MARSH

MARSH RISK MANAGEMENT RESEARCH

BUSINESS INTERRUPTION INSURANCE EFFICACY: FIVE KEY ISSUES

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MARSH & McLENNAN COMPANIES

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INTRODUCTION

Business interruption (BI) is not just a consequence of property damage; it can be anything that interrupts a business. Terrorism, supply chain failure, natural catastrophes, and cyber-attacks all have one thing in common — the threat of BI. This emphasizes the importance of organizations being prepared and ensuring funds are available to pay for loss mitigation and continuity plans. As businesses become more exposed to such major events, risk management and risk transfer must work together to make companies more resilient. BI doesn't necessarily fit into the existing insurance categories; therefore we need to build an enhanced level of comfort and security with regard to BI and risk.

Nevertheless, a property damage event remains one of the major exposures a company can face, and property damage/business interruption (PD/BI) is one of the main insurances purchased. It is therefore a great place to start on our journey towards improved BI coverage.

This report builds upon client survey data, case law, industry statistics, and the views of global business leaders to consider five key issues in BI, the limitations of existing cover, and the mechanisms for its improvement.

The five issues selected for this report are as follows:

- Getting the values right.
- Setting the indemnity period.
- Ensuring BI claims are paid in wide area damage scenarios (natural catastrophe risk).
- The limitations of supply chain cover in PD/BI policies.
- Optimizing claims settlement.

The Business Interruption Wording Review Report, published in 2012 by the Chartered Institute of Loss Adjusters (CILA), highlights many other concerns that are worthy of consideration; however, the five chosen in this publication reflect the primary concerns raised by colleagues, clients, loss adjusters, lawyers, and insurers, and represent the core areas where we believe that improvement is required. Some solutions have been proposed by both insurers and brokers; however, the majority of policies placed today continue to reflect the issues raised, and, for this reason if no other, are worthy of our attention.

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GETTING THE VALUES RIGHT

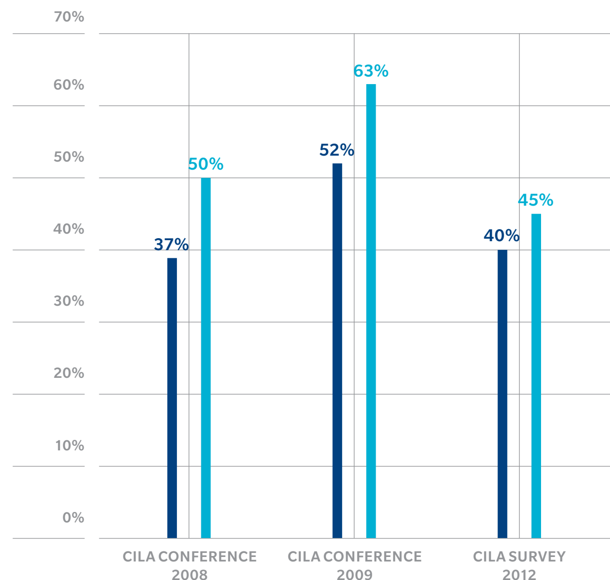
As with all types of insurance, ensuring the values declared are accurate and provided in accordance with the policy definition is critical in the placement of PD/BI cover. The penalties for getting the values wrong can be significant, with the application of an averaging provision reducing recovery proportionally, and, even with the protection of a declaration-linked policy (133.3̇% values uplift), there is the potential for insurers voiding cover entirely.

Unlike many other types of insurance, gross profit (or gross earnings) values are not typically collected by businesses for any other purpose. Moreover, gross profit utilized in corporate accounts does not equate to the insurance gross profit calculation required by the policy. There is some confusion around how that value should be calculated, which is further compounded by the need to reflect future growth and establish a figure to match to the indemnity period. Historically, this has resulted in significant numbers of incorrect declarations being made. **FIGURE 1**, taken from the Chartered Institute of Loss Adjusters (CILA), shows that, in 2012, 40% of all declarations were too low – by as much as 45%.

Interestingly, the CILA statistics do not suggest any significant improvement in the accuracy of valuations between 2008 and 2012 (the most recent statistics available). The 2014 Eurokey case (see opposite) illustrates the potential impact of inaccurate declarations in the event of a claim.

FIGURE 1 | DECLARATIONS

Source: Chartered Institute of Loss Adjusters



BUSINESS COMMENTARY

Mark Dawson, risk manager at global travel company Thomas Cook, explains how the company is improving data collection:

"We currently collect property values from all sites/ business units using a basic questionnaire and manually collate the data. We are looking to improve this process potentially through the use of an electronic value collection tool. BI values had previously been gathered at a business unit level, but now they are established centrally, based on an agreed insurance gross profit definition."

According to Mark, the following changes have been made to the way program limits are set:

"The program limits were historically set based upon what had previously existed. This changed recently to reflect the correct values – we are now able to verify the adequacy of the limit. Our BI declared values are now accurately calculated and reflect the new insurance gross profit definition in our policy. The program limits are also closely aligned with our maximum foreseeable loss (MFL) and normal loss expectancy (NLE) exposures, with sub-limits following those calculations. We started again from scratch, calculating several key loss scenarios."

