Pandemic Insurance: The Future of Excess and Surplus Lines

by

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Introduction

Above a banking crisis, natural catastrophe, or cyber warfare, the threat of a pandemic is the number one long-term risk for the insurance industry to be concerned with, as ranked by a Towers Watson survey of global insurance industry executives in December 2013 ("Insurers Say Global," 2013). Many business owners, unaware of the adverse effect a pandemic event could have on their business, do not carry the appropriate insurance for pandemic risk. The insurance industry, however, is aware of this threat. Pandemic risks are heightened in the modern age due to global travel, increasing populations, and a higher concentration of people in cities ("Pandemic: Potential insurance"). Though they are low-frequency events, their high-severity nature makes them impossible to ignore (Baltz, 2006). As the E & S market typically leads an innovative response, it sees not only the risk, but the opportunity in a pandemic event. Through risk management practices, insurance coverages, and corresponding marketing strategies, surplus lines carriers can mitigate the effects of pandemics on businesses, and profit from this opportunity.

The Big Picture

Pandemics can devastate an economy. They primarily impact the airline and tourism industries, which are large contributors to the global GDP. During the 2003 Severe Acute Respiratory (SARS) outbreak, North American and Asia-Pacific airline carriers lost a combined seven billion dollars in revenue. Businesses reliant on global air travel were impacted. Park Place Entertainment, owner of Caesar's Palace in Las Vegas at that time, saw revenue drop fifty percent in one quarter due to the SARS event (Begley, 2013). Dr. Dennis Carroll, director of the U.S. Agency for International Development's programs on new and emerging disease threats said, "The biggest driver of the economics of pandemics is…***risk aversion, as people change their behavior to reduce their chance of exposure***," (Begley, 2013). In Lloyd's "Pandemics: Potential Insurance Impacts" report, the Emerging Risks Team expects a repeat of the 1918 pandemic event to "cause a global recession with estimated impacts ranging from 1% to 10% of global GDP" ("Pandemic: Potential Insurance"). Researchers at the Centers for Disease Control and Prevention estimate the total economic impact of a pandemic in the United States to be between $71.3 billion and $166.5 billion (Meltzer, Cox & Fukuda).

Exposures

There are many business exposures to consider in a pandemic risk. Inevitably, a social disruption will occur; people will stay home to avoid infection ("Managing Influenza Pandemic", 2007). According to the CDC, 35% of the workforce could be affected by a pandemic at any given time (Hughes, 2007), which may cause supply chain disruption, product insufficiencies, and loss of business income (Willis, 2006). Pandemics cause no physical damage to the premises and therefore would not act as a direct physical loss trigger for coverage (Primavera, Boeck & Odum, 2010). Emergency evacuations, quarantine expenses, and relocation of facilities create additional costs for a business. Contamination exclusions are standard in property and business income policies (Willis, 2006). Similar to strategies used in early Pollution and Employment Practices Liability policies, insurers that do not exclude contamination often place a low sub-limit for "quarantinable diseases" (Froderman, Merrill & Heald, 2009). These exposures create risks beyond the scope of standard commercial insurance coverage.

Employer's Duty

Employers have a duty to the public and their employees if a pandemic occurs. The work environment and responsibilities associated with employment can increase a worker's exposure to a virus; the employer may be obligated to indemnify employees if a virus is contracted "out of and in the course of employment" (Froderman, Merrill & Heald, 2009). Employees in the travel, hospitality, and entertainment industries have a higher risk of contracting and spreading a virus. Businesses with poor emergency plans may be held liable for failing in their duty of care to their employees and clients ("Pandemic: Potential insurance"). Claims filed by invitees of the business would likely exceed the aggregate limits of a CGL (Froderman, Merrill & Heald, 2009).

The Opportunity

Though businesses cannot be completely indemnified through insurance mechanisms for all losses, opportunities exist for the insurance industry to assist with the financing of more manageable and predictable portions of pandemic risk. Pandemic coverage resembles early days of Cyber Liability and Employment Practices Liability coverage during which standard line carriers would not accept the risk. The surplus lines market innovatively responded to the need for those coverages, and is in a similar position today to help businesses minimize the effects of pandemics.

Risk Management

Risk mitigation techniques must be implemented to protect the insured and the insurer when managing pandemic risk. Insurers, government agencies, health care providers, and the general public must collaborate to reduce the risk ("Managing Influenza Pandemic", 2007). The Center for Disease Control and Prevention provides a Business Pandemic Influenza Planning Checklist for large businesses. It addresses pandemic planning, policies, allocation of resources, and communication ("Business Pandemic Influenza"). The insurance industry should advocate for a small to mid-sized business version of this checklist and integrate it in the underwriting process. The CDC also offers a highly successful Crises and Emergency Risk Communication training course on Pandemic Influenza ("CERC: Pandemic Influenza"). Insurance companies should encourage business executives to take this course, and should give premium credits for proof of participation.

John Hughes, Risk Manager of Alex Lee, Inc. said, "Some of the biggest names in the corporate world have decided it's wiser to develop a plan they may never need than to find out too late they need a plan they don't have" (Hughes, 2007). Pandemic planning should consider the following: multiple waves of the virus over a 45 to 60 day period, human assets, communication, federal and state government, and a focus on cross training employees (Baltz, 2006). Employers must consider whether their employees can work from home and keep the business functioning if an outbreak occurs ("Are You Prepared"). Potential insureds should plan accordingly and utilize all resources available to prevent, prepare for, and respond to a pandemic.

