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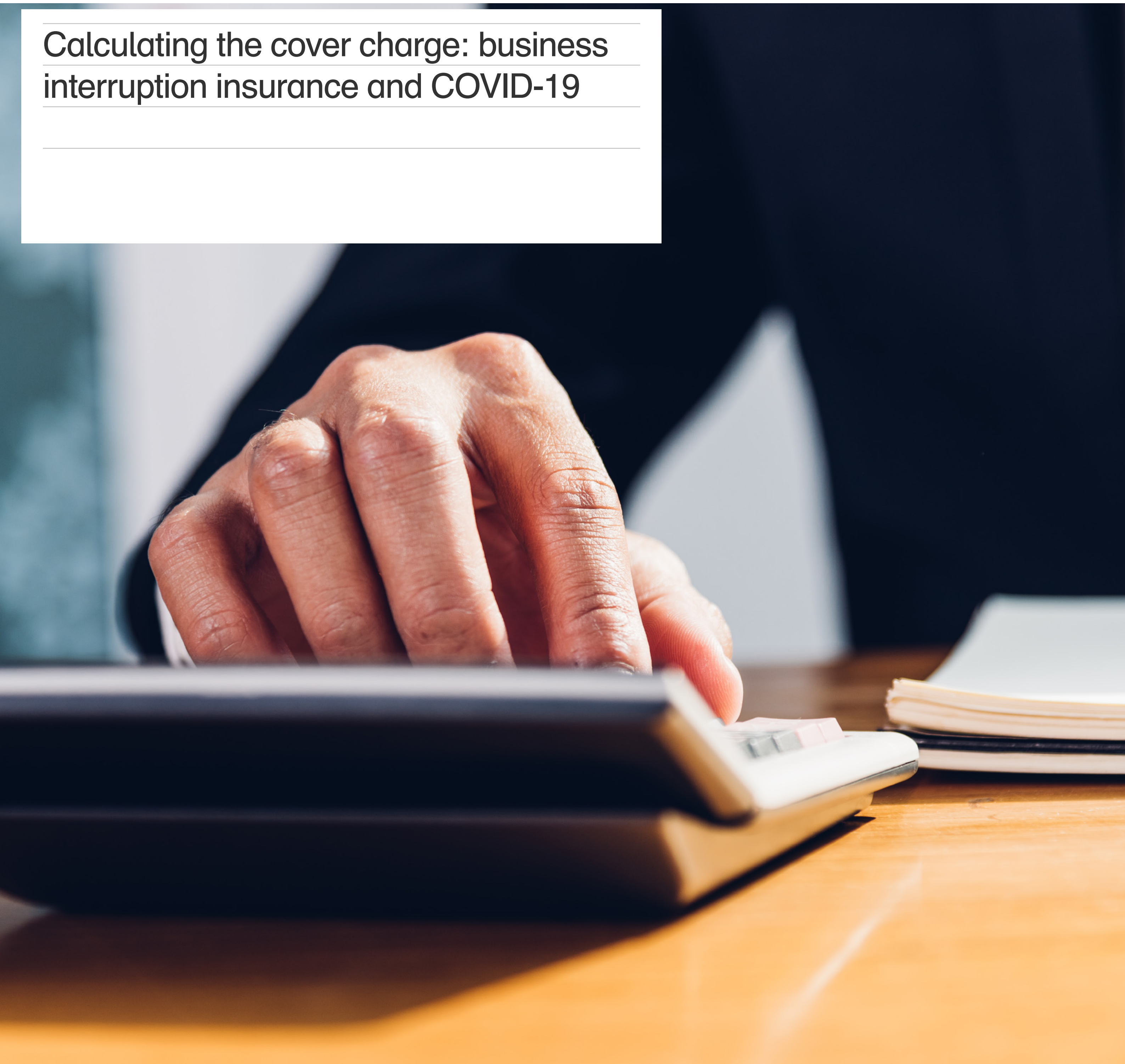
Calculating the cover charge: business interruption insurance and COVID-19



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The COVID-19 pandemic has had a major impact on businesses across the world. Many have turned to their insurance providers to claim compensation under their business interruption (BI) insurance. However, even if a firm is covered for financial losses caused by the pandemic, determining the compensation amount is far from straightforward. What are the challenges, from an economic and financial perspective, in determining the compensation for these policyholders?

Since the beginning of 2020, COVID-19 has swept through the world and caused widespread human tragedy and economic harm. To control the spread of the virus, governments of many countries have imposed strict restrictions on commerce and the movement of people. With their ability to continue their normal operations significantly reduced, a large number of businesses, especially those in the retail and hospitality industries, have been forced to shut down, at least temporarily.

