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June 26, 2020

Hon. William Lacy Clay, Chair
Subcommittee on Housing, Community Development
and Insurance
House Committee on Financial Services
U.S. House of Representatives

Hon. Steven E. Stivers, Ranking Member
Subcommittee on Housing, Community Development
and Insurance
House Committee on Financial Services
U.S. House of Representatives

Dear Representatives Clay and Stivers:

Due to concerns expressed by many small businesses affected by the economic impact of the coronavirus, Congress is considering various proposals to expand business interruption (BI) insurance coverage to include closures due to pandemic events. On behalf of the Casualty Practice Council of the American Academy of Actuaries,[1] I am offering the following comments on the general issue of insuring against pandemic events and on the specific proposal to create a Pandemic Risk Reinsurance Program as outlined in H.R. 7011.

H.R. 7011 addresses the question of how to enable expansion of BI coverage to include closures of businesses due to pandemic events. In these comments, I will first address the broad issues and then take a more detailed look at the legislation.

What makes insuring a pandemic different

Currently, pandemics are excluded from most BI insurance policies because pandemics, by definition, impact many people or businesses over an extended continuous period of time. Generally, property/casualty insurance works by pooling risk, taking limited and randomly occurring events (fires, automobile accidents, windstorms) and distributing the associated expected costs over a large pool of policyholders. This risk distribution is facilitated by the

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

reinsurance market, which spreads the risk over the global financial markets. When an event is potentially very widespread, perhaps affecting millions of policyholders for a continuous extended period on a global basis, the model of distributing costs over a larger pool does not work well.

Also, a commercial insurance model does not work well for events like a pandemic when the potential cost is large, has no clear maximum, and occurs very infrequently. We discussed this problem in greater detail in a recent letter to the Financial Services Committee. [2]

Existing government insurance programs may provide insights for the design of a new program

In some cases where the private insurance market has been unable or unwilling to provide very large amounts of coverage for certain risks that are hard to estimate or might never have occurred before, the federal government has established programs to facilitate insuring against such perils (e.g., terrorist attack, nuclear power plant meltdown, and flood). In the case of the Terrorism Risk Insurance Act (TRIA), a limit is set on the maximum financial risk the insurance industry is expected to take, and TRIA further provides a plan for the federal government to step in if it becomes necessary to fund payment of claims above that limit.

In the case of flood insurance, the National Flood Insurance Program (NFIP) is the primary insurer (selling policies directly to homeowners and small businesses) and the U.S. Treasury steps in to back the program with loans when storms cause insured losses to exceed the funds that the NFIP has on hand, as the NFIP has no cap on the amount covered. These loans are intended to be repaid after the event by surcharges added to insurance policies for future coverage, although enacted legislation has sometimes directed that certain loan amounts be forgiven.

These federal programs do not follow the private sector's insurance practices of determining exposure, spreading the potential cost over the insured population, and then collecting sufficient funds and maintaining sufficient assets to pay all claims when they arise. By putting a cap on how much risk the marketplace is expected to handle and then providing a federal backstop for the rare and unpredictable event that exceeds that cap, these federal programs facilitate a vibrant insurance market. While different government insurance programs have varying designs for government reimbursement, they do provide for recoupment by the U.S. Treasury.

Business interruption insurance is complicated

BI insurance is an unusual and complicated coverage. A BI policy is triggered after a physical event has occurred and the insured business has been shut down for a specified period. The insurer then pays the business owner an amount that represents lost profits and some ongoing operating expenses for the duration of the shutdown up to the amount of time or dollar limits specified in the insurance contract. BI claims often take months to be fully settled, as there is an initial waiting period, lost income must be determined, and the closure of the insured business must run its course.

