Marsh

Property and business interruption cover considerations

Environmental, social, and governance

November 2021

This is the first article in our series exploring how environmental, social, and governance (ESG) issues and risks can be mitigated and/or protected by insurance coverage.

Our initial focus is on the physical risks posed by climate change, and how they impact property and business interruption insurance. Subsequent articles will examine how ESG issues affect other classes of insurance, such as public and professional liability, management liability, motor, and trade credit.

ESG IS A FRAMEWORK TO MAP OUT A COMPANY'S IMPACT ON THE WORLD, AND WHAT IT IS DOING ABOUT IT

E

Environmental captures climate change, energy efficiencies, carbon footprints, greenhouse gas emissions, deforestation, biodiversity, and other environmentally sensitive issues.

S

Social covers labor standards, wages and benefits, diversity, human rights, community relations, privacy and data protection, health and safety, supply chain, and other social justice issues.

G

Governance captures the governing of the "E" and the "S" categories plus corporate governance considerations.

Highlights

The increased frequency and/or severity of natural catastrophes and extreme weather events has disrupted businesses and supply chains and had a direct negative effect on property and business interruption insurance. Combined with consumer and investor pressure on insurers to respond to an ESG agenda, the insurance industry has a critical role to play in building a more sustainable future.

ESG cover considerations for property and business interruption insurance outlined in this report include:

Flooding and natural hazard risk

- Insurers are carefully monitoring, and in some cases reducing, their exposure to extreme weather-related losses.
- Organisations will need to pay particular attention to newly imposed natural catastrophe sub-limits and exclusions. For heavily exposed sites, insurers are likely to require higher levels of self-insurance and/or improved resiliency.
- Organisations may need to invest in site surveys and modelling data to assess the extent to which their sites are exposed, or how much damage is likely to result.
- Developing a flood emergency response plan will help businesses recover more quickly from a loss, and give insurers greater confidence to put forward competitive quotations.

Nontraditional construction materials and methods

- The construction sector is under pressure to build more sustainably, potentially changing their risk profiles.
- Insurers will need to understand the implications and the risks to ensure appropriate pricing.
- Construction organisations should engage with insurers early.

Localised power generation

- Many organisations are embracing localised power generation using new or less established technologies that are, from an insurance loss perspective, relatively untested.
- Policyholders should involve their broker and insurers early in the design process to ensure appropriate risk protections are considered, and to assess available insurance market capacity.

Carbon credits (UK emissions trading scheme)

- Policyholders participating in such schemes should consider how an event that interrupts their business might affect their use of carbon credits, and the adjustment of any subsequent insurance claim.

Rebuilding “green”

- When reinstating property, organisations may prefer to use more sustainable materials, and/or with improved thermal or energy efficiency.
- It is important to consider what tactics and covers can be designed, in collaboration with their insurer, to deliver the intended outcome.

