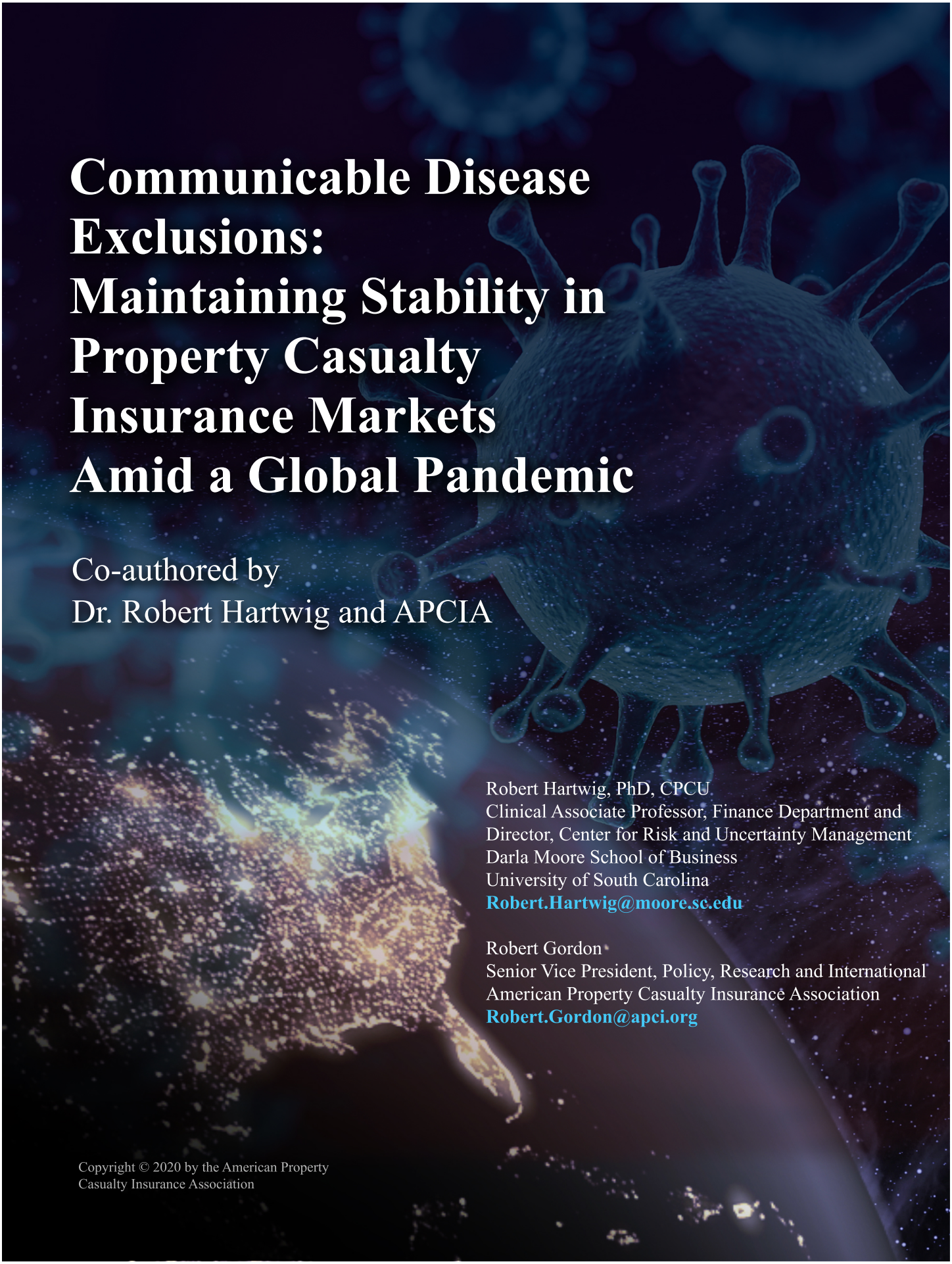

Communicable Disease Exclusions: Maintaining Stability in Property Casualty Insurance Markets Amid a Global Pandemic