SPOTLIGHT

GETTING THE VALUES WRONG

The case of **Eurokey Recycling Ltd v Giles Insurance Brokers Ltd, 2014, EWHC 2989 (Comm)** highlights the potential impact of inaccurate declarations.

Eurokey Recycling, a company that provides recycling and waste management services, suffered a fire in May 2010. Following the fire, the insurer soon focused on significant discrepancies between the sums Eurokey had declared for the values of its stock, plant and machinery, and BI at the policy's inception and the actual figures as of the time of the loss just several weeks later. Faced with the threat that the insurer would seek to avoid the policy and the likely application of an averaging (coinsurance) provision because the company was underinsured, Eurokey accepted a total recovery of US$820,000 (£550,000). In Eurokey's later dispute with its broker, the company said it believed it could have achieved an insurance recovery of US$4.1 million (£2.7 million) had values been declared differently, and the coverage been based on those values.

Eurokey's limited BI recovery underscores the critical importance of communication in gathering information to supply to insurers. Although the annual information-gathering process can be cumbersome at times, and there can be, for example, temptation to rely on last year's figures, it is potentially perilous to do so. Collecting key financial figures, including turnover (revenues) – both historical and projected – is an essential first step in a process that must be undertaken with care. The information gathered not only serves to inform insurers about the risk, it should inform your BI purchasing decisions, including what sum to insure and what indemnity period to seek. Therefore, careful teamwork and communications, both internally and with a broker, are needed.

The potential impact on a business of declaring inaccurate or inappropriately calculated values can be significant; however, for a large and complex organization, collecting all the required data and submitting accurate values is unlikely to be straightforward.

Mark identifies the reasons that drove the change in approach, and outlines some further changes he would like to implement in the future, as follows:

"We suspected our BI declared values were too low, and we did not have a clear view of our worst lost scenario. Our preference is for a proactive approach (rather than reactive post-loss). Our broker negotiated for the consultancy costs of a BI review to be funded by the market. The comprehensive and detailed report widened our understanding of our own exposures and convinced insurers to offer wider cover at a lower rate. The detailed modeling considered a number of potential scenarios, and the recommendations provided informed both the purchase of program limits and the inclusion of key policy extensions. The insurer- and broker-supported BI review allowed us to accurately calculate the exposures, tailor our cover, and utilize the premium savings to extend cover in other areas. It is much easier to negotiate cover and premiums on this basis – it put us back in the driver's seat. Insurers were involved in the process, and gained a much greater understanding of the risk and exposures faced, so it is a great example of tripartite collaboration for a successful result.

We are a continuingly evolving business and I would anticipate undertaking a BI review at least once every three years to ensure that our cover is closely aligned with the changing risks we face. It is essential to ensure declared values are correct to avoid underinsurance issues in claims."

RECOMMENDATIONS

The statistics provided suggest that inaccurate value declarations are a significant issue, both for business purchasers (who are exposed to potential underinsurance penalties) and insurers (who do not receive a full understanding and premium for the risk that they are insuring).

By taking the time, pre-renewal, to accurately calculate annual gross profit (or gross earnings) values, companies can, with the help of their broker, materially reduce the likelihood of post-loss disputes and help ensure full recovery in the event of a claim.

A detailed BI review is the most comprehensive mechanism for setting accurate policy limits that reflect true exposure, with policy extensions established to reflect specific business risks. This approach is considered essential for large, international companies, and will benefit all businesses seeking to accurately present their risks.

It is, however, perhaps time to consider an approach based on existing accounting data or annually published accounts. An underwriting mechanism based on annual wage roll and accounting gross profit could provide a similar declaration mechanism for companies that is less liable to error, while providing underwriters with an adequate indication of exposure.

MARSH

SETTING THE INDEMNITY PERIOD

The maximum indemnity period (MIP) is the period for which insurers will indemnify the claimant for financial loss arising from an insured event. In contrast to US gross earnings (GE) policies, gross profit policies require the declaration of a fixed MIP at placement. This period should be adequate for the business to reconstruct and recover trading and profit levels to those that would have existed had the loss not occurred.

The estimate of recovery time is essential for both gross profit and GE policies. GE policies offer actual reinstatement time plus a set period of recovery.

For businesses, setting an appropriate MIP can be significant, given the number of factors that can influence both physical reconstruction and recovery time. Factors for consideration in setting the time to return to normal profit can include:

- Where there are long delivery times for materials or specialist machinery that needs to be replaced.
- When the business is carried out in property – for which the insured is either a tenant or owner – that would take a long time to rebuild as a result of its scale, location, or other factors (such as historic listing or planning restrictions, for example).
- When the company is highly dependent on a few customers – loss of a single customer can have a significant impact, and gaining replacement customers can be a lengthy process.

While the length of the MIP can vary for a number of reasons (not least the insurance buyer's industry), our survey of Marsh clients in regions that use the gross profit form (**FIGURE 2**) suggests that a significant percentage of companies continue to rely on periods of 12 months or less.

Furthermore, when UK companies undertake more detailed reviews, the majority (55%) subsequently elect to change the period, with most increasing the period insured.