In the UK, many affected businesses have turned to their insurance providers to claim compensation under BI insurance. However, both the Association of British Insurers (ABI) and the Financial Conduct Authority (FCA), the UK's financial regulatory body, have noted that standard BI policies are focused on business losses resulting from property damage (e.g. incidents of theft or fire), and do not cover financial losses due to forced closures by authorities to contain a pandemic.[1]

While payout is applicable under certain BI policies, in particular those that contain 'non-damage' extensions, this remains an area of major disagreement. For example, coverage under certain non-damage extensions may be limited to pre-determined diseases and/or to instances where the business was interrupted because the disease was present at its premises, rather than due to a closure mandated by a public authority.[2]

To help resolve this uncertainty, on 1 May 2020, the FCA announced that it 'intends to obtain a court declaration to resolve contractual uncertainty' regarding the coverage of some BI insurance policies.[3] In the meantime, several groups of policyholders are considering taking legal action to demand compensation from their insurance providers.[4]

Whether a policyholder is covered for financial losses relating to the COVID-19 pandemic is a legal question, and is not the focus of this article. Instead, we discuss the challenges, from an economic and financial analysis perspective, in determining the compensation amount for BI insurance policyholders that are covered for financial losses caused by the pandemic.

How can compensation be determined?

Not all businesses have BI insurance coverage. Assuming that a business does have coverage, there is a question as to what it is covered for and, if applicable, how any compensation should be determined.

A general framework for determining the compensation amount

While the exact wording varies across BI insurance policies that cover financial losses, generally speaking, policyholders are insured for losses caused by an insured event during the indemnity period, up to the pre-specified limit on the BI insurance cover. Therefore, the three main elements for determining the compensation amount are as follows.

- **Financial losses**: these represent the impact of the insured incident on the financial performance of the policyholder. They can be calculated as the difference between (a) the profits of the policyholder (e.g. a restaurant) in the 'counterfactual' (or 'but-for') scenario, where the insured incident (e.g. fire) does not take place; and (b) the profits of the policyholder in the 'actual' scenario, where the incident and any necessary damage-mitigation measures do take place.

- **Indemnity period**: this is the maximum period of time during which financial losses caused by an insured incident are covered by the BI insurance policy.

- **Limit on the BI insurance cover**: this is the maximum amount that the BI insurance policy will pay out to a policyholder for the financial losses covered by the insurance policy. If this amount is smaller than the actual financial losses suffered by the policyholder, the policyholder will not be fully compensated for the impact of the incident.

Assessing the financial losses of a BI insurance policyholder requires a careful analysis of how the company would have performed financially had the insured incident not taken place (i.e. the counterfactual scenario).

This is not a straightforward task but, depending on the specific circumstances of each situation, it can be done using one of several methods. For example, the company's performance in the counterfactual scenario can be estimated based on the company's historical performance, augmented by a reasonable growth rate; or based on the company's business and financial plans prepared before the incident; or by reference to the financial performance of similar companies that were not affected by the incident.

By definition, the company's performance in the counterfactual is not observable, and the economic assessment requires assumptions to be made about what would have happened if the insured incident had not taken place. Therefore, it is not surprising that policyholders and their insurers sometimes arrive at substantially different results. As a consequence, both parties need to ensure that the assumptions and forecasts used in their analyses are supported by, or consistent with, observable evidence, and that they can withstand the scrutiny of neutral third parties (e.g. a court, if the two parties cannot resolve their disagreement between themselves).

Complications of assessing compensation amounts amid COVID-19

In the current situation, assessing the financial losses incurred by policyholders amid the COVID-19 pandemic faces four further complications.

a. What is the appropriate counterfactual scenario?

The first complication concerns the construction of the counterfactual scenario, which depends heavily on the definition of the insured incident. There are at least two candidates for the definition of the insured event: the COVID-19 pandemic itself; and the government-imposed restrictions resulting from the pandemic.

If it is the former, a company's business plan created before the pandemic, say at the end of 2019, can be used as a reasonable starting point for assessing the company's financial performance without the pandemic. However, if the BI insurance policy is restricted to the financial losses caused by the government-imposed restrictions, the losses could be much more limited, and it may not be reasonable to use the company's pre-pandemic business plan to forecast its financial performance in the counterfactual scenario.

As an example, consider an international restaurant chain with operations in both the UK and Sweden. During the month of April 2020, restaurants in the UK were forced to close by the UK government's lockdown restrictions, while restaurants in Sweden remained open. How should the financial losses of the restaurants in the UK be assessed? Should their financial performance during the lockdown be compared against their expected performance based on the restaurants' forecast for April 2020, as prepared by the restaurants' management at the end of 2019? Or should the counterfactual performance be assessed with reference to the performance of the restaurants in Sweden, which have experienced a sharp decline despite the fact that the Swedish government did not impose any lockdown restrictions on restaurants?

b. How long will the impact of the pandemic last?