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The COVID-19 pandemic has shaken the United States economy to its core. Lockdowns ordered by state governments and implemented to contain the spread of the coronavirus forced the closure of millions of American businesses, causing employers to shed tens of millions of jobs and sending the country's unemployment rate soaring to nearly 15 percent by April. The resulting collapse in economic activity led to a 32.9 percent contraction in the nation's GDP during the second quarter, following a 5 percent drop in the first quarter, bringing to a swift end what had been the longest economic expansion in American history.[1] The pandemic also precipitated fear among investors, sending the world's financial markets into a tailspin, with the major stock markets in the United States shedding one-third of their value in a span of weeks. While the stock markets have begun to recover, the damage to the economy and long-term impact of this still evolving crisis is unknown.

The latest crisis for the insurance marketplace is the rejection by regulators of property-casualty insurer exclusions to clarify, once and for all, that communicable diseases (e.g., COVID-19) are not covered. Viral outbreaks and pandemics have always been and continue to be broadly uninsurable.[2] Historically, viral and pandemic risk has never been broadly considered to be covered, even in the absence of an express exclusion.[3] The introduction of exclusionary endorsements in the past for viruses, bacteria and other pathogens did not change the underlying policy intent but rather provided additional clarity to reduce attempts to use litigation to expand direct coverage to include an uninsurable exposure. Those efforts to contravene policy language and expand direct coverage where none is intended manifests today in the proliferation of COVID-19 related lawsuits.

Reinsurance markets are similarly trying to react responsibly to the cost and uncertainty these lawsuits present by excluding the uninsurable risk. Reinsurance treaties are now including near-absolute communicable disease exclusions, particularly as they relate to liability protection. That means primary insurers must file similar exclusions in order to maintain consistency between the coverage they offer and the reinsurance available to them. Today, many of those filings are not being approved. The rejection of primary company exclusions combined with the widespread adoption of such exclusions in reinsurance contracts threatens to compromise the relationship between insurers and reinsurers that has been so critical in maintaining stability in insurance markets for decades.

[1] U.S. Department of Commerce.

[2] Hartwig, R. and Gordon, R., "Uninsurability of Mass Market Business Continuity Risks from Viral Pandemics," American Property Casualty Insurance Association, June 2020.

[3] Widely included coverage conditions in insuring agreements, like "physical loss or damage to covered property," reflect the uninsurable nature of the virus and pandemic risk, whether there is an exclusion endorsement attached to the policy or not.

The Uninsurability of Pandemic Risk

There is widespread, international recognition that the economic consequences of large-scale pandemic risks are fundamentally uninsurable. The International Monetary Fund has estimated that COVID-19's global economic toll will reach $9 trillion.[4] Looking ahead, science tells us that pandemic risks are intensifying as globalization and urbanization proceed apace, potentially costing as much as $23.5 trillion over the next 30 years.[5] These sums vastly exceed the combined capital resources of all property-casualty insurers and reinsurers operating in the world today.

The significance of this final point—that potential economic losses arising from pandemics vastly exceed the combined capital resources of *all* property-casualty insurers and reinsurers operating in the world today—cannot be understated. Neither insurers nor their reinsurers can cover risks for which the global capital markets will not—or cannot—commit capital. Recognition of this fact is the ultimate reason why very little pandemic risk coverage has ever been brought to market by insurers and reinsurers.

Pandemics represent an extreme and rapid accumulation of risk on an international scale that cannot be diversified in the private sector. Only governments, which uniquely possess the authority to both borrow and tax over time, can manage risks of this magnitude.[6] Consider that, in the United States, authorized federal spending on COVID-related relief (through July 30) totaled nearly $4.2 trillion.[7] This figure—which represents just five months of federal COVID spending and is certain to rise—is more than five times the $800 billion in surplus for the U.S. property-casualty insurance industry, a sum that has accumulated gradually over the course of more than a century. However, because commercial (i.e., business) insurers account for just 47 percent of annual direct premiums, the share of policyholder surplus backing commercial lines of insurance is far below the $800 billion industry total.[8] Viewed from another perspective, federal COVID-related aid through July 2020 was 76 times larger than the $55.1 billion in premiums written in key commercial property insurance lines throughout all of 2019.[9]

