bermuda market, or give rise to justified firming of pricing and market hardening.

Insurance Linked Securities Impacted?

There have been many investor inquiries about the effect of COVID-19 on ILS structures. For disaster relief products like the World Bank's pandemic catastrophe bonds, and the pandemic risk-linked swaps issued concurrently to support the Pandemic Emergency Financing Facility, this health emergency is precisely what is covered, so it is expected that investors will lose their principal as a result of the arrival of COVID-19.

For other ILS products the story is generally a good one, with little sign that ILS will be significantly hit on an aggregate basis by BI losses on property catastrophe reinsurance contracts as the result of the pandemic. Thus, ILS is truly demonstrating its reliance and economy-proof appeal as a diversified asset class. The precise impact for each ILS structure will, of course, differ depending on the vehicle (cat bond, collateralised re, ILS fund) but on the whole we do not expect investors in ILS structures to be significantly affected by COVID-19 BI losses. Those structures are predominantly triggered by extreme weather events and are, as such, uncorrelated with the global financial markets, which are already 20% down across the board and only heading further on a downward curve.

This raises the real reason for the inquiries. With investment yields in the equity and bond markets since the 2008 crisis being what they have been, ILS has proved an excellent alternative, providing high double digit returns on investment, prior to the loss-making seasons of 2017 and 2018. Now, with bargains to be had in those traditional financial markets, investors are checking their fund redemption provisions or, especially as we have seen with multi-strat funds, are selling cat bonds at a discount in the secondary market to invest in those other distressed asset classes. For investors in open-ended funds, they might be able to redeem in 60 days while the economy is still in turmoil and turn a bargain in the distressed markets. For closed-ended funds, investors will need to ride this out and hope that the wind does not blow this hurricane season. Similarly, for investors in collateralised reinsurance, there is little liquidity available until the deal underwritten expires.

For those more exotic, non-elemental coverages in ILS (such as long term insurance or credit) which are currently a relatively small but rapidly growing segment of the ILS market, the pandemic could conceivably cause per risk losses, but it would seem doubtful that there will be a significant aggregate loss. In conclusion, it would appear that ILS again is showing its value as a diversified asset class and it is business as usual.

The Global Economy and our Lawmakers

If history teaches us anything, we know that the biggest threat to the Bermuda re/insurance market – both the evergreen and ILS sectors – is the threat of legal and legislative change from overseas. We have already touched on the threat posed by the US plaintiff bar and with that threat come the risks of claims inflation, claims fraud and stretched economic loss theories. We have already seen one case in Louisiana state court filed by a restaurant in New Orleans seeking a declaration that it is covered by Lloyd's for BI arising from the Louisiana governor's public gathering restriction. We expect that we will see many more. It has been suggested that claims such as this are probably the reason why some governments and public authorities have been hesitant to issue lockdown mandates.

We are already seeing legislative changes afoot, at the US Federal and State level, as well as new legislation from the UK. The US House Financial Services Committee has called for the passing of a Pandemic Risk Insurance Act, which is reminiscent for the insurance industry of the Terrorism Risk Insurance Act 2002 passed after 9-11 and would form good intelligence for a sharing of risk between government and the private sector for COVID-19 losses. Such legislation is responsible and welcome. Separately, we are seeing US states take a more direct approach. New York, New Jersey, Ohio and the Commonwealth of Massachusetts are all considering passing bills forcing commercial property insurers to pay BI claims arising from COVID-19, voiding any exclusions ruling out coverage. On one hand this sharing of losses makes some sense. COVID-19 is out of control in many developed countries, most of which are not as experienced or as technologically capable as South Korea were (from its 2015 battle with MERS) to deal with the mass testing and aggressive measures required to halt the spread of the virus. The longer we must all socially distance – or "shelter in place" as we call it in Bermuda – the longer the deleterious economic effects will continue. On the other hand, the insurance industry is extremely well developed and in both the US and the UK has evolved from lessons learned from near collapses in the past. So, contractual terms have matured and have been included for a reason: to secure the stability of a much needed risk transfer industry. Why should insurers be forced to pay, when they have adapted their contractual terms to avoid taking on such risks, especially when governments could perhaps have done more to anticipate and control the spread of this virus?

We're All in This Together

In conclusion, while the insurance industry globally and in Bermuda is currently relatively well insulated from BI claims and the economic effects of this pandemic, it is possible that legal and legislative changes will force the re/insurance industry to take some of the pain, along with our governments, which are all stepping up to offer truly meaningful short term financial support. That might give rise to litigation. What is certain is that we are all going to feel the negative effects of this pandemic. Economic losses and unemployment will continue to increase. We will likely be entering another recession at least as severe as in 2008. However, there are signs that this pandemic is different and brings forth the optimism, best intentions, and commitment for government, industry and citizens to work together and get through this dented, but not defeated.

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