Another complication relates to the uncertainty regarding how long the pandemic will continue to affect BI insurance policyholders. At the time of writing this article, many governments have started a gradual easing of the lockdown restrictions.[5] However, the impact of the lockdown on the financial performance of restaurants (among other businesses) is likely to continue even when the lockdown restrictions are fully removed. This could be due to customers having a lower disposable income (due to receiving lower income during the pandemic, a national economic downturn, and/or expected higher taxes to fund the government rescue packages) and therefore not visiting restaurants as often as before. Alternatively, they may have developed new eating habits during the lockdown, or increased their wariness of social interactions that could lead to disease transmission. As a result, financial losses could continue even after the removal of government lockdown restrictions.

c. How can the financial performance in the actual scenario be assessed?

The third complication concerns the company's financial performance in the actual scenario. While this performance is generally observable, there is a potential question about whether the company has done all that is reasonable to mitigate the impact of the incident.

Assume that there are two near-identical restaurants (i.e. they both serve the same type of food in the same price range, the quality of their food is the same, they are located near each other, and their businesses are of the same scale), and that they were expected to deliver the same financial performance in the absence of the pandemic and the accompanying lockdown restrictions. However, during the lockdown in April 2020, suppose that one restaurant decided to adapt and offer a takeaway service, while the other decided to stay closed and offer no such service. Should these two restaurants receive the same BI compensation?[6]

d. How can the impact of other factors be taken into account?

Finally, another complication is whether (and how) the impact of other factors should be reflected in the assessment of financial losses. For example, assume that all restaurants are covered for the financial losses caused by the pandemic under their BI insurance policies. At an aggregate level, would it be reasonable (or fair) for all restaurants to receive full BI compensation?

This question is not as strange as it first appears. Even without the pandemic, a large number of existing restaurants would have gone bankrupt—that is, they would have been in the same financial situation with or without the pandemic.[7] As a result, at the aggregate level, full financial compensation of all restaurants may be excessive. Of course, it is difficult to predict exactly which restaurants would have gone out of business during the indemnity period for unrelated reasons: even with the same observable characteristics, there is significant variability in individual restaurants' success. However, precisely because a large number of businesses may claim to be affected by the pandemic, the law of large numbers allows one to predict that the losses incurred by some of these will not be attributable to the pandemic.

Last orders

Even when a firm has BI insurance coverage for damages caused by the pandemic, determining the appropriate compensation amount is far from straightforward. Multiple factors need to be taken into account in assessing the financial performance that the firm would have experienced in the counterfactual scenario. Similarly, careful analysis is required when assessing the performance of the firm in the actual scenario that reflects reasonable loss mitigation. To arrive at a robust assessment for a BI insurance dispute, it is more important than ever for the quantum experts to work closely with the legal advisers and tailor the standard financial and economic techniques to account for the case-specific facts and available evidence in each case.

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[1] Association of British Insurers (2020), 'Statement on business insurance and Coronavirus', 17 March, https://bit.ly/2ZHo8Ox. Financial Conduct Authority (2020), 'FCA statement – insuring SMEs: business interruption', 1 May, https://bit.ly/3dcja02.

[2] Association of British Insurers (2020), 'Coronavirus (COVID-19) Information Hub: Business Insurance', https://bit.ly/2TNKidZ, accessed 15 May 2020.

[3] See Financial Conduct Authority (2020), 'FCA statement – insuring SMEs: business interruption', 1 May, https://bit.ly/2TJbpqE.

[4] For example, a group of several hundred policyholders have obtained litigation funding to sue Hiscox Insurance in order to claim BI compensation. See the Hiscox Action Group webpage, https://bit.ly/2Xal0Yl, accessed 15 May 2020.

[5] For example, on 10 May 2020, the UK Prime Minister Boris Johnson set out some details of 'a conditional plan' for easing the lockdown in England, which was enacted on 26 March and extended on 16 April and 7 May. See Institute for Government (2020), 'Boris Johnson's plan to ease the coronavirus lockdown', 11 May, https://bit.ly/2XDg12D.

[6] Another potential question regarding the loss mitigation is whether the policyholders have made the best use of available government support—e.g. furlough schemes for staff—in the actual scenario.

[7] For example, a US study found that more than a quarter of first-year restaurants fail, and just under 60% of restaurants fail within the first three years. See Parsa, H., Self, J., Njite, D. and King, T. (2005), 'Why Restaurants Fail', *Cornell Hotel and Restaurant Administration Quarterly*, August.