The extremely broad nature of the clarifications required by insurers and reinsurers from all communicable disease exposures, not just those related to pandemics, signals wider concern on the part of the industry and investors and thus broader ramifications for property-casualty insurance markets. It is critically important to understand the underlying factors for these actions, the majority of which are tied to the rapidly evolving risk landscape amid the pandemic and rising global economic stress. With some 4,000 coronavirus-related lawsuits already filed—

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[4] International Monetary Fund. "The Great Lockdown: Worst Economic Downturn Since the Great Depression, April 14, 2020, accessed at: https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/

[5] Hilsenrath, J. "Global Viral Outbreaks Like Coronavirus, Once Rare, Will Become More Common." *Wall Street Journal*, March 6, 2020.

[6] Hartwig, R., Niehaus, G. and Qiu, J., "Insurance for Economic Losses Caused by Pandemics." Working Paper, University of South Carolina, August 2020.

[7] Committee for a Responsible Federal Budget. Figure excludes $2.2 trillion in funds disbursed or committed by the Federal Reserve.

[8] S&P Global Market Intelligence data for 2019.

[9] NAIC annual statement data as reported by S&P Global Market Intelligence. The $55.1 billion figure consists of 2019 direct premiums written in the following lines: Fire, Allied Lines and Commercial Multi-Peril (non-liability).

approximately 1,000 of them against insurers—uncertainties related to the tort system in the United States loom especially large.[10]

Reasons Why Reinsurers Are Introducing—and Insurers Are Seeking—Communicable Disease Exclusions

First, with respect to COVID-19 specifically, reinsurers are concerned about their accumulation of losses on a global scale and the immediate need to conserve capital. It's also important to bear in mind that insurers and reinsurers have received no premium for the vast majority of projected COVID-related losses because the risk itself is not covered. Lloyd's of London has estimated that global losses from COVID-19 to the non-life insurance industry could total $203 billion (including projected losses of $107 billion from underwriting claims with the rest from correlated losses in insurers' investment portfolios). A substantial share of the underwriting losses could ultimately be borne by reinsurers, potentially resulting in one of the largest losses in reinsurance history. Global accumulation of losses of this magnitude represents a significant capital event for the reinsurance industry, resulting in additional exclusions for communicable disease to preserve increasingly scarce capital. Importantly, the same global pool of reinsurance capital being called upon to finance pandemic-related losses is also vulnerable to covered losses from traditional catastrophe risks such as hurricanes, earthquakes and wildfire. Indeed, insurers around the world incurred $27 billion in insured catastrophe losses during the first half of 2020, 35 percent above average for first-half losses over the past 30 years. Some 82 percent of those insured losses occurred in North America.[11] In the United States, average annual insured catastrophe losses totaled $35 billion between 2010 and 2019, up from $25 billion per year during the previous decade. Some reinsurers could experience additional catastrophe losses through their life reinsurance exposures.

Second, there is concern that the current first wave of COVID-19 will be followed by potentially more devastating second and even third waves of the disease late in 2020 and into 2021, a scenario of great concern to many epidemiologists. Again, for reinsurers, a resurgence of the coronavirus in the months ahead underscores the urgency of taking necessary steps to preserve capital today.

Third, plaintiffs' attorneys have developed imaginative and contorted interpretations of policy language in an organized effort to create coverage where none exists and/or where none was intended—and for which no premium was collected. By extension, reinsurers of primary insurers subject to unforeseen rulings on policy language could find themselves liable for large losses despite no premium having been ceded to them to cover the risk. As previously mentioned, thousands of coronavirus-related lawsuits have already been filed, a significant proportion of them against insurers. Many of these lawsuits derive from disputed business interruption claims, but disputes are also arising under coverages related to general liability, employment practices liability, workers compensation and directors and officers liability. Third-party litigation financing firms are funding some of the surge in lawsuits, exerting additional stress on the system.

Liability risk clearly represents a potentially massive and difficult-to-quantify exposure for insurers and their reinsurers, the ultimate cost for which will likely not be known for years. Willis

[10] COVID-19 Complaint Tracker, Hunton Andrews Kurth at https://www.huntonak.com/en/covid-19-tracker.html.
[11] Munich Re at https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2020/natural-disaster-figures-first-half-2020.html.

