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UK COVID-19 Business Interruption Court Ruling Brings Greater Clarity but Questions Remain

The test case does not directly address how resulting claims payments will be calculated

Following the English High Court's judgment in the Financial Conduct Authority's (FCA) business interruption (BI) insurance test case, AM Best expects COVID-19-related BI claims to have a material impact on UK commercial property insurers' 2020 earnings. The aggregate solvency of the UK non-life insurance sector, however, should remain robust.

The judgment brings greater clarity to insurers and policyholders in respect of the interpretation of BI policy wordings. There remains, however, some uncertainty around the volume and severity of valid claims. Either side may appeal the court's decision, subject to procedural rules, and the test case does not directly address how resulting claims payments will be calculated.

The FCA brought the test case to resolve uncertainty about insurers' liability for certain BI policies. Specifically, the case looked at whether some BI policies should respond to the COVID-19 government-mandated lockdown and cover the lost earnings of small-to-medium-sized enterprise (SME) clients.

The judgment concluded that most disease clauses in policy wordings provided cover, as well as a number of denial of access clauses. Denial of access wordings were found to be more restrictive, with the validity of these claims hinging on the nature to which COVID-19 restrictions affected individual businesses, for example if a particular business was ordered to close completely or not.

In AM Best's view, the judgment provides policyholders with increased clarity as to whether they will receive payment from their insurers (a process that may otherwise have been lengthy and more costly).

Insurers now have a better understanding of which of their policies are expected to respond to COVID-19-related BI claims. Given the representative nature of the policies and wordings selected by the FCA, the judgment also provides guidance for the interpretation of BI policies outside the sample used in the test case.

Judgment likely to impact insurers' earnings not solvency

AM Best estimates that commercial property premiums account for approximately GBP 7.5 billion of the GBP 50 billion gross premiums written by UK-domiciled non-life insurers, and that around 10% of commercial property premiums relate to business interruption extensions. The FCA estimates that 370,000 policies will be affected by the test case judgment.

Although COVID-19-related BI claims will have a material impact on UK commercial property insurers' 2020 earnings, AM Best expects the aggregate solvency of the overall UK non-life insurance sector to remain robust. At year-end 2019, the Solvency II ratio for the combined 100 largest non-life UK insurers stood at around 170%.

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In June 2020, the Prudential Regulation Authority (PRA) wrote to UK insurers regarding the outcome of resilience testing of companies to potential stresses that may be caused by the COVID-19 pandemic. The PRA reported that stressing the assumptions made by insurers around the robustness of their BI policy wordings showed that the sector was in aggregate resilient, but that some more severe scenarios could have a significant impact on the capital positions of a few companies.

The impact of BI losses on individual insurers' results and solvency will depend on the nature of business written, the level of reinsurance protection in place and the diversification of earnings.

In the UK, BI insurance is purchased typically as an endorsement to a commercial property insurance policy and is generally triggered only after physical damage, such as fire or flood, renders the property unusable. Therefore the majority of UK BI policies do not cover infectious disease. However, some BI policies explicitly cover other causes, such as infectious disease. Uncertainty over the interpretation of contract wording – and whether government actions to control a pandemic, such as COVID-19 should trigger such policies – was at the heart of the test case.

The COVID-19 outbreak has highlighted a gap between the insureds' and the insurers' expectation of what is covered by certain commercial property policies. Historically, BI policies that covered infectious disease have generally indemnified the insured for the mandated closure of a commercial property as the result of infectious disease on or near a site.

The unprecedented actions by governments across the world (including the UK) to reduce the spread of the virus, and their impact on business operations, are unlikely to have been contemplated by insurers when they developed their policy language. Unsurprisingly, actions are now being taken across the commercial insurance market to reduce ambiguity in BI wordings and provide explicit exclusions relating to pandemic risk.

A key factor determining the financial impact of the test case ruling on UK insurers will be their ability to make recoveries from reinsurers. The structure of programmes purchased will vary from insurer to insurer, and recoveries will depend on deductibles and limits. Uncertainty surrounds the extent to which COVID-19 claims will aggregate within and across different lines of business for reinsurance purposes. That aggregation will determine whether cover is triggered and if limits in excess of loss contracts are reached.

The definition of the event or occurrence that triggers the reinsurance cover is important. While loss triggers are likely to be a source of dispute, the clarification, as part of the test case, that the COVID-19 pandemic and government and public response form a single cause of a covered loss, is likely to increase insurers' per event losses.

The higher an insurer's per event loss, the more likely it is to make recoveries on its excess of loss reinsurance policies. Dispute risk between insurers and reinsurers is lower where quota share cover is written back-to-back, with the reinsurer committed to following the fortunes of its cedent.

Insurers facing reputational challenges

Outside the financial impact of claims settlements, insurers have been contending with the reputational damage arising from disgruntled policyholders and adverse press attention. Insurers have been criticised in the media for rejecting BI claims, particularly by policyholders from SMEs in hard-hit industries such as hospitality. Policyholder groups pursuing legal action against some specific insurers have also received significant media coverage.

The expectation gap between policyholders and insurers around the cover provided in BI policies has highlighted inconsistency and a lack of clarity in policy wordings. AM Best notes insurers are taking action to improve transparency. Emphasising how valid claims are quickly adjusted and paid should also help mend damaged reputations.

AM Best is reviewing the judgment in detail and assessing its impact on the earnings, reserves and capital position of individual rated entities.

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