Riot and civil unrest

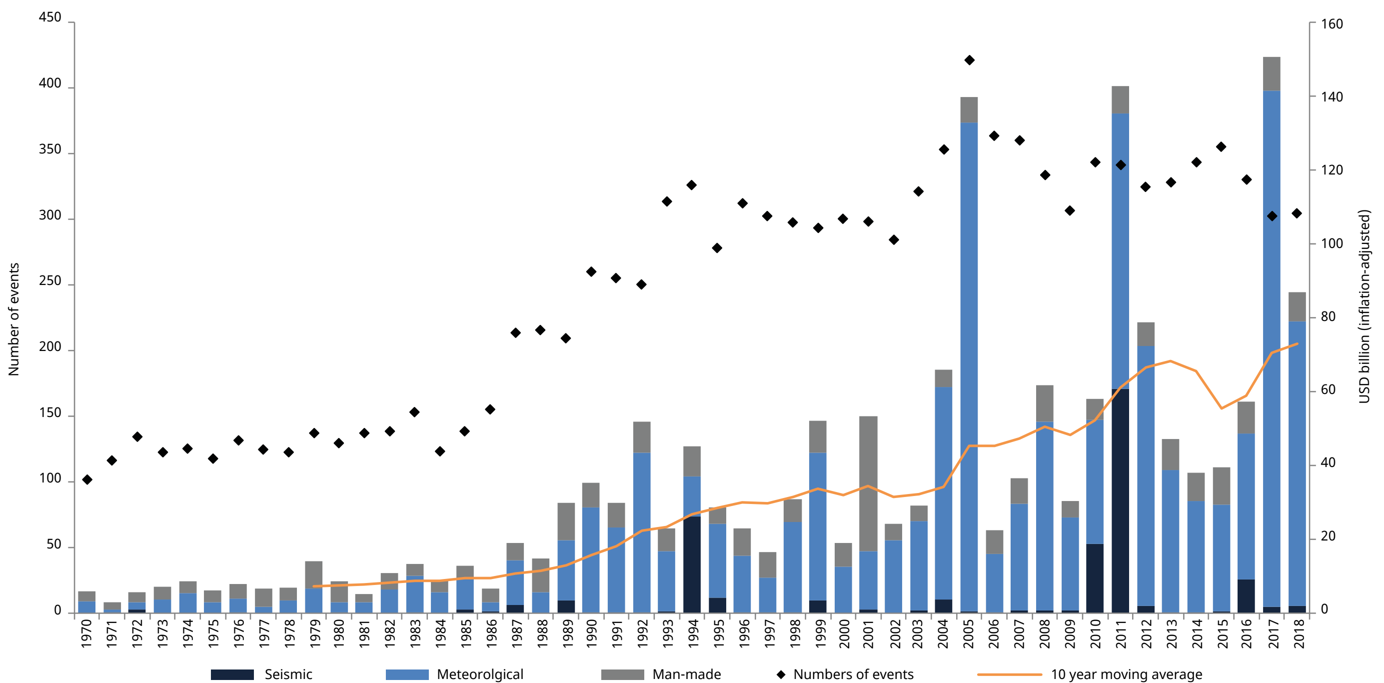
- Protests related to ESG issues can be expected to continue to occur, the large majority of them peaceful.
- Most commercial property insurance policies cover damage to buildings and other property caused by riots, civil commotion, strikes, and vandalism.
- Unrest fuelled by ESG issues could impact coverage for physical damage caused by protesters going forward.

Introduction

Extreme weather events, climate action failure, and human environmental damage have been recognised as three of the top global risks by the World Economic Forum for the past three years.[1]

The increased frequency and/or severity of natural catastrophes and extreme weather events has disrupted businesses and supply chains and had a direct negative effect on property and business interruption insurance. Climate change losses suffered by the insurance industry and their insureds steadily increased between 1970 and 2018 (see Figure 1).

01| Global insured inflation-adjusted catastrophe losses — 1970–2018



1 World Economic Forum — The Global Risks Report 2021.

“In June 2021, the Bank of England announced its first comprehensive stress test of the ability of the British financial system to cope with climate change.”

“the insurance industry has a critical role to play in building a more sustainable future.”

In a March 2021 paper, the Swiss Re Institute noted: “Global insured losses from natural catastrophes were USD81 billion in 2020; man-made disasters resulted in USD8 billion insured losses”[2]. Such statistics show the direction of travel as it stands today. Faced with the prospect of increasing losses, underwriters are likely to reconsider the scope and cost of cover provided under property and business interruption programmes going forward.

The ability to meet the financial exposures arising out of growing numbers of policyholders suffering damage or disruption due to climate change events is not the only concern for insurers. The Prudential Regulation Authority (PRA) has issued guidance setting out its expectations as to how insurers should manage the financial risks arising out of climate change. Such risks are not limited to physical risks, but include financial risks related to energy transition, which can arise from the process of adjustment to a low carbon economy. There are also financial liability risks, where parties who have suffered loss and/or damage from the physical and transition risks seek to recover financially from those they believe responsible.

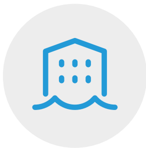
In June 2021, the Bank of England announced its first comprehensive stress test of the ability of the British financial system to cope with climate change. The test will scrutinise the resilience of the country’s 19 biggest banks and insurers — including HSBC, Barclays, Aviva, RSA, and Lloyd’s of London — to stresses from the shift to a net zero carbon economy over coming decades, as well as the impact of extreme weather. The stress test will consider their invested assets, reinsurance protection, and insurance liabilities. The need to demonstrate financial resilience to regulators and manage future financial exposures will be key drivers in underwriting strategies.