Towers Watson has estimated that insured COVID-19 business interruption and event cancellation losses in the United States could range anywhere from $2.0 billion to $22.7 billion, while general liability losses could reach $27 billion. Claims and associated litigation related to employment practices liability coverage could amount to as much as $3.6 billion.[12]

The enormous range in estimates and the potential for extreme losses stem primarily from uncertainty related to litigation. Confronted with the enormity of claims and litigation-driven uncertainty, reinsurers recognize they have little choice but to reaffirm the uninsurability of pandemic risk and scale back their communicable disease exposures. Primary insurers, in turn, must ensure that the coverage they offer is aligned with the language in their reinsurance treaties, necessitating the exclusion filings with state insurance departments.

Communicable Disease Exclusions: Implications for Insurers and Policyholders

The uninsurability of pandemic risk, compounded by the certainty of protracted and costly litigation has caused investors in insurance and reinsurance markets to retrench. In economic terms, the market has effectively begun to seize. Insurers, reinsurers and regulators all have important roles to play in order to minimize the impacts of this market seizure on policyholders but the role of regulators is paramount in maintaining market stability and preserving solvency.

Because capital markets regard pandemic risk as uninsurable, reinsurance treaties today are increasingly reflecting that reality through the introduction of broad communicable disease exclusions across virtually all property lines of insurance and increasingly in many casualty lines. Again, these exclusions apply to *any* and *all* claims involving communicable disease, not just pandemics or epidemics. Concurrently, state insurance regulators are rejecting filings or discouraging primary insurers from filing and relying upon communicable disease exclusions that have long been part of direct coverage forms. Regulators' resistance to communicable disease exclusions in direct coverage creates a prospective gap between primary and reinsurance language that is unambiguously severe and immediate. [13]

Consequences of Misalignments between Coverage Form and Reinsurance Treaty Language

Disapproval of parallel exclusions for direct coverage creates a serious prospective misalignment between policy forms and reinsurance treaties, the immediate consequence of which will be a rapid and unanticipated accumulation of unreinsured exposure on the books of property-casualty insurers operating in the United States today. Any misalignment in language represents a potential gap in reinsurance protection. Any gap in reinsurance protection, in turn, could represent an accumulation of unreinsured risk on the books of the primary insurer. If the magnitude of the unreinsured risk is large or is growing rapidly—as is the case with communicable disease litigation exposure—a material strain on the insurer's capital would be inevitable, forcing it to reduce exposure. If the insurer cannot reduce its exposure, the insurer's solvency becomes increasingly at risk.

[12] Willis Towers Watson, *Scenario Analysis of the COVID-19 Pandemic.* May 1, 2020.

[13] Exclusion provisions in reinsurance treaties help define the relationship between reinsurers and primary insurers and not between insureds and primary insurers.

Historically, insurers avoid or severely limit their exposure to risks that cannot be reinsured, just like lenders, investors, and other businesses avoid many economic activities that cannot be insured. The costs to the insurer are typically too large in terms of capital commitment, the diminished volume of business that can be underwritten, increased volatility in underwriting and financial performance and greater scrutiny from ratings agencies and regulators.

The recent adoption of communicable disease exclusions in reinsurance treaties leaves insurers with three options:

(i) non-renew policies in their entirety—leaving policyholders with no coverage whatsoever;

(ii) allow potential exposure to communicable disease, which may not be reinsured, to accumulate on their balance sheets, threatening the insurers' stability and solvency, and necessitating rate adjustments to account for the risk (that could similarly leave most policyholders with no coverage), or

(iii) file for parallel communicable exclusions with state insurance regulators.

Of these three options, seeking regulatory approval for communicable disease exclusions is indisputably the least disruptive. Policies would renew seamlessly with the new communicable disease exclusions in place and would otherwise remain continuously in force. Coverage would remain available and affordable and claims would be paid as usual. Approval of these exclusions would also simultaneously mitigate the growing solvency risk facing insurers. In sum, regulatory approval of insurer communicable disease exclusions is the only option that achieves the twin regulatory objectives of maintaining market stability—as measured by availability and affordability of coverage—while simultaneously assuring the continued strength and stability of the industry itself.

