AEAI/RIMS International Conference
October 15-18, 1989
Monte - Carlo

Please respond to

TUESDAY, OCTOBER 17, 1989

SESSION NR 13

BUSINESS INTERRUPTION COVERAGES, INCLUDING CONTINGENT B.I.

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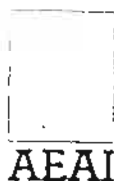

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BUSINESS INTERRUPTION COVERAGE AND CONTINGENT BUSINESS INTERRUPTION

Albert W. van Blitterswijk

The term Business Interruption Insurance is known in insurance all over the world and the basic principle of this kind of insurance does not need much explaining. Yet for a clear understanding I start with a definition (there are a great many!) of Business Interruption Insurance: in broad terms it is 'loss of profits arising from complete or partial business interruption as a result of material damage to the business premises, equipment, fittings or goods'. In Europe, damage must as a rule have 'named perils' as its cause, whilst in the United States the 'all risks principle' is usually taken as a basis. Business interruption will lead to a decrease in turnover and hence in earnings. Needless to say, this has an immediate effect on the operating results. Indeed part of the cost such as salaries, social security, debt redemption and interest continues unchanged. Moreover expected profit will be lost as a result of the interruption. In Europe it is customary for loss of market share to be covered after repair of the damaged property, naturally within the agreed time limit for payment, whilst with the 'gross earnings form' in the United States payment is usually terminated on repair of the property. As with almost every formula this brief and simple definition will not be complete, but we all know what is meant.

In material property insurance there is always certainty about the maximum loss in the event of damage. For if the premises burn down the lost value and the cost of rebuilding are known. No such certainty exists in business interruption insurance, which is a form of immaterial insurance. Major material damage may result in minor consequential loss. However, minor material damage may only be the tip of the iceberg with an enormous consequential loss beneath the water surface. In a business depending for example on modern electronics production may come to a complete halt if a microcircuit which is unique or difficult to come by is damaged by fire or by another cause. Business interruption insurance can then be an indispensable facility.

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Is this form of insurance universally accepted by now and is it as natural as fire insurance for material damage? If I restrict myself broadly to what I have seen in West European countries - there may be differences from one country to another - the following conclusions can roughly be drawn:

- Not all medium-sized and small businesses have business interruption insurance policies (estimates are that in the Netherlands only 50 per cent of businesses in the medium-size and small category have business interruption coverage).

- Although official statistics are not available a very substantial number of large to very large businesses have some form of business interruption insurance.

- Among multinationals however business interruption insurance in the professional insurance market showed a downward trend. This may be due to the introduction of a high deductible amount, to insurance within the captive, or to not insuring a part or all of the business interruption risks. This trend among multinationals is undoubtedly connected with their financial strength. If there is growth of capital that can serve as a 'reserve buffer' there will be a more selective approach to taking out business interruption insurance policies. This may however be risky if it is not coupled with optimum and maximum risk management and risk control aimed at preventing consequential loss. If there is no such combination the capital earned and invested in the business is unnecessarily exposed to risks.

As is known in the insurance market Unilever has in the past taken out hardly any business interruption insurance policies, permitted exceptions being:

- where Unilever is in partnership with others;
- where plant is unique or production cannot be transferred elsewhere;
- where for other reasons this insurance is to be recommended.

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The reasons behind this pattern, which is also found in other multi-nationals, may be as follows:

(a) The multinational's financial strength.

(b) Internal statistics show that over a very long period of time the amounts of the damage have invariably been lower than the premiums which would have had to be paid for the insurance concerned, and this can be largely attributed to good risk management.

(c) There are factories of the same kind in various countries. If these factories are co-ordinated from a central point it is possible in the event of damage to have production taken over by a factory making the same sort of products.

Like any other, this system has its advantages and disadvantages.

Advantages include the following:

- The premium is retained within the business, which can be important from a cash flow point of view.

- It is a well-known fact that not being insured in practice leads to damage being repaired far more quickly and creatively than when the business is insured, for then the reasoning is: 'We are insured anyway!'

Possible disadvantages are:

- a cumulation of claims in a year, although catastrophic risks have to be insured in the market. A long term view on claims, however, is more important.

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- quick transfer from one factory to the other where similar products are made is not always simple as there are differences between the various countries in:

  - food regulations;
  - product formulations geared to national taste;
  - pack sizes.

  This means that production and packaging equipment first has to be adjusted which may take a few days!

The present trend towards a more open market within the EC may also influence the significance of business interruption insurance. This certainly applies to companies with operations in more than one country. Owing to physical as well as tariff boundaries export from one EC country to another EC country is not yet completely free, but as from 1993 there will in principle be free movement of goods between the member states. The flow of goods will then move more freely and will be able to increase in volume as a result of the removal of borders.