However, the impact of ESG on the insurance market is broader than financial resiliency. The availability or affordability of insurance is an enabler and can act as a driver for change. Combined with consumer and investor pressure on insurers to respond to an ESG agenda, the insurance industry has a critical role to play in building a more sustainable future. For example, within the last 12 months, a number of insurers have publically gone on record to withdraw their support for environmentally undesirable projects, such as the construction of new coal mines. Further, as a significant source of funding for the (re)construction industry, insurers are important stakeholders for the adoption of environmentally sustainable building materials and methods.

The following pages highlight some potential impacts on ESG-related insurance coverage, along with other points for policyholders to consider as ESG considerations become key factors within insurers’ underwriting strategies.

2 Swiss Re Institute — Sigma No 1/2021.

ESG cover considerations for property and business interruption insurance



FLOODING AND NATURAL HAZARD RISK

Insurers are carefully monitoring, and in some cases reducing, their exposure to extreme weather related losses. A joint report[3] commissioned by the Association of British Insurers and Flood Re in June 2021 observed that flooding is the greatest natural disaster risk in the UK, with an estimated one-in-six properties in England and Wales at risk. Internationally, other natural catastrophe risks, such as wildfires and storms, are significant pressure points for insurers.

From a coverage perspective, organisations will need to pay particular attention to newly imposed natural catastrophe sub-limits and exclusions, checking these are adequate for site-specific exposures and interdependent business interruption losses. For heavily exposed sites, insurers are likely to require higher levels of self-insurance and/or improved resiliency, such as flood defences.

As ever, information is key. To determine the level of cover they need, organisations may need to invest in site surveys and modelling data to assess the extent to which their sites are exposed, or how much damage is likely to result. Developing a flood emergency response plan will help businesses recover more quickly from a loss, and give insurers greater confidence to put forward competitive quotations. For high-risk areas, insurers may require a flood emergency response plan as a condition of cover. When flooded properties are being repaired or rebuilt, insureds and their insurers should explore practical measures such as installing electrical sockets higher up on walls, using waterproof wallboard rather than traditional plasterboard, or installing damp channels and sump pumps to direct and remove water.

3 https://www.abi.org.uk/news/news-articles/2021/06/joint-abi-and-flood-re-report-highlights-the-need-for-adequate-maintenance-of-the-uks-flood-defences/

NON-TRADITIONAL CONSTRUCTION MATERIALS AND METHODS

A report[4] from the United Nations published in December 2020 found that CO2 emissions from the construction and operation of buildings accounts for 38% of total global energy-related emissions. The sector is under pressure to build more sustainably; this quest for innovation can change the risk profile for insureds and their insurers. As the construction sector looks to address its impact on the level of CO2 emissions and use more sustainable materials and methods, insurers will need to engage with policyholders to understand the implications and risk and, in particular, to ensure appropriate pricing.

For example:

- Modular construction involves factory-produced structures or rooms being delivered to site for assembly/connection. It brings social advantages, such as better controls for workplace safety, as well as the introduction of factory-level standards of quality control. However, the insurance risks differ from conventional construction methods, including the potential for batch level product liability defects, novel uses of technologies and materials, and transit and commissioning risks. Some UK property insurers have been reluctant to insure property portfolios with significant volumes of finished modular/modern materials units.
- The use of cross-laminated timber (CLT) is gaining favour in UK construction projects. CLT comprises prefabricated wood-based panels, constructed by bonding lengths of timber in a lattice pattern with adhesives and/or wooden dowels, to deliver load-bearing walls, roofs, and floors. A similar process of layering and bonding wood is used to create glue-laminated beams, an alternative to traditional steel RSJs. Sourced sustainably, using timber in construction projects has many environmental benefits; however, there are risk and insurance factors. Many insurers will take a conservative view of CLT, and may require additional risk protections, such as sprinkler systems due to concerns that CLT may be more flammable than traditional materials. The cost of these risk measures, alongside any negative impact to insurance premiums and cover, needs to be assessed early in a construction project to avoid unwelcome surprises.
- More generally, as with any new products and technologies, initially there could be a scarcity of supply. Longer lead times to source non-traditional construction materials, and difficulty in finding contractors with appropriate experience, could extend rebuilding times. Organisations may need to insure for longer business interruption indemnity periods.