Communicable Disease Exclusion Filings by Insurers

In order to realign language in policy forms with the terms of reinsurance treaties in today's market, insurers throughout the country have sought regulatory approval for communicable disease exclusions across multiple lines of business. Approvals of these exclusions for direct insurance would help maintain market stability and preserve financial strength. However, as mentioned previously, these requests have generally been rejected by regulators, or insurers have been asked to withdraw filings. Relatively few rejections have cited legal authority (i.e., existing law) for the rejection. Most commonly, regulators are simply refusing to consider insurer requests. While it is understandable that regulators might be reticent to approve new exclusions during the current pandemic, allowing insurers to align their policies with available reinsurance is essential to maintaining coverage availability and insurer solvency in the marketplace.[14]

Some regulators have expressed concern that insurer requests seem overly broad in that they include filings for exclusions in both property and casualty lines or that the proposed exclusion relates to all communicable diseases, not just pandemics. But the communicable disease exclusions

[14] APCIA member survey entitled "Exclusion Rejection and Withdrawal Survey", which generated responses from 56 primary insurers regarding related actions in 31 states as of July 16, 2020.

now appearing in reinsurance treaties increasingly apply to most major coverages. The exclusions are nearly universal in commercial property insurance as well as business owner policies (BOPs) that provide both property and liability protection to millions of small businesses across America. Inland marine policies are likewise affected. Communicable disease exclusions are becoming increasingly prevalent in liability policies as well, including commercial general liability, commercial umbrella, professional liability, aircraft liability, railroad liability and garage owners' liability. Workers compensation is also being impacted, especially coverage for catastrophic workers compensation claims. Some reinsurance treaties even exclude communicable disease exposures in the personal umbrella line.[15]

With the introduction of communicable disease exclusions in reinsurance treaties, reinsurers broadly are reacting to the cost and uncertainty presented by proliferating COVID-19 lawsuits that seek to expand direct coverage to include this uninsurable exposure, contrary to direct policy intent. Primary insurer filings for communicable disease exclusions simply mirror the uninsurability of this exposure underlying the exclusions introduced by reinsurers. Indeed, insurers seek not only to align the language in their policies with that of their reinsurers and thereby avoid any potentially destabilizing accumulation of communicable disease risk, but to affirm the fact that virus and pandemic risk is uninsurable and contrary to policy intent. Viewed in this way, regulator-approved exclusions represent a form of safety valve that can relieve dangerous pressures building in the insurance marketplace.

Exclusions introduced by reinsurers are most frequently based on language originating in the London markets, a key source of reinsurance capacity for U.S. property-casualty insurers. Two exclusion endorsements from the London Market Association (LMA) are the most commonly employed, LMA5394 (for property reinsurance) and LMA5399 (for casualty reinsurance):

(i) **LMA5394** is a broad communicable disease exclusion for use with property treaty reinsurance contracts that excludes "any loss, damage, liability, claim, cost or expense of whatsoever nature, directly or indirectly caused by, contributed to by, resulting from, arising out of, or in connection with a Communicable Disease or the fear or threat (whether actual or perceived) of a Communicable Disease regardless of any other cause or event contributing concurrently or in any other sequence thereto."

(ii) **LMA5399** is a broad communicable disease exclusion for use with casualty treaty reinsurance contracts that excludes "all actual or alleged loss, liability, damage, compensation, injury, sickness, disease, death, medical payment, defen[s]e cost, cost, expense or any other amount incurred by or accruing to the reinsured, directly or indirectly and regardless of any other cause contributing concurrently or in any sequence, originating from, caused by, arising out of, contributed to by, resulting from, or otherwise in connection with a Communicable Disease or the fear or threat (whether actual or perceived) of a Communicable Disease."