BI is an optional coverage that businesses must elect to add to basic property insurance. Only about 40% of small and midsize businesses buy BI coverage.[3] To illustrate more directly,

[2] https://www.actuary.org/sites/default/files/2020-05/Pandemic_Risk_Comments_20200511.pdf

[3] Jeff John Roberts; "Who pays for the pandemic when insurance companies refuse?"; *Fortune*; May 14, 2020.

academic research found that only 30% of the businesses affected by Superstorm Sandy received insurance payments for business interruption.[4]

Small businesses generally do not buy BI coverage as a stand-alone policy. Larger businesses that purchase more complex insurance packages may buy it separately. Companies that manage large events may buy all-risk policies that include public health closures. An additional specialized coverage that may be either a stand-alone policy or attached to other packages of insurance policies is event cancellation coverage with specified policy provisions. Some more high-profile events such as canceled concerts, sports events, and so forth have been reported with large payouts. [5,6]

Expanding BI coverage to include a new risk (e.g., pandemic virus) will increase the cost of BI insurance policies. The result could be an available expensive coverage with limited numbers of small businesses deciding to purchase it.

What this legislation does

H.R. 7011 would cover business interruption policies written by participating insurers. Claims under such policies would be defined to also include event cancellation. Upon purchase of a policy from a participating insurer with a pandemic inclusion, a policyholder would pay a premium that represents the insurer's expected exposure to potential pandemic claims. When a declared pandemic generates $250 million in covered losses, the governmental role would be triggered. The government's share, 95% of losses above insurers' deductibles up to a total of $750 billion, would be funded from general funds of the U.S. Treasury.

When claims occur, the policyholder would submit a claim to its insurer. The insurer would aggregate its claims to see whether these types of claims meet its aggregate deductible. When the deductible is met, the insurer would then submit the information claim by claim to the federal government for the federal government to process. The federal government would pay 95% of the amounts above each insurer's deductible. The legislation is not clear on whether the governmental funds are a reimbursement to the insurer when the insurer's deductible has been met or whether these claims are paid directly to the insured businesses. In addition, the legislation provides that the participating insurer is liable only for its deductible, but the 5% that the federal government does not pay above its deductible appears to fall to the insurer to pay. Thus insurers would be responsible for losses in their deductible layer plus 5% of losses in excess of their deductible layer (with no limit) plus potentially a portion of the remaining 95% of losses in excess of their deductible layer, to the extent these are not paid for or reimbursed by the federal government, for example when the total losses are less than $250 million.

Considerations that would impact the effectiveness of the legislation:

1. **Participating insurers**. H.R. 7011 is based on an assumption that insurers are willing to participate in the program. The legislation is unclear on several points, raising questions that may have an impact on the willingness of insurers to participate. These include the following:
    a. Are all insurers offering business interruption insurance required to be participating insurers?

[4] Collier et al.; "Firms' Management of Infrequent Shocks"; *Journal of Money, Credit and Banking*; OSU; 2019.
[5] De Paoli et al.; "A World Wanting Payback Pulls Insurers Into Epicenter of Crisis"; *Bloomberg*; June 10, 2020.
[6] Gene Maddaus; "Productions Need Insurance to Start Rolling—but Actuaries Don't Want to Take the Risk"; Variety; May 20, 2020.

    b. Are all insurers offering business interruption insurance, even if not participating insurers, required to cover pandemic risk?

   Considerations of how much of the market is participating is important, as that affects how insurers set premiums for the pandemic coverage. Insurers need to understand what percentage of the government-capped coverage would be available and the timing of its availability.