BUSINESS COMMENTARY

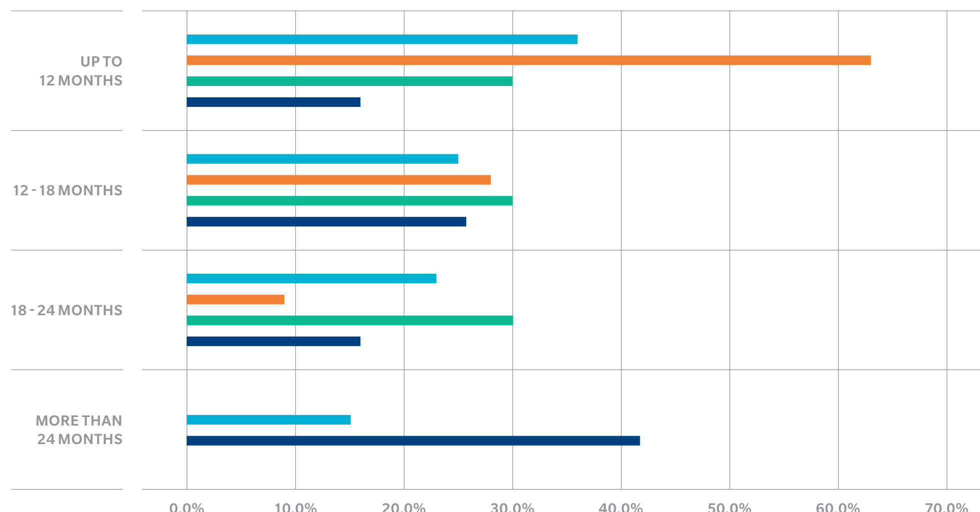
Following a recent business interruption review in the Asia Pacific region, we asked for some feedback on the results. (The respondent has requested to remain anonymous.)

How have indemnity periods been set?

"Historically, we did not purchase BI cover, other than additional increase cost of working (AICW). The indemnity period was 12 months across the asset base, increasing to 18 months upon the appointment of a new broker. The indemnity period was based purely on the AICW exposure with respect to redirection between the company's two key handling facilities.

FIGURE 2 **LENGTH OF MAXIMUM INDEMNITY PERIODS (MIPS) OF MARSH CLIENTS BY REGION**

Source: Marsh



SPOTLIGHT

IT'S NOT JUST THE NUMBER OF MONTHS

A UK retail organization has been traveling a long road to continuing its full operations, and even its relatively lengthy BI indemnity period has run out. It operates a retail convenience store – a small four-unit commercial development owned by the borough council (local government), which is situated in a densely populated residential area.

In March 2013, a fire originated at an adjoining store and engulfed the development, completely destroying the insured's store. The rebuilding process suffered several delays, and it was not until late 2013 that the borough council awarded the construction contract to start the rebuilding process. Although the building was a basic single-story structure of relatively modern construction, and might have been rebuilt, under ordinary circumstances, in a period of nine to 12 months, rebuilding is not expected to be completed until early 2015.

About six months after the fire, with rebuilding still in the planning stages, the insured installed a portable unit in the car parking area of the development and resumed limited operations. That temporary location, though, has generated only 35% of its expected turnover and, while the insurance cover responded to the approximately 65% revenue shortfall, the policy's 18-month indemnity period has now expired.

This claim is evidence that even a comparatively lengthy indemnity period of 18 months may not be sufficient under certain circumstances. Due consideration should be given to the impact the surrounding area may have on rebuilding, and, for commercial lease tenants, the characteristics of the landlord that may affect the rebuilding timeline.

Businesses are increasingly recognizing the importance of setting carefully considered indemnity periods, rather than accepting standard 12-month limits.

The basis for insuring BI did not match the ever-changing nature of our business. Accordingly, a BI review was conducted by our broker, resulting in the purchase of gross revenue cover, as well as an increase in the level of AICW protection. With respect to the indemnity period, this was increased to 24 months, based on the worst-case scenario of a major loss at a key distribution facility."

Is the indemnity period the same for all locations?

"Yes. 24 months applies across the whole portfolio. This is reflective of "worst-case scenario" rather than an analysis based on specific locations. This is also reflective of what is available in the current market at minimal cost."

Has this changed in recent years? If so, why and how?

"A recent review of the risk exposure, as it more appropriately relates to the different aspects of our business, has altered our perception of the impact of a major loss, and the time agreeing appropriate works with all parties. We continue to work closely with our broker to ensure that the indemnity periods selected are appropriate. With respect to key distribution facilities, 12 months is not sufficient to clear a site, go through planning permissions, rebuild, and recover production/revenue to pre-loss levels."

RECOMMENDATIONS

The importance of taking the time to assess and set appropriate indemnity periods is being recognized by more businesses, and working with brokers and insurers on business-specific scenarios is an effective mechanism in crafting the right cover. In establishing realistic scenarios it is also important to consider, not only external factors, but also existing business continuity planning. It is vital to understand that the indemnity period is for loss of gross profit and/or increased costs. Profit may be protected through mitigating actions, but those actions may attract increased costs, for which a suitable MIP is required.