[15] *Id.*

Implications of Rejecting Insurer Communicable Disease Exclusion Filings

Any structural impediment that restricts the ability of insurers to diversify risk through the use of reinsurance leads to excess concentration and accumulation of that risk on insurers' books. As reinsurance treaties are renewed with communicable disease exclusions, the accumulation of risk increases the potential for ruinous loss and broadly increases solvency risk. The likelihood of rating agency downgrades likewise increases. In the absence of any other means for diversifying risk—and denied the opportunity to exclude the risk—primary insurers' only option is to reduce or eliminate exposure to the risk itself. In the case of communicable disease, remaining financially viable in order to pay claims for all categories of loss means non-renewing policies with potential communicable disease exposures while reducing coverage limits and raising rates on any exposures that remain. This is precisely the situation in which the property insurance market—and increasingly casualty insurance market—find themselves today.

Misalignment of Policy and Reinsurance Treaty Language: Additional Consequences

As noted above, two of the most concerning consequences arising from the misalignment of terms and conditions between the policies sold by primary insurers and their associated reinsurance treaties are the erosion of insurance market stability (measured in terms of availability and affordability of coverage) and the potentially solvency-threatening accumulation of unreinsured communicable disease exposure if courts ignore the coverage conditions in primary policies.[16] There are, however, many other potential consequences likely to affect insurers, policyholders and insurance markets as a whole:

- **Self-Reinsurance Costs:** Insurers unable to reinsure or exclude communicable disease risk will incur self-reinsurance costs. Specifically, additional capital must be committed to back the self-reinsured risk. The "cost" can therefore be measured as the opportunity cost of that capital which is now encumbered and no longer available to underwrite other risks. As a result, insurer underwriting capacity is reduced as reserves for actual and potential losses are established. In economic terms, the supply of insurance will diminish.

- **Retrenchment of the Retrocessional Market:** Reinsurers typically reinsure their own exposure through the use of retrocession insurance, which is effectively reinsurance for reinsurance companies. Retrocessional market capacity for most lines with communicable disease exposure will likely experience a retrenchment similar to that in the reinsurance market itself, as retrocessionaires become more cautious.

- **Spillover Effects:** Widespread adoption of communicable disease exclusions throughout reinsurer portfolios could result in a "spillover effect" for other lines—even lines less likely to be impacted by COVID claims, including personal lines.

[16] There are a variety of coverage conditions insureds must satisfy to establish a right to recovery under a disputed policy. Primary among those coverage conditions is the requirement there be actual or direct physical loss or damage to covered property. Unless and until that and other coverage conditions are satisfied, a loss related to COVID-19 is not a covered loss, whether there is an exclusion endorsement or not attached to the disputed policy.

- **Barrier to Entry:** The inability to reinsure or use communicable disease exclusions will deter new insurers from entering the market. A potential entrant could deem the risk too large.

- **Deterrent to Innovation:** Capital constraints and heightened uncertainty will slow the pace of new product innovation by insurers, including products designed to manage pandemic risk.

Size and Importance of Reinsurance Markets

A seamless transfer of risk from insurer to reinsurer is a requirement for the smooth functioning of all insurance markets. But to fully appreciate the indispensable role of reinsurers, the sheer size of the reinsurance market itself must be considered. In the five-year period from 2015 and 2019, primary insurers in the United States ceded an average of $91.9 billion per year to non-affiliated reinsurers. This figure equates to 14.3 percent of average annual direct premiums written over that period.[17]

Another way to assess the importance of reinsurers to the overall marketplace is to examine their essential historical role in the payment of catastrophe losses. In a study of 56 large catastrophes between 1985 and 2012, reinsurers paid, on average, 35 percent of total insured losses. Generally speaking, the larger the loss, the higher the share of losses borne by reinsurers.[18] Early estimates suggest that reinsurers will bear approximately 50 percent of covered COVID-related losses.[19]

One lesson to draw from this analysis is that large-scale *insurable risks* such as hurricanes, earthquakes and wildfires cannot be insured without the participation of reinsurance markets. As for the large-scale and *uninsurable risk* of communicable disease, without the ability to mirror reinsurer exclusions in primary policy forms, all risk excluded by the reinsurance market is pushed down into the primary markets. Without the ability to exclude or otherwise scale back exposure to that risk through non-renewals, risk accumulates on the books of primary insurers. That accumulation of risk threatens the stability of those insurers and results in reduced capacity and higher premiums for policyholders.

