Contingent Business Interruption (CBI)

ITSEMAP

In 2011, parts of Thailand were underwater for six months due to severe flooding; the material damages therefrom were estimated at 45,000 MUSD. This resulted in major losses in supply chains and revealed imperfections on how catastrophic risk and its consequences were traditionally insured.

In addition to direct and consequential losses, it was necessary to review traditional clauses in terms of criteria for determining one or several events and their inherent importance as regards deductible, priorities and limits.

In short and in many cases, consequential losses due to contingencies exhausted the sublimit of insurance coverage.

The purpose of this document is to identify and analyze the main factors affecting the risk of CBI coverage and to identify possible courses of action to help manage said risk.

SUPPLY CHAIN

Globalization is leading to an increase in sales and purchase markets for raw materials and manufactured products (both intermediate and products for end consumers).

At the same time, the following takes place:

- Reduction of logistic costs and subsequent ability to supply or sell products in markets that would be outside the realms of the imagination not so long ago.
- Specialization in individual businesses with clients and suppliers/providers; the latter are also specialized and offer their support throughout the entire product lifecycle.
- Need to reduce cost of capital derived from the growing implementation of "just-in-time/just-in-sequence" processes and reduction of leeway in production capacity and supply times.
- Growing need to assure quality and consequent complex product and process certification that makes it difficult to change providers/suppliers.
- Concentration of certain products in different positions of the supply chain in a limited number of companies and production centers.

Consequently, there is significant vulnerability to possible events in the facilities themselves and to events in other plants of the same group or related groups, in the same region or more distant regions.

Also, if a certain type of industry focused on certain types of products for certain production sectors in a specific geographical area, a catastrophic event will necessary have global repercussions on the entire sector due to loss of production and the reduced number of options.

THE CONCEPT OF CBI

In general terms, CBI refers to the loss of gross profit of a certain activity as a result of a materialized hazard in a different risk situation.

Here is a clear example: for a specific activity (A), a raw material supplier (B) that is hard to replace with another supplier or raw material is affected by a large fire that reduces its activity and, as such, reduces the supply of, or increases the price of supplying, the raw material and results in loss of gross profit of (A) for either of these reasons:

- Reduced production and sales of (A).
- Increased production or logistic costs of supply using a different product or supplier.

Conceptually, this vulnerability does not depend on whether or not the client companies and the supplier are from the same group. However, in insurance terms, whether or not the companies and supplier are covered by the same insurance program makes a big difference. If they are indeed under the same program, we would talk about lost profit derived from a covered risk at an insured facility; whereas if they are not under the same program, the loss refers to a third party.

As a result, there are two very different cases from the point of view of insurance coverage:

- **Interdependencies** whereby facilities from the same group have a client-supplier relationship and any circumstance that affects the production capacity of one of the facilities has an impact on all downstream and upstream facilities in the supply chain, at least in the short term. If the circumstance is a risk covered by an insurance program, profit loss across the entire corporate chain will be covered.

- **CBI** whereby the circumstance is materialized in a risk situation that is not covered by the insurance program; the policy only covers this circumstance if the respective benefit has been taken out.

CBI may be triggered by:

- Clients
    - Immediate or successive
    - Named or in general
- Providers/suppliers
    - Immediate or successive
    - Named or in general
- Ability to attract the market of a nearby business (e.g. hotel complex in theme park with claim involving the latter)
- Denied access (of people or cargo)
- Utilities (power, water, gas, communications, etc.)

At all events, the cause of the claim must fall under the risks covered by the policy.

Consequently, it is easy to see what kind of multiplying effect this type of coverage would have if a serious event were to affect a key plant in supply chains, or particularly if a catastrophic event were to affect a region with several key plants; or if the coverage not only applied to suppliers/providers or clients but also to their suppliers/providers or clients, with consequent major impact, especially for large reinsurance companies.

REINSURANCE PERSPECTIVE

As end recipients of a significant portion of the risks underwritten by insurance companies, large reinsurers have been trying for some time to understand and know this risk and to define control mechanisms. They have then shared their key findings with the insurance companies by giving presentations to ceding insurers and by adding increasingly more restrictive clauses to their agreements.