An alternative tactic may, however, be to adopt the US gross earnings approach, whereby the MIP is not a set time period, but rather the time taken to reinstate (however long that might be) plus a fixed recovery period. This can be valuable for complex businesses with specialist equipment, although care should be taken to ensure that the post-reinstatement recovery period is maximized (90 days is often the standard limit provided).

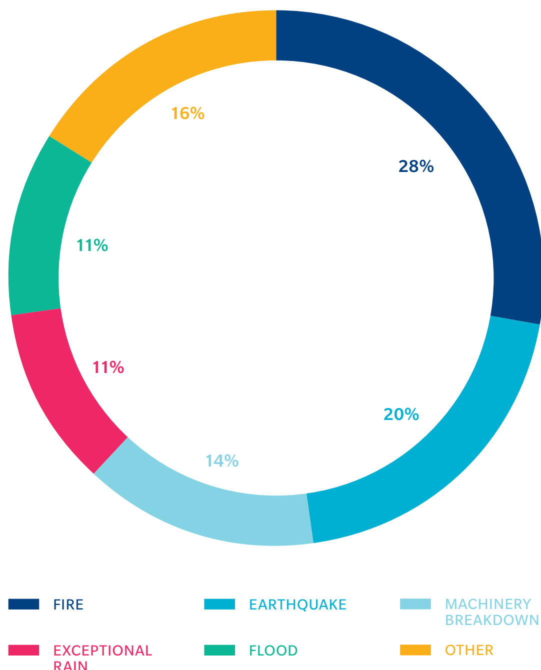
More challenging may be to discard the MIP completely. Businesses are obligated to mitigate their losses, and, with a good knowledge of exposures, underwriters should be able to price risk without an arbitrary time limit.

WIDE AREA DAMAGE

The devastation caused by natural catastrophe events remains the worst loss scenario facing many businesses. This is due to the increased exposure to natural hazards in today's global marketplace, both directly and indirectly (through global supply chains or an international customer base).

The *AGCS Global Claims Review 2014* reviews the primary causes of global property claims worth more than €1 million (US$1.14 million) for the five years between 2009 and 2013. As can be seen in **FIGURE 3**, wide area damage events (such as exceptional rain, earthquakes, and flood) represented 42% of all claims by value.

FIGURE 3 | **TOP CAUSES OF GLOBAL PROPERTY LOSSES 2009-2013 (BY VALUE)**
Source: AGCS



No one is safe from natural catastrophe events, but the situation is intensified due to the uncertainty around cover provided by traditional policies. One issue is in relation to sufficiency of limits — frequently, it is insurers that dictate the limits available (rather than the insured determining the limits that are required) — the other, and more fundamental, issue is the doubt over the effectiveness of coverage.

Munich Re produces continuous analysis of insured losses as a percentage of total losses in relation to natural catastrophe events. Some are really quite shocking, as can be seen below.

INSURED PROPORTION OF RECENT SELECTED NATURAL CATASTROPHE LOSSES
Source: Munich Re

	INSURED LOSS	TOTAL LOSS	% INSURED
KATRINA (2005)	US$62.2 BILLION	US$125 BILLION	49.8%
JAPAN (2011)	US$40 BILLION	US$210 BILLION	19.0%
THAILAND (2011)	US$16 BILLION	US$43 BILLION	37.2%
SANDY (2012)	US$30 BILLION	US$65 BILLION	46.2%
HAIYAN (2013)	US$0.7 BILLION	US$10.5 BILLION	6.7%
EUROPEAN FLOODS (2013)	US$3 BILLION	US$15.2 BILLION	19.7%
INDIA (2014)	US$0.5 BILLION	US$7 BILLION	7.1%

On average, 64% of total losses in the US are insured, which is actually a large percentage compared to other parts of the world (for example, in Europe, the figure is only 16%; and, in Asia, less than 1%). There are many reasons for such a shortfall, including conscious decisions not to insure, or industry standard exclusions (such as nuclear). Emerging risks can also be to blame, for which no insurance has yet been sought (for example, interruptions caused by natural catastrophe events that affect the suppliers of suppliers hidden in the chain).

SPOTLIGHT

TRENDS CLAUSE SWEEPS AWAY RECOVERY

The case of **Orient-Express Hotels Ltd (OEH) v Assicurazioni Generali SpA (2010)** continues to cause disquiet across the insurance industry. It is the ongoing element of uncertainty as to how insurers will view a loss given the legal precedent that means this issue remains a live topic for debate.

The Windsor Court Hotel in New Orleans, United States, owned by OEH, was damaged by hurricanes Rita and Katrina in 2005 and forced to close, while the city of New Orleans itself was subject to evacuation orders.

OEH made a claim to insurers for the property damage and the BI losses. The insurers stated that the BI loss must be "in consequence of damage," however, and claimed OEH suffered loss "in consequence of the event." Under its policy, which included a "Trends" clause (similar to an "Experience of the Business" clause in the US), OEH could only recover for any BI losses it would have sustained "but for" the physical damage to the hotel. The English High Court of Justice ruled that OEH should be treated as though it were an "undamaged hotel in an otherwise damaged city," and so because OEH would have received fewer guests due to conditions in the city, OEH did not receive any insurance recovery under the core coverage (some recovery was achieved under a prevention of access clause). Some considered the outcome for OEH harsh, and the decision has led to questions about the BI recovery an insured can expect in the event of a natural catastrophe event.