Comparison to Life Insurance Markets

Communicable disease exclusions are being sought by property-casualty insurers but there are no pandemic exclusions in traditional life insurance policies.[20] This raises the question as to why. And, if life insurers can manage mortality risk arising from pandemics (and communicable disease risk more broadly), why can't property-casualty insurers do the same with the risks they underwrite?

First, for life insurers, excess mortality (mortality above what would normally be expected over a specific span of time) resulting from disease outbreaks is a well-studied phenomenon on a global scale. Epidemiologists have extensive historical data on thousands of disease outbreaks around the

[17] S&P Global Market Intelligence.
[18] Holborn, Reinsurance Association of America (RAA). Data include catastrophes outside the United States.
[19] Reinsurance Association of America. Includes covered losses outside the United States.
[20] National Association of Insurance Commissioners, "COVID-19 and Insurance," *NAIC Insurance Brief*.

world regarding their impact on mortality. While there is always much uncertainty surrounding the characteristics of any new pathogen and disease, such as the novel coronavirus and COVID-19, there is vastly more data available for life insurers and their reinsurers to model than there is for property-casualty insurers.

Second, for property-casualty insurers modeling the cost of viral outbreaks is nearly, if not entirely, impossible. The ultimate cost of such outbreaks to property-casualty insurers has relatively little to do with epidemiology and more to do with subjective decisions by thousands of government officials regarding whether and when to close, partially close or reopen (and reclose) major segments of the economy.[21] Modeling these decision processes is neither practical nor feasible. The outcome of such a modeling process would not provide meaningful data nor would it result in affordable premiums for policyholders.

Summary and Conclusions

The COVID-19 pandemic is a generational event in human history. The societal and economic upheaval spawned by the pandemic has affected every nation, every institution, and every industry, altering the global risk landscape in the process. As global bearers of risk, insurers and reinsurers find themselves at the epicenter of the pandemic's maelstrom of uncertainty.

Although the property-casualty insurance industry has remained resilient throughout the COVID crisis—despite expected covered losses approaching $100 billion—structural dislocations have now emerged that may threaten the industry's stability. Foremost among these is the dangerous prospective accumulation of communicable disease risk exposure on the books of primary insurers. By approving insurer filings related to communicable disease exclusions, regulators can preserve and maintain stability throughout the property-casualty insurance marketplace. Otherwise, unreinsured exposures—driven largely through costly and uncertain litigation and court misinterpretation of policy terms—will accumulate rapidly, growing with each reinsurance treaty renewal, threatening both market stability and insurer solvency.[22] Insurers, unable to exclude the risk, have no option but to reduce their exposure to this volatile and uncertain unreinsured risk.

While policy non-renewals are the simplest and fastest option available to insurers to reduce their unreinsured communicable disease exposures, they are also the most disruptive to policyholders. For that reason, insurers have sought regulatory approval for communicable disease exclusions to eliminate the uncertainty in how courts' might errantly treat primary policy coverage conditions. If approved, the realignment in language between primary policies and reinsurance treaties would ensure the continued smooth functioning of many key property and casualty lines.

Unfortunately, insurers have generally been rebuffed in their efforts to obtain approval for communicable disease exclusions.[23] The prospective accumulation of unreinsured exposure leaves insurers with a limited number of unattractive and highly disruptive options—non-renewals, reduced limits and higher premiums among them. Operating without reinsurance is not an option.

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[21] For purposes of clarification, claims for civil authority coverage are subject to satisfying all coverage conditions set forth in primary policies. See *Supra*, Footnote 16.
[22] *Supra*, Footnote 16.
[23] *Supra*, Footnote 14.

As demonstrated in this paper, primary insurers' sharing of risk with reinsurers is essential to the smooth functioning of all insurance markets and the terms and conditions established in the reinsurance markets cannot be ignored. The reinsurance market is large, global in nature and it has historically borne a high proportion of insured losses from major catastrophes around the world.

Regulators today have before them a unique opportunity to use their authority to preserve market stability for millions of policyholders while also fostering an environment in which insurers can thrive and work to innovate products that will reduce the pandemic and communicable disease exposures of the future.