Over time, we expect the insurance market to grow more comfortable with these more sustainable building materials and manufacturing techniques. But now, in a transitioning market, we recommend policyholders consult with their broker and insurers early in the design stage to ensure cover availability within an expected budget. Engaging with insurers at an early stage will help them to understand the changing risk profile, so policyholders looking to move to more sustainable construction are not prevented from doing so by prohibitive premium levels.

4 2020 Global Status Report for Buildings and Construction, UN Environment Programme: https://globalabc.org/news/launched-2020-global-status-report-buildings-and-construction.

LOCALISED POWER GENERATION

Seeking energy efficiency, many organisations are embracing localised power generation, and are using new or less established technologies including wind turbines, hydroelectric plants, and solar, sometimes connected to battery power cells. For example, an organisation in Scotland recently installed a multimillion pound energy centre, taking methane from an anaerobic digester directly into hydrogen fuel cells, using a chemical process to convert gas to electricity.

Such installations may use technologies that are barely a decade old and are, from an insurance loss perspective, relatively untested. Some technologies involve increased fire or explosion risk. For example, lithium batteries can suffer thermal runaway — a chain reaction in which a damaged battery begins to release energy in the form of heat, leading to further damage in a feedback loop.

The insurance industry is understandably cautious about these newer exposures. Again, it is important that policyholders involve their broker and insurers as early as possible in the design process to ensure appropriate risk protections are considered, and to assess what capacity is available from the insurance market. Ideally, physical separation from the power generating equipment and the existing buildings, plant, and machinery on site will ensure that insurance availability for the existing assets is not compromised.

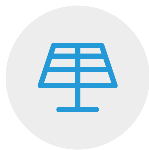
From a business interruption insurance perspective, there is a need to consider how localised power generation interacts with traditional offsite “failure of public utilities” extensions. It may be appropriate to consider specialist engineering/machinery breakdown policies to insure against the risk of impairment to an organisation’s own generating equipment.

If power-generating equipment feeds into the mains grid, the revenue from this should be included within the figures declared for business interruption insurance. Equally, if the equipment is impaired, an increased cost of working extension may prove useful to facilitate the additional cost of buying in electricity at commercial rates.

CARBON CREDITS (UK EMISSIONS TRADING SCHEME)

Policyholders participating in such schemes should consider how an event that interrupts their business might affect their use of carbon credits, and the adjustment of any subsequent insurance claim.

For example, if a business is impaired and no longer able to maintain operations, it may emit less CO2 during this period of interruption. Consequently, it may have unused carbon credits to “bank” or sell on to third parties. To avoid dissatisfaction with the claim settlement, it is important to agree upfront with the insurer how this financial “benefit” should be treated when calculating the business interruption claim.



REBUILDING “GREEN”

When reinstating property, organisations increasingly prefer to rebuild using more sustainable materials, and/or with improved thermal or energy efficiency.

Historically, insurance is defined by the principle of indemnity — to put an insured back to where it was financially before the loss, neither rewarding, nor penalising. Elective “green” improvements to a building — and particularly those that are more costly — may, conventionally, be regarded as betterment and entitle an insurer to reduce the claim settlement.