The United Nations continues to attempt to narrow the gap between insured and total losses through its International Strategy for Disaster Reduction (UNISDR) and UN Resilient Cities campaign. Unfortunately, many reasons for the shortfall come as a surprise, such as:

- No reinsurance (insufficient capital from local insurers to pay claims).
- Underinsurance (average applied to claims where values are under-declared).
- Unavailable insurance or restricted insurance (insufficient limits or wide area damage restrictions).
- Claims disputes.

There is often a mismatch between the expectation of BI policies and the reality of the contract in place. The expectation is for cover in the event of financial loss as a consequence of physical damage, but the reality is that cover is restricted by the fact that policies only compensate for insured perils at the insured premises. Wide area damage can then create further uncertainty in BI due to the argument that losses are as a result of an event (rather than damage at insured premises). **Orient-Express Hotels Ltd v Assicurazioni Generali SpA (2010)** highlights this issue more than any other, and is referred to above.

An insured might find cover restricted to the prevention of access limits, rather than full value, and, as such, it becomes necessary to distinguish between losses flowing from:

- Damage to the insured property – covered under the core policy.
- Causes specified in the extensions – often covered but usually subject to sublimits.
- The underlying event – not covered at all.

RECOMMENDATIONS

Companies wishing to avoid the possibility of a reduced recovery in similar circumstances should be advised to engage insurers and negotiate wordings appropriate to their exposures. There are different strategies organizations can employ to address the "wide area damage" wordings issue, including a consideration of the trends clause, denial of access/loss of attraction clauses, and potential policy endorsements, as follows:

- The provision under the trends clause that the loss must be adjusted "but for the damage" could be amended to state "but for the event causing damage," such that the concept of the wider area damage is removed.
- In addition, consideration of appropriate and meaningful denial of access, loss of attraction, and contingent suppliers' and customers' extensions may be considered. Working through loss scenarios, when combined with natural catastrophe modeling, can provide an insight into likely recovery times and the real financial impact. Standard extensions are unlikely to prove adequate.
- Endorsements have also been drafted that seek to avoid the possibility of the implementation of the "but for" test; however, notwithstanding the intent of the underwriter, the real test will come when the validity of such endorsements is put to the test by a claims team backed with a contrary legal opinion.

Planning is therefore essential, and loss scenario analysis (including insurers) is vital to understand how your PD/BI policy will react, and whether your limits are sufficient. If the unwanted answer from insurers comes — that cover for wide area damage is not included — then alternative risk transfer solutions, such as parametric trigger policies, can be considered.

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SUPPLY CHAIN

A typical business structure usually incorporates a complex web of suppliers and customers that often spans the globe. As a result, the landscape of risk changes dramatically; the variety of potential events and interruptions faced is vast. Traditional PD/BI insurance policies were not developed to cope with such exposures, and, as demonstrated below, do not offer the protection required in today's market. But there are alternative solutions available.

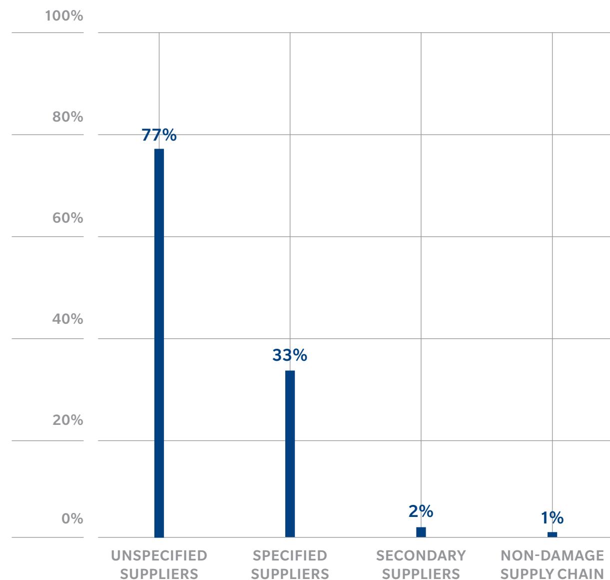
Business interruption and supply chain losses represent the number one concern for businesses around the globe (including in the US, where 61% of participants identified them as the top business risk in 2014). The World Economic Forum's *Global Risks 2015* report provides a view of the type of risks businesses face in the global arena, and maps those risks in terms of likelihood and impact. The top perceived risks have changed dramatically from physical risks to non-damage exposures such as cyber-attacks, infectious diseases, and interstate conflict.

Supply chain risks account for around 50%-70% of all insured property losses — as much as US$26 billion a year according to the *Allianz Risk Barometer 2014*, which surveyed more than 400 corporate insurance experts from 33 countries. Traditional BI policies, however, provide only partial protection, at best, for losses arising out of supply chain failure.