Albeit the CBI risk is not impossible to restrict, it would be very difficult and expensive to identify and evaluate given the complex web of interdependent risk situations, alternatives, etc. This is especially pertinent in sectors that are constantly changing due to innovations and products and where it would not always be possible to notify of changes with enough notice.

The largest portion of the reinsurance business volume consists of agreements wherein the ceding insurers normally retain a large part of the risk. Also, these companies:

- Hold **stakes** in direct insurance and reinsurance of relatively **atomized** captive companies.
- Grant themselves **relatively low sublimits** in all programs.
- And the **number of affected schemes** is lower.

For all of these reasons, it is relatively unlikely that, for each of the ceding companies, the priority of their protection agreement is exceeded; and if it is actually exceeded, it will involve a small amount or a small increase in connection with the claim behind the CBI.

In other words, for reinsurers the significant part of this risk would mostly be retained by the ceding companies, or result from a relatively small amount when compared to the possible compensation.

Consequently, it could be inferred that the main concern of the reinsurance sector arises from the possibility of catastrophic events happening in areas with large concentrations of particularly sensitive industries such as automobile, electronics and, especially, the consumer industry.

CLAUSES FROM LEADING COMPANIES

Since in most cases clauses are provided by the client or the leading company, the conditions are stipulated therein and, in general, allow for less restrictive coverage. This usually includes all hazards that are listed in coverage for machine damages-malfunction; utilities; extension of denied access to cargo and regardless of where access is denied; and, where appropriate, "loss of attraction."

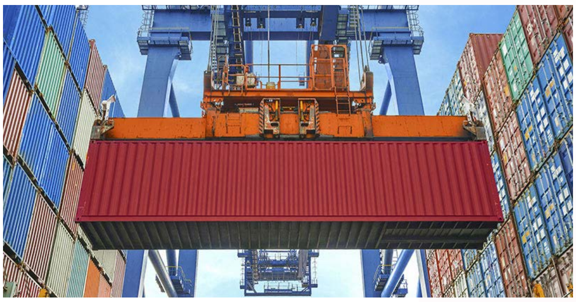
Furthermore, it is common to grant larger limits to named suppliers/providers-clients and sometimes to another level of critical, named suppliers/providers and clients, in connection with unnamed suppliers/providers and clients, indirect suppliers/providers and clients, catastrophic events, etc.

INFORMATION PROVIDED DURING UNDERWRITING

The level of detail of the information that is received to analyze the operations reflects several cases:

- Simple request for coverage, without specifying clients or suppliers/providers
- Specification of named clients and suppliers/providers with a simple list where they appear as business groups
- Lastly and very rarely, details about locations subject to exposure to CBI with exact identification of supplier/provider and client locations. This information is required for activities that request high limits.

However, the limits on information about the supply chain are often influenced by factors such as:



- Extremely dynamic sectors with consequent constant changes in products, markets and, as a result, the supply chains.
- Extremely sensitive information in relation to competitors and suppliers/providers.
- Possible coverage limitations if out of date.

As a consequence, the problem arises from lack of information and may lead, where appropriate, to extremely complex processing and, in all cases, heterogeneous processing.

CBI RISK MANAGEMENT AT MAPFRE GLOBAL RISKS

The following cases would apply:

- **Risk that the coverage would be activated for an insured:** Given the claims history, this risk is relatively infrequent and under control by the sublimits and parts of the risk assumed by MGR.
- **Risk that the coverage accumulates from a claim with FLEXA coverage** with major PD-BI of a MGR insured party; each would be handled as a separate claim with its respective retention in relation to reinsurance agreements.
- **Activation of relevant CBI coverage due to a catastrophic event** in countries with high use of capacity, which increases the claim by an amount that had not been forecast in accumulation estimations. However, due to the nature of the insured activities in countries with higher accumulation, this does not seem to be an additional relevant risk. ■