Consequently, for organisations keen to build back better and greener, it is important to consider what tactics and covers can be designed, in collaboration with their insurer, to deliver the intended outcome:

- Most policies already contain “public authorities” extensions, to fund the additional costs of complying with modern building regulations. Enhanced wordings include cover for the undamaged portions of the building — an important consideration for partial losses. Building regulations are mainly focused on safety, but improvements to thermal efficiency are likely to be permitted under this clause.
- Some property insurance policies include specific provision for “green” reinstatement — the additional rebuilding costs to conform to green standards. Such green standards would include products, materials, methods, and processes certified by a green authority that conserve natural resources, reduce energy or water consumption, avoid toxic or other polluting emissions, or otherwise minimise environmental impact.
- An “obsolete buildings” or “modern materials” clause can provide for a different basis of settlement, using more suitable modern materials. Policyholders should explain to insurers how they would repurpose their sites, should they be damaged beyond reasonable repair. It is good practice to retain a written record of these discussions in case a loss occurs.
- For industrial plant and equipment, insurers and loss adjusters have sometimes argued that improved performance in the latest model of the replacement item — such as lower power usage or increased productivity — should count as betterment. This runs counter to a responsible ESG narrative, and with growing awareness of environmental impacts we expect to see greater flexibility from the insurance market. In the meantime, adding “involuntary betterment” and “technological upgrade” clauses to the policy typically provides a way to protect against such deductions.

RIOT AND CIVIL UNREST

Activism has long been a hallmark of societal change. Organisations today are facing and responding to activism, largely peaceful, related to their ESG agendas. Some recent issues — related to racial inequality, pandemic restrictions, climate issues, and others — have sparked protests in which heightened tensions led to property damage and civil unrest.

Most commercial property insurance policies cover damage to buildings and other property caused by riots, civil commotion, strikes, and vandalism. For example, the August 2011 riots in England resulted in insurers paying out £200 million in claims.

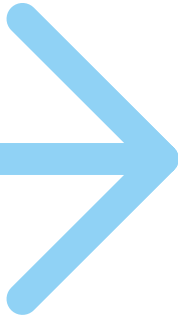
Social unrest may increase going forward. For example, climate change protestors continue to highlight concerns that insufficient action is being taken by governments to reduce their greenhouse gas emissions in order to reach the goals of the Paris Agreement.

Further unrest fuelled by ESG issues could impact coverage for physical damage caused by protesters going forward. It is possible that underwriters with increasing concerns over the frequency and scale of such events may look to exclude or limit cover in cities or areas perceived as being high risk.

Going forward some of the coverage issues to consider include:

- Outside of Northern Ireland[5], most property policies automatically cover damage caused by riots, following notification of the claim to insurers within strict timescales. Equally, damage caused by vandals or malicious persons is also typically insured.
- However, there is a possibility that damage to property caused by protestors, such as climate change or animal rights activists, could be certified as an act of terrorism (for which separate cover needs to be bought). The government-backed terrorism reinsurer, Pool Re, defines an act of terrorism as "persons acting on behalf of, or in connection with, any organisation which carries out activities directed towards the overthrowing or influencing, by force or violence, of Her Majesty's Government in the United Kingdom." Organisations should consider their need for terrorism cover, to close the risk of a gap in coverage.
- Traditionally, business interruption cover is triggered by a valid physical damage claim. In practice, many businesses affected by events such as protest marches or blockades will be undamaged. Non-damage business interruption extensions can cover the effects of police closures, or unlawful occupation within a radius of the insured location. Over the last 12 to 18 months, many of these "contingent non-damage" business interruption extensions have become harder to obtain as the insurance market contracts and responds to the COVID-19 pandemic. Nonetheless, for organisations with significant exposure — for example, those in city centre locations — nondamage business interruption cover should remain a negotiation priority.
- Internationally, policies may exclude or limit coverage for riots, civil commotion, and terrorism. Policyholders with risks located overseas should discuss their specific coverage requirements with their broker and insurer.

5 The Criminal Damage (Compensation) (Northern Ireland) Order 1977 provides a right to claim compensation from the Department of Justice for loss suffered as a result of damage caused by an unlawful assembly of three or more persons or by terrorist acts.



We hope that these initial comments on how the increasing focus on ESG risks may impact property and business interruption insurance coverage provide a useful introduction to issues that policyholders need to consider.

Here at Marsh, we will help policyholders understand the coverage implications specific to their insurance requirements as they navigate their own sustainability journey. Please look for future articles in this series, which will evaluate ESG implications for other classes of insurance.

For further information, please contact your Marsh representative or visit the Marsh website. www.marsh.com

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