Utilizing Resources for Insurance Companies

The insurance industry is more informed than ever about the potential consequences of a pandemic event. The Risk Management Solutions (RMS) Infectious Disease Model, a software system created to manage the risk of infectious diseases, has been available to insurance companies since 2007. It allows companies to "maintain a database of their exposure" and "monitor their risk as the portfolio changes or as new scientific developments improve our understanding" ("Managing Influenza Pandemic", 2007). The RMS Influenza Risk Model uses SIR modeling, which allows users to determine the effect a pandemic virus would have on today's population while accounting for response plans in use that may reduce the overall impact. It calculates the number of people who are "susceptible, vaccinated, have been exposed, are currently infected, or have recovered or died from the flu at a given time period" ("Managing Influenza Pandemic", 2007). The model determines a pandemic's overall impact by estimating two main factors: infectiousness and virulence. The infectiousness of a virus is the speed with which a pandemic spreads through the population and how many people it infects. Virulence is the severity with which it will make a person ill. Understanding the characteristics of a future pandemic allows the risk management and insurance industry to plan appropriately and develop economic models for underwriting various pandemic exposures ("Managing Influenza Pandemic", 2007).

Past and Present Pandemic Coverages

Risk transfer solutions for pandemic business risk are still in early stages of development and commercialization. Hays Companies of Illinois previously marketed pandemic coverage to large insureds with a business interruption exposure of $100 million or greater (Sclafane, 2009). High-risk clients such as hospitals, hotel chains, and large educational groups were targeted, and given coverage for losses and expenses incurred due to decreased business and employee absenteeism in the event of a pandemic. Large companies, however, are not the ideal market for this product. They often have risk mitigation plans in place and substantial capital to survive the impact of pandemics. The likely offered limits of a pandemic insurance policy will be too limited to provide material coverage for large insureds. However, small to mid-size businesses, without this same depth of resources, could be forced out of business as a result of a pandemic. They employ more than half the workforce and play a substantial role in the economy. The individual exposure of a smaller company would be far less than that of a large corporation. Meaningful limits for these companies would be less expensive to fund, though extremely valuable to the client.

Trade Disruption Insurance (TDI) is a relatively new form of coverage for pandemic risk that has been successful. Offered on a limited basis through Lloyd's underwriters, TDI provides umbrella coverage to companies with global supply chain operations (Willis, 2006). It fills gaps due to exclusions in traditional Marine, Transit, and Business Interruption policies, and covers extra expenses for public relations, management resources, and contingency planning (Newstead Group, 2012). Unlike standard Business Interruption coverage, TDI does not require a direct physical loss trigger. Excess and surplus lines companies should make note of this coverage when creating their own pandemic insurance policies.

Writing Pandemic Coverage

Surplus lines insurers must protect their financial exposures and their insureds to write and profit from selected pandemic risks. Pandemic insurance should be used as a short-term funding mechanism to minimize the severity of the risk and keep small to mid-size businesses afloat. Insurers should apply their experience with Employment Practices Liability policies, which provide legal resources to help manage claims, and contracted crisis management firms to manage the crisis from a public relations standpoint. Similar "embedded" recovery services should be offered alongside limited time based Business Interruption and Extra Expense policies for pandemic risks. Loss of profits must also be addressed; a time limit and business income cap for this coverage is necessary. Markel, for example, previously wrote a policy with per-day limits for up to thirty days (Sclafane, 2009). Insurers should create a set of trigger points, such as an extended waiting period, for pandemic coverage. One policy for a system of educational institutions requires that at least "15% of the students and/or faculty be absent for a two week period due to pandemic-related illness" before coverage begins, and halts coverage until the World Health Organization declares the pandemic to be greater than a level one or two (Sclafane, 2009). Triggers must be adjusted based on the insured's size and industry. Insurers should be fully aware of the profile of their portfolio, as pandemic losses will vary depending on the location, size, and industry of policyholders.

Marketing Pandemic Insurance

The approach taken to marketing pandemic-related coverages will determine the product's success. Small to mid-sized businesses often take their chances with low frequency events to save money in the short term. Therefore, a successful marketing strategy is contingent upon the product's affordability and availability. It is important to note that, if proper risk mitigation measures are taken, pandemic coverage can be made affordable. Since many small to mid-sized businesses fit the risk appetite of standard lines, surplus lines pandemic coverage would be completely separate from a business owner's policy or commercial package policy; it would require the unwavering support of retail agents. Once a pandemic policy is created, surplus lines companies should increase their agency visits and make clients aware of the pandemic risks to small and mid-size businesses through well-planned presentations and risk analyses.

Conclusion

Standard insurance carriers ask the question, "Can we insure this, yes or no?" Excess and surplus lines carriers ask, "***How*** can we insure this?" Excluding all pandemic risks is not the answer. There is a need for pandemic insurance and, because the standard market will not fully address it, this is an incredible opportunity of which the surplus lines market should take advantage. Through the implementation of risk management strategies and the creation of insurance policies to help small to mid-size businesses address pandemic risks, the surplus lines market can stay relevant, face the risks, and continue to protect the interests of insureds.

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