In PD/BI policies, supply chain failure is generally addressed through suppliers' extension clauses, which provide an indemnity to the insured in the event of a loss of gross profit arising out of physical loss or damage at a direct (first tier) supplier's premises. This is also referred to as "contingent business interruption" or CBI, which usually incorporates events at customer premises too.

FIGURE 4 | **SUPPLY CHAIN COVER AMONG MARSH CLIENTS***

Source: Marsh



Our review (**FIGURE 4**) of Marsh clients suggests that while most (77%) retain cover for unspecified suppliers, materially less purchase tailored cover for specified suppliers (33%), and that the number that consider either secondary suppliers or bespoke non-damage supply chain policies is minimal (2% and 1%, respectively).

Supply chain interruption can arise for a range of reasons; however, traditional coverage at present is generally limited to that arising from physical damage at a direct or primary supplier. This is sometimes further restricted to FLEXA (fire, lightning, explosion, aircraft) perils. When combined with the restricted limits provided by insurers for suppliers' extension and the increasing complex, international supply chains relied on by many firms, the insurance industry currently has a solution that falls materially short of being comprehensive.

* Results displayed illustrate the percentage of respondents that purchase each individual type of cover.

SPOTLIGHT

LIMITATIONS OF THE TRADITIONAL SUPPLIER'S EXTENSION CLAUSE

The case of **Millennium Inorganic Chemicals Ltd v. National Fire Ins. Co. of Pittsburgh, PA and ACE American Ins. Co., 893 F. Supp. 2d 715 (D. Md. 2012), reversed, No. 13-1194, 2014 U.S. App. LEXIS 3096 (4th Cir. Feb 20, 2014)** highlights the limitations of the traditional supplier's extension clause:

Millennium's Western Australia production facility was powered by natural gas delivered via pipeline, when an explosion at the plant of natural gas producer, Apache, halted production and led to a general gas crisis. Millennium's supply of natural gas was curtailed (the Australian Government stepped in to prioritize the delivery of natural gas to essential services), and Millennium had to shut down its production.

Insurers denied Millennium's CBI claim on the basis that only the pipeline owner, Alinta (and not the natural gas producer, Apache) was a direct supplier to Millennium, and that coverage did not extend to indirect suppliers. Millennium, for its part, argued that although its contract was with pipeline owner, Alinta, which delivered the natural gas, Apache was, in fact, the provider and direct supplier of the gas. The trial court agreed with Millennium, concluding that "the physical relationship between the properties ... is as or more important than the legal relationship between the properties' owners." It found that the term "direct," as used in the policy, was ambiguous, and should be constructed in favour of Millennium by virtue of the contra preferentum doctrine meaning interpreted against the drafter. However, the appellate court – comprised of a three-judge panel with one judge dissenting – disagreed and held that "direct" clearly meant "without deviation or interruption from an intermediary," such as pipeline owner Alinta. The appellate court's decision left Millennium without coverage for its loss.

BUSINESS COMMENTARY

This situation is recognized by Geoff Edwards, CEO at Bowers and Wilkins (B&W) – the British manufacturer of high-end audio equipment that maintains a complex international supply chain, with manufacturing in the UK and China:

"We spent a considerable period of time mapping our supply chain. Once we became aware of the potential issue of agents and secondary suppliers, using our broker, we were able to negotiate cover with insurers at no additional cost."

In an ideal world, Geoff says that a business interruption supply chain solution would perform as follows:

"We view business interruption as anything that can impact on our ability to trade. We work closely with our suppliers and take care to manage our risks. We would want protection against a catastrophic failure to supply that extends throughout our supply chain."

Finally, B&W once considered a bespoke supply chain policy with a non-delivery of product trigger. However, B&W chose not to purchase cover due to:

"The two key benefits were the wider policy cover including non-damage and the fact that cover was throughout the supply chain. The challenge for us at the time was in evaluating the cost benefit of a new product. As the market matures, this is an area we will re-visit."

RECOMMENDATIONS

The insurance industry recognizes that the provision of suppliers' extensions is, on its own, not a comprehensive solution to the severity of supply chain risks faced by a large number of organizations. More detailed information on supply chain risks is required before informed decisions on the need for alternative risk transfer can be made.

- Undertaking a thorough review of an organization's supply chain allows a clearer identification of exposures faced. Typically, supply chain risk has been treated as an operational risk, and the cost is swallowed in normal expenses. The quantification of potential loss through scenario work results in more informed decisions on whether the risk can still be managed, and whether alternative risk transfer solutions are value for money.
- Opportunities exist within traditional policies to design wider cover that provides greater limits for defined suppliers and extends cover to secondary suppliers of suppliers.
- The insurance industry is able to deliver new supply chain policies now and, as companies establish a clearer picture of exposures, such products will become more economically viable and will provide the depth of cover demanded by buyers.

CLAIMS SETTLEMENT

PD/BI insurance exists primarily to provide an effective risk transfer mechanism for companies, and the value, or otherwise, of the cover will inevitably be judged on its ability to respond in the event of a significant claim. It is widely acknowledged that the claims process, particularly with regard to PD/BI, can be lengthy, complex, and highly scrutinized.