2. **Setting premiums**. Participating insurers would be setting a premium provision related to the new pandemic coverage that would be charged to policyholders. Determining the added premium will be difficult, as previously noted. The determination is further complicated by the specifications of what layers of coverage are the responsibility of the insurer. As a reminder, the premium would cover the insured businesses' expected losses that the insurers pay, the insurers' expenses, and a provision for uncertainty—sometimes called a risk margin—under the program.
    a. The expected loss estimates used in the pricing of pandemic BI policies would factor in the policy specifications related to what type of lost cash flows are covered—that is, whether it is revenue, income, expense, or other specified amounts—as well as the time horizon or dollar limits on these amounts. Note that business interruption policies do not provide unlimited coverage.
    b. In addition, the participating insurer would factor into the premium and its underwriting (that is, how many policies it is willing to write) scenarios when its deductible will be met. If the insurer is expected to advance payment to policyholders after its deductible is met prior to the federal government providing reimbursement, consideration for that may be made in the premium.
3. **Premium levels**. Participating insurers would develop models to set a premium amount, but the provision for the uncertainty or risk margin embedded in the premium could increase the premium for the coverage to levels that might be considered unaffordable. Alternatively, the amount of coverage through the adjustment of policy limits could be reduced. If the limits are reduced, that would also impact non-pandemic coverage limits as the legislation describes that the pandemic coverage is to be similar to the non-pandemic coverage on the same policy.
4. **Level of the federal cap on government participation**. While $750 billion is certainly large, this may not be a sufficiently large cap to cover all insured losses. Under a scenario where the cap does not cover the full amount of insured losses, there would need to be an approach to allocate in a fair manner the reimbursement to the policyholders. That approach would need to consider all claims from all policyholders. The impact of such an approach would be a potential delay in making any payments to any policyholder in order to mitigate issues associated with asking for a return of a previously provided claim settlement. This assumes that neither the insurers nor the federal government would be responsible for any losses above the $750 billion cap, which is what the legislation currently appears to provide.
5. **Claim adjudication and settlement**. Business interruption claims inherently take time to settle. The total value of a claim may not be known until a business is ready to fully reopen and the lost revenues and expenses are tallied up and presented to the insurer. The insurer then carefully considers the justifications for these amounts and uses trained claims adjusters to review the financial documentation prior to paying a claim. This claims handling process takes time and generally much more staffing than handling routine claims such as automobile physical damage. There are several impacts of this process to keep in mind.

a. The cash flow back into the economy is not immediate. In addition, the amounts are not intended to keep payroll and benefit amounts flowing to individual employees. The amounts are paid to the businesses themselves as indemnification for the losses without specification on how the business is to reopen.
b. When business interruption has been triggered under a property catastrophe event such as a hurricane, the number of businesses impacted is smaller than under a pandemic. Insurers have been able to handle the BI claims in those situations, but the BI claims may still take months or even years to reach final settlement. If pandemics are covered, the number of claims would swell. Combined with the time needed to handle these claims, additional delays in processing are likely to occur.
c. In order to facilitate the handling of so many claims at one time, the coverage for pandemic BI may need to differ from non-pandemic BI in order to simplify the claims handling and further economic goals by more readily getting cash into circulation and preventing a bottleneck. There is more than one way that the coverage could be simplified. If simplified, that may mean that the format of the coverage would not be consistent with other business interruption insurance.

Technical matters

In addition to the items already discussed, there are other technical matters that the current version of H.R. 7011 leaves unclear. While we recognize that rulemaking procedures after legislation is passed often deal with technical matters, additional clarity related to the intent of the legislation on several of these matters could simplify the implementation process. Considerations and questions to address include:

1. The premium used in determining a participating insurer's deductible includes more than just the premium associated with the policies that include business interruption insurance. That would work to increase the deductible in proportion to the overall coverage provided. This could serve to discourage insurers from being willing participants if business interruption insurance is currently only an incidental coverage that they provide. For example, the premium base includes workers' compensation and general liability, neither of which has a business interruption component.
2. The trigger, insurer deductibles, and the aggregate limit in the legislation are described as being on a calendar year basis. What if the pandemic spans more than one year? How would this work?
3. Commercial insurance policies are not all effective on the same date. Their policy terms start throughout the year and can span into the following year. How would the calendar year provisions noted above interact with these policies?
4. Would there be a specific procedure to declare that a covered public health emergency has ended?
5. What happens if there is a subsequent reoccurrence of the same virus? How would it be handled if there is more than one covered public health emergency in one year?
6. There is provision in the legislation to avoid duplication of compensation for insured losses. The federal share is to be offset for payments made via other government programs. How would the participating insurers know these amounts at the time the claims are being settled?

* * *

The Academy's Casualty Practice Council has worked in the past to help the Congress and other stakeholders to better understand the actuarial implications in flood insurance, terrorism risk, and other property and casualty insurance issues. We look forward to working with you and your staff as you consider the challenge of providing business interruption insurance coverage in the event of a pandemic event.

We can be reached by contacting Marc Rosenberg, senior casualty policy analyst at the American Academy of Actuaries, at rosenberg@actuary.org or 202-785-7865.

Sincerely,

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Vice President, Casualty
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Cc: Members of the House Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs