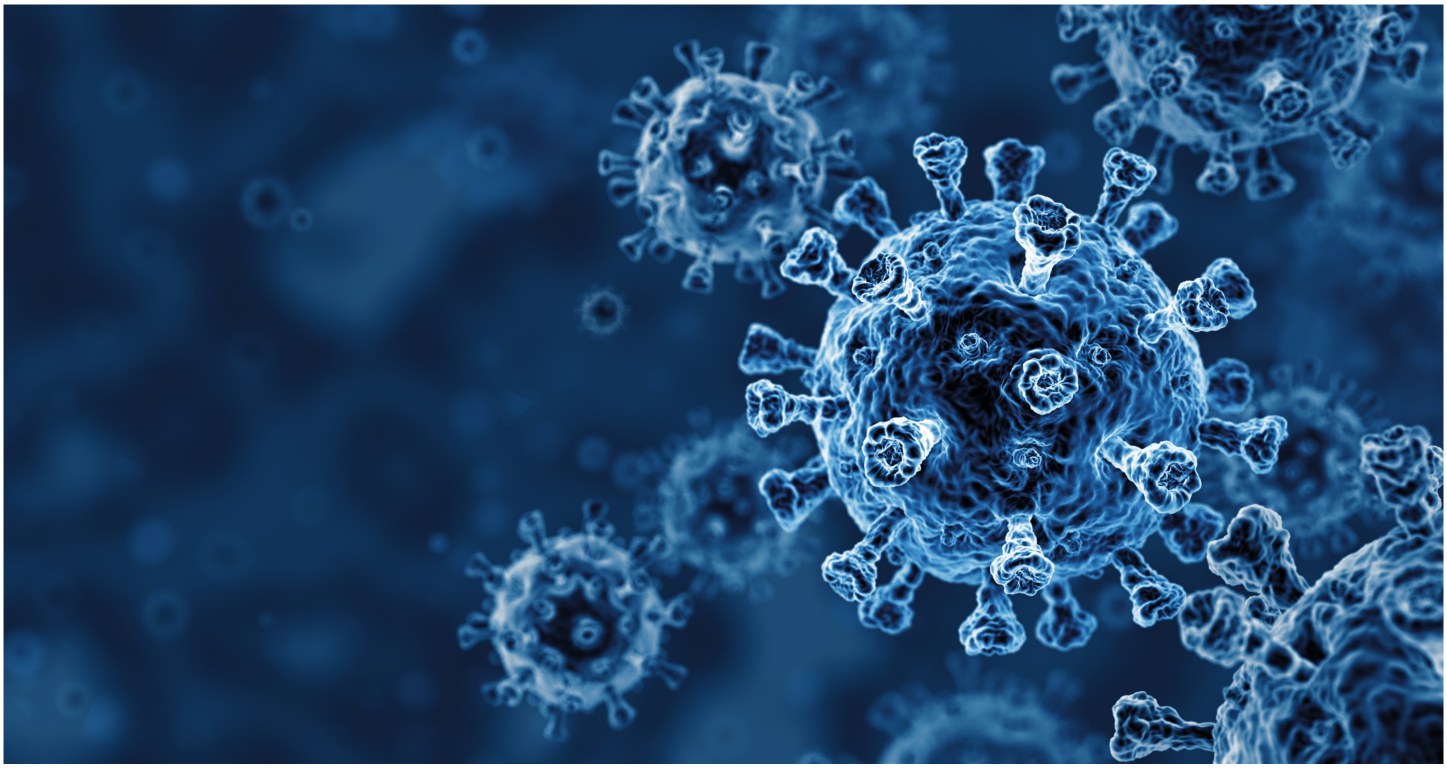
Private Equity Investors:
Looking Ahead to the New Normal



As the economic impact of COVID-19 stretches into its second month in the US, the insurance industry wrestles to understand the long-term effects the pandemic will have on both our clients and the industry itself. Most public thought leadership has been directed towards the ability of companies to access capital needed to meet immediate and ongoing financial obligations and replace lost income. However, there are a myriad of insurance-related dynamics that should be considered as a part of a holistic evaluation of the macro economic climate.

In the following brief, we'll discuss some key issues germane to private equity investors as they contemplate the immediate impact of COVID-19 on existing portfolio companies and the future implications the virus will have on business.

Impact on Coverage

The purchase of insurance is predicated on the expectation that coverage will indemnify the business following damage to property or loss of revenues by external, fortuitous elements; ensure continuity of operations through the ensuing period of restoration (an industry term referring to the time after a property loss up to the point that the business returns to its pre-loss state); and defend against third-party liability claims. Insurance brokers, often on the front line with clients, are being challenged to navigate misconceptions about standard insurance policy application, and, in some instances, inconsistency between emerging legislation and rudimental insurance principles.

Property Insurance

Most managers have identified the financial loss resulting from mandated quarantines as the most significant COVID-19-related exposure, both in magnitude and immediacy. Unfortunately, the pandemic has had the unintended consequence of illuminating a wide-spread misconception about business income interruption insurance: namely, that *any* unforeseen interruption to a business is insured. Traditionally, business interruption has been a subset of property insurance that follows from damage to covered real property.

As written today, the carrier underwriting intent – and arguably the language on point in a majority of property insurance policies – would not support coverage for lost revenue or continuing expenses arising from COVID-19 related loss. The traditional response of insurers is that the policies will not provide business income interruption coverage because: 1) the closure didn't result from physical damage to covered property, and/or 2) policies have specific exclusions for losses from bacteria, viruses or other microbial matter.

However, there is an emerging view that coverage may be available, as a result of: 1) litigation, if courts rule that traditional exclusions are ambiguous or inapplicable, 2) legislative actions that require insurers to pay income claims, or 3) insurers voluntarily paying some subset of claims, as a means of preserving stakeholder goodwill. Any of one these scenarios, while likely beneficial to individual policy holders in the near term, could, in concert with other factors, have far-reaching consequences that impact cost and availability of insurance into the future.

Exposures Under Other Policies

While the first-party financial loss (that is, loss of revenue) is top of mind, COVID-19 (and, really, any future pandemic) creates a new set of third-party liability risk exposures that most managers have not faced.

It is not difficult to imagine a scenario in which a business could see coverage triggered under multiple policies as the result of a sickness and, potentially, poor management decisions.

- **Workers' compensation**: Did an employee contract COVID-19 in the course of employment that was caused by the conditions specific to that particular work? For example, if a front-line service industry worker contracts COVID-19 at work and dies, could the deceased employee's family make a claim against the employer? Potentially. (Questions companies should be thinking about: what are they doing to protect workers? how does it vary from competitors?)
- **Commercial general liability**: Could a business be found legally liable if a customer contacts COVID-19? Potentially, if it is the business that did not maintain its premises in a manner that is deemed to be safe for its invitees. Commercial general liability policies tend not to have an infectious disease or pandemic exclusion and could respond to negligence resulting in bodily injury or property damage.
- **Directors and officers liability**: Claims could allege mismanagement of the company, which might range from how public safety was addressed by management to the reporting of financial information to creditors and investors. Absent atypical policy language, there are fairly sound expectations for coverage.
- **Employment practices liability**: Claims might arise from wrongful termination (if an employee is terminated and has COVID-19, there may be allegations of discrimination, with COVID-19 functioning as a disability), wage and hour violations (for which coverage is limited under most policies), and interruptions compensation and benefits for furloughed (rather than terminated) employees. Essentially, any action taken that affects employees should be evaluated by employment council, and appropriate steps should be taken to mitigate the likelihood of claim arising from the acts.

In summary, there are any number of actions a business might take that could result in third-party claims for damages. Managers should consider the potential ramifications of their actions though the lens of the risk manager and proactively take steps to reduce the likelihood of claims arising.

Note: Evaluation of coverage by line of business can only be achieved by individual contract review and insurer response. Our comments above are general observations, not client specific.

Insurance Cash Flows

Insurance premiums can generally be categorized as either variable or step-variable costs. Variable cost policies utilize an underlying exposure basis to determine the premium, and that exposure basis is likely to be affected by COVID-19.

For many businesses, general liability and workers' compensation premiums are auditable. A deposit premium is paid at inception, while the final premiums are determined by actual revenue and payrolls during the policy period, which is determined upon policy audit, typically 1 – 3 months after expiration. For a business with reduced payrolls or a drastic decline in revenue, the exposure basis generated through the pandemic and into the restarting of the business may not parallel the estimate of payroll/revenues at inception. Depending on the magnitude of this disconnect, and insurer cooperation, there may be an opportunity for midterm adjustments resulting in reduced cost burden.

While real property (building) values may remain stable during the pandemic, business personal property (inventory and work in progress) may change during the quarantine and for some time thereafter, until demand returns to the pre-virus state. Insurance limits should be correspondingly amended.

Marine cargo insurance and stock throughput, specialty coverage for property in transit and in storage, often include monthly reporting provisions. Insureds would therefore see an immediate reduction of insurance premiums. However, if the policies are rated on annual exposures, the premium paid may far exceed the actual exposure.

If a portfolio company is expecting a material delta (for example a decrease of 20% or more) of payroll, revenue, sustained inventory values, vehicles in use or insured shipments over the course of the in-force policies, corresponding levels of premium relief may be available. While some insurers to this point have declined to re-rate policies, the alternatives (insolvent clients, lower premium spend/limits purchased and lost insurance business) are less desirable then the potential shortfall in premiums.

For larger businesses with loss-sensitive casualty programs (large deductible of self-insured), it may be appropriate to evaluate accrual practices. If a business normally takes a WC loss charge monthly, the amount of the charge might rightly be adjusted to account for changes in payroll or vehicles in operation.

Collateral and Collateral Recapture

To the extent that a business has lower payrolls as a result of furloughs or layoffs, it should see a reduction in workplace injuries during the period and should demand insurers adjust their loss models and collateral requirements accordingly. (Notably, the industry generally sees an uptick in claims and employee injury when morale declines, as is often the case when layoffs are assumed to be forthcoming.) For any company with collateral obligations in support of large deductible programs, we recommend that insurance brokers are reminded of their obligation to actively manage the collateral requirement with insurers at renewal.

Actuarial forecasts may need to be adjusted to accommodate either the reduction in exposure, or, potentially, the shift in payrolls (and corresponding loss rates) when employees work from home. These actuarial adjustments could, arguably, have significant financial impact on the profitability of the company, given loss calculations include not only raw estimates of the value of claims but also incurred but not reported factors, medical inflation in future years, etc. to derive the estimate of ultimate liabilities. Depending on the line of business, these factors can inflate "raw" losses from 25% to 40% or even higher.

Broker Response to COVID-19

Most providers of professional services have nobly risen to the occasion and are doing their best to provide valuable guidance to their clients. Unfortunately, as we saw during the Great Recession, a handful of bad actors may emerge, espousing questionable advice that is self-serving at best and actually harmful to clients at worst. Like most sales pitches, these contain kernels of truth, and merit discussion without wholesale dismissal. Caution should be applied in the context of:

- **Brokers offering premium reductions mid-term, if appointed broker of record.** As discussed above, policy premiums are often a function of reported exposures (payroll, revenue, etc.) at policy inception. Under normal market conditions, there may be opportunities for insureds to cancel the coverage mid-term, though the insured might be subject to a short-rate penalty (10% of the unearned premium) or a minimum earned premium provision (25%). While there is nothing inherently wrong with changing insurers mid-term (in some cases, such as M&A, it is in fact advisable), the financial crisis saw some insurance brokers obscuring the change in exposures used to rate the policies. Insureds should be certain that 1) any new policies utilize not only the reforecast exposure basis, but also lower rating structures than in-force policies, and 2) incumbent carriers agree to waive cancellation penalties (or rate savings outweigh the penalties).

A secondary, no less important, consideration in midterm cancel/rewrites is potential disruption of coverage. It remains unclear how certain insurance coverages will ultimately respond to this pandemic. Continuity of insurers may prove more beneficial than efforts to reduce short-term cost. And rest assured, any new insurer incepting coverage will completely "wall off" coverage from COVID-19 (so as not to inherit a known loss).

- **Brokers advising clients to file (or not to file) business interruption claims, despite policy wording that would seem to preclude coverage.** The insurance industry is facing uncertainly and challenges in connection with policy application for business income interruption losses. A cottage industry of law firms and insurance consultants is developing to collectively argue that traditional requirements for direct physical loss at an insured location should be deemed "met" by the nonstructural physical loss associated with the presence of COVID-19. Insureds, along with their broker representatives, are struggling to determine if claims should be presented to the respective insurance carriers. At this point, business should take an analytical and measured approach to any resource – be it broker, law firm or consultant – that promises insurance recovery.

Insurers and Market

Expectations of the impact on insurers has changed rapidly in the past three weeks. Ultimately, the cost and ease of obtaining insurance is a function of insurer capitalization and expected claim payments. These two factors converge in what's called insurer appetite, which is then manifested in the aggregate in a "hard market" (rising prices, decreased risk appetite of underwriters) or "soft market" (declining prices and appetite for more risk). One need only look at the rapidly changing sentiment expressed by rating agencies and stock analysts to understand that the future market state is far from known.

Several variables will impact insurer solvency and appetite going forward:

- **Potential for significant uptick in loss experience**: While it is relatively unlikely the private insurance industry will be saddled with the financial responsibility for the income loss of insureds, an increase in claims across other lines is probable.
- **Quantitative easing**: Negligible yield in fixed income securities will put greater pressure on liquidity requirements, reserves and, ultimately, underwriting standards.
- **Lower premiums**: In the short term, premium volume could fall as a result of markedly lower revenue and payroll forecasts.

Much of the risk is reflected in the significant loss of market capitalization across the largest insurers over past two months. These factors are coming into play after several quarters of a steadily hardening insurance market. However, insurers are generally well-capitalized, particularly relative to historic levels, and the underwriting discipline of the last 12 months should be reflected in adequately priced risks (at least on a pre-COVID-19 basis).

For the foreseeable future, we expect insurers will maintain and increase underwriting discipline, and the availability of certain lines for industries hit hard by the pandemic, such as employment practices liability for a first-time purchaser of in the health care space, will become increasingly rare.

It is possible that market hardening could accelerate if insurers seek rate increases to offset declining exposures. This is particularly true in the present soft market anomalies, notably California workers' compensation. However, especially with the liquidity being pumped into capital markets, a soft insurance market could feasibly follow in 18 – 24 months, with insurers seeking to take back market share to help offset lower investment yields.

Takeaways

We think it is unlikely that insurance markets will return to business as usual, but rather that a new normal will take shape over the next 6 – 24 months. The hallmarks will include:

- Grappling with inherent unknowns, such as secondary waves of illness, uncertainly predicting consumer demand and sentiment, claims frequency and severity. COVID-19 and future viruses (of which there now seems to be broader public acknowledgement) have the potential to disrupt forecasts in unpredictable ways.

- Supply chains are likely to be remapped to mitigate potential disruptions from countries that have inadequate protocols to effectively manage pandemics, and/or lack transparency of their governments.
- Lenders will demand borrowers insure against pandemics.
- Continued cash flow issues are likely to result in the inability of customers to pay premiums. To mitigate counterparty risk, we anticipate expanded use of hedging products, such as trade credit insurance, futures contracts and, potentially, catastrophe bonds.

From the industry, COVID-19 demands improved risk strategies to ensure business continuity, and it is likely insurers will begin to contemplate these measures in their underwriting, across lines. We anticipate the industry will demand of insurers (and as an inevitable result the federal government, to finance directly or via reinsurance) a facility to provide coverage for business interruption losses incurred during a pandemic. In fact, one such proposal has been developed by the insurance industry, which might function in much the same way TRIA/TRIPRA responded to the World Trade Center attacks. While TRIA/TRIPRA never paid any claims, it brought certainty to a market that otherwise could not have been addressed by private corporations.

For more information on the evolving COVID-19 situation, visit Latest-Insights.NFP.com