Today, organizations operate in an interconnected global economy, and while the definition of what constitutes a successful claim will vary from event to event and business to business, the importance of clear communications, clarity around coverage, and prompt and predictable interim payments is universal.

The development of the global claims environment is well illustrated by the global loss data summarized in **FIGURE 5**, based upon information for natural catastrophe and "man made" events collected annually by Swiss Re.

While there is significant variance in annual values, annually adjusted totals continue to rise, yet the relative rise in insurance recoveries is materially slower.

This is primarily as a result of rapid growth in regions subject to higher natural catastrophe risks and a lag in the purchase of correlating insurance, particularly business interruption. In India, for example, while economic growth has outstripped the "developed world" over the past 20 years, the purchase of PD/BI insurance by Indian property clients is around as little as 20% (compared to more than 90% in the United Kingdom [Marsh figures]).

This reality presents a challenge for claims professionals managing larger losses in a greater diversity of scenarios and, with the rise in claim numbers and values, has come an increasingly sophisticated and detailed claims process. The complexity of significant business interruption claims can result in differences of opinion; however, while some do result in long-running disputes, many can be resolved through the early identification of concerns and clear communication between insurers' advisors and clients' experts.

Expectations in relation to the length of time required to settle PD/BI claims must be managed. It should be recognized that many PD/BI claims span a full indemnity period (and sometimes beyond), therefore a PD/BI claim may not be settled until the indemnity period expires.

FIGURE 5 | **GLOBAL TOTAL AND INSURED CATASTROPHE-RELATED LOSSES (1990-2014)**

Source: Swiss Re

TOTAL LOSSES
INSURED LOSSES
LINEAR TOTAL LOSSES
LINEAR INSURED LOSSES

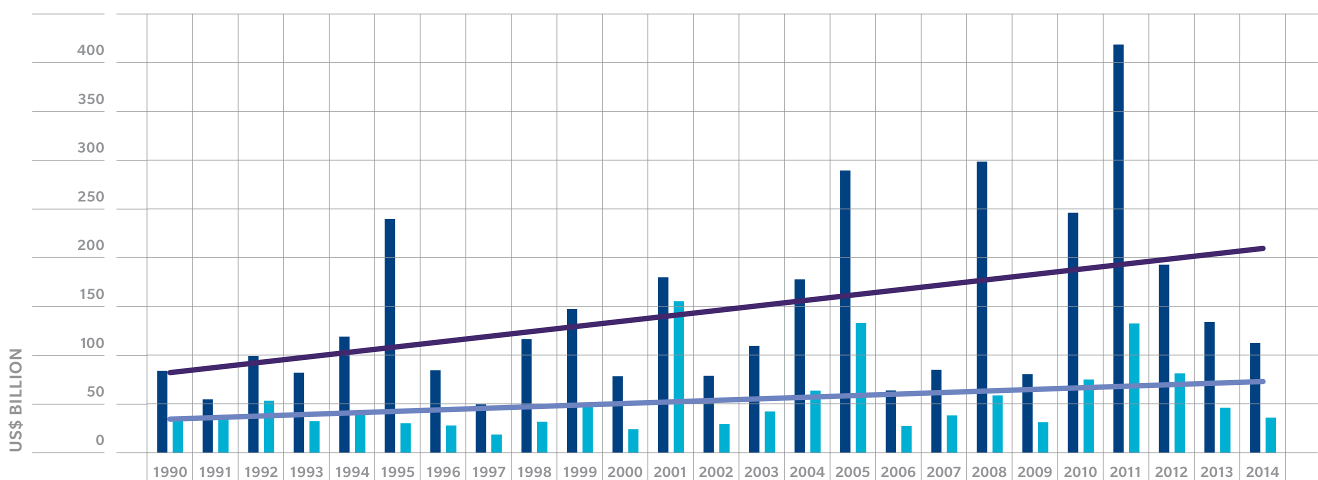
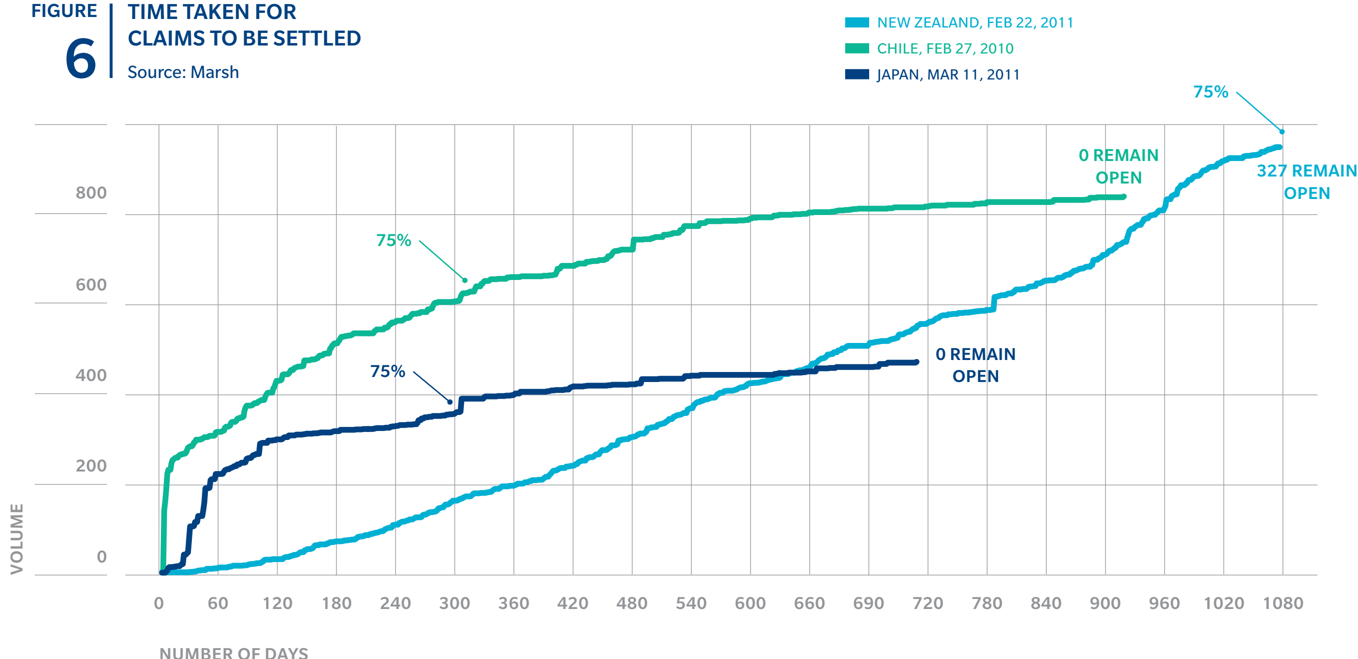