In many cases a factory in a certain country now manufactures a quantity of products of differing kind. Production of similar goods will also take place in another country. A manufacturer of, say, preserved fruit and vegetable products produces for the German market in the factory located in Germany, whilst an affiliated business in France makes the same products for the French market. Apart from possible differences in taste there is likely to be specialisation in the EC in that the factory located in Germany will then make all products of a specific kind for Germany and the other EC countries while the affiliated business in France will manufacture all products of the other kind for France and the other EC countries.

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Naturally such a set-up has cost advantages but the other side of the coin is that the whole business becomes more dependent on a factory making a specific kind of product. If for example the factory in Germany drops out owing to a fire or other catastrophe and the other factories cannot take over - which is highly likely in view of specialisation - part of the profit may be lost for a long time. In other words business interruption insurance becomes considerably more important also to companies which used to do without business interruption insurance in view of the spread of their production units. In general in the process industries the average business interruption loss is showing a manifold increase. Higher concentrations of value, greater use of technology and the increasing complexity of production operations would all lead to a greater emphasis on loss control. In my opinion the risk and insurance managers in the EC should closely watch this development. Risk management is essential here as well. Concentration in one factory and the attendant risks are also a specific part of the risk manager's domain.

A company will ultimately have to seek the insurance cover called for by the new situation. This does not necessarily mean that in such cases business interruption insurance must be arranged from top to bottom. Depending on the company's financial strength it may suffice to accept a high amount of deductible or high retention in the captive, whilst risks of a more catastrophic nature are placed in the market. Larger production units involve a greater need for larger storage accommodation which is often combined with the tendency for more sophisticated stock management. In view of the present operating principles of back to basics, concentrating on core activities etc. the customary procedure is for storage and distribution to be contracted out to a specialised third party. This brings to the fore the problem of third-party warehouses, and fire and business interruption insurers know very well what risks are involved. Certainly in a time when costs have to be reduced or kept low the operational management will have to look for the cheapest warehouses with the lowest rental. Experience shows however that they do not always look for the best protected warehouses. In the interests of

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the continuity of the business the risk manager can do useful work here and formulate requirements or guidelines in co-operation with the operational management which have to be met before a rental contract with a third-party warehouse is concluded.

Business interruption insurance for any remaining risks and damage can then be useful and necessary. It should be borne in mind that loss of stocks means empty shelves in the shops. The business interruption insurer will then make a payment, it is true, but this does not fill the shelves or scare off competitors.

Unlike material property insurance, business interruption loss involves factors such as:

- Interdependence between group companies which are each other's suppliers or customers. It will have to be determined as accurately as possible to what degree interdependence between group companies exists and to what damage such interdependence may lead. Alternatives will have to be found in advance so that the original dependence can be reduced.

- Suppliers and customers' risks in general.

A characteristic feature of this is that although the company has not incurred material damage it may incur immaterial damage, a business interruption loss, if owing to material damage a big customer is unable to buy or a supplier can no longer supply the necessary raw or auxiliary materials. Just think of a power station which owing to a fire or an explosion is unable to supply the electricity required by the customer. The risks involved in not being able to buy or supply are varied and can have a major effect on the company's operations. An initial approach, quantification of risks and finding solutions, for example not being dependent on one supplier, is the risk manager's domain. Including this risk in the business interruption policy may be a logical consequence.

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One aspect of business interruption cover is to determine an indemnity period. This is the period between the actual event causing the business interruption and the moment when things are back to normal. This indemnity period has to be determined very seriously, some of the major factors being:

- The time needed for clearing before a start can be made with actual repair work.
- Check whether rebuilding on the same site is possible and permitted.
- The time needed for drawing up rebuilding plans. Usually such plans are not available 'from the shelf'.
- The time needed to obtain the necessary permits, and the degree to which the period can be extended by government authorities making additional requirements on rebuilding.
- Can delay be caused by action groups that are against rebuilding.
- Period for replacing critical equipment. Can this period be shortened?
- Start-up time for production.
- Time needed to make up for any loss of market share or customers.

In this short space of time I have not discussed business interruption as a result of pollution and extortion, but the principle to be maintained here and for the entire domain of business interruption is that however excellent security and insurance may be, it is always better to have a factory that's operating than a fistful of insurance cheques. The continuity of the business must always be the starting point.

As said before, when speaking about business interruption insurance in European practice we still think of insurance which leads to a payment in case of fire, explosion, lightning and other causes referred to as named perils. The next step is that the entrepreneur asks himself what other risks may threaten his continuity, and this leads us to the field of contingency planning. The difference between business interruption insurance and the contingency plan is that business interruption

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insurance concentrates on guaranteeing a financial return for a certain period of time whilst the contingency plan is aimed at continuity of the return on capital employed for an indefinite period of time. As said earlier on, the contingency plan is separate from the events covered by business interruption insurance.

The formulation of a contingency plan requires thorough analysis of the business. All its risks will have to be identified and quantified. Another thing is that a company is not a static entity but a dynamic one which means that the contingency plan constantly needs updating. The problems involved in formulating and adjusting the contingency plan will now be explained by Mr Strijbos and Mr Meyers.

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