FIGURE 6 | TIME TAKEN FOR CLAIMS TO BE SETTLED

Source: Marsh



Settlement timelines will inevitably vary by country and by the type of event due to differing circumstances. As displayed in **FIGURE 6**, the majority of claims submitted after the Chilean earthquake on February 27, 2010, were closed within 12 months, and 18 months after the earthquake on March 11, 2011, in Japan. However, New Zealand continued to experience seismic activity following the February 22, 2011 earthquake, and, as such, property damage was more difficult to assess. In addition, the scale of the event in New Zealand was larger than the country's loss adjusting, engineering, and insurance industries were equipped to deal with, delaying the settlement of a significant percentage of claims.

Overall, the global insurance industry's response to catastrophic events is to be commended, with the most experienced claims teams traveling to support their local resources and providing real client service in what can be the most challenging of conditions. Disputes do, however, remain a reason for settlement delays. *The Financial Times* (July 20, 2014) reported on Mactavish's evidence to the Law Commission and HM treasury, which suggested that "45% of businesses strategically significant insurance claims are disputed by the insurer" – a statistic that does not reflect well on our industry.

It is essential to do as much pre-loss preparation as possible to avoid any surprises post-loss. All parties should be clear on loss exposures, loss quantification and methodologies, and what will be required in relation to supporting a claim for PD/BI. No one has a crystal ball, so the calculation of expected sales will always remain subjective, but a clear protocol, clear communication lines, a pre-agreed methodology, and a good understanding of exposures will help everyone's understanding of the PD/BI risk faced and will help the process run more smoothly. A proactive approach is always preferred to a reactive post-loss panic.

BUSINESS COMMENTARY

We spoke to Stephen MacPherson at Kelda Water in Aberdeen, Scotland, who provided insight into the claims process following a major loss. Stephen emphasized the importance of communications when managing the process, commenting:

"I learned that the process was very straightforward, as long as I was making sure that all stakeholders were being kept informed with updates and the opportunity to review and comment on plans. Treating everyone as a team really worked well."

Stephen also provided the following advice to organizations that have not suffered a loss such as his:

"My advice would be to embrace the process, keep as much detailed evidence as possible, and keep all stakeholders regularly updated."

SPOTLIGHT

LES DOMMAGES MATERIELS?

The case of **Manpower, Inc. v. Insurance Co. of Pennsylvania, 732 F.3d 796 (7th Cir. 2013)** illustrates the extent to which insureds and insurers are likely to have differing opinions of a loss suffered.

Right Management (RM), the French subsidiary of US staffing company Manpower, was a tenant in a mixed historical/modern office structure. In 2006, a collapse badly damaged the building's garage and courtyard. RM's private office space was undamaged, but the Parisian Department of Public Safety prohibited occupation of the entire building and continuously extended that prohibition. RM simply had to relocate its business without ever having regained access to its offices.

In the US lawsuit between Manpower and the insurer on the master difference in conditions policy, Manpower had difficulty in proving its BI loss. The arguments and conclusion are instructive for policyholders who will need to supply evidence in support of their claimed BI losses and the brokers and claims advocates who advise them. At one stage of the case, the court granted a motion by the insurer to exclude the testimony of Manpower's expert witness on BI. The court found that the expert had not used reliable methods in calculating the BI loss and, without that testimony, Manpower could not prove its claim.

The policy defined the loss as "net profit lost because of the BI" adjusted for continuing expenses (the gross earnings policy form uses net profit plus fixed costs to establish insurance gross profit), and further provided that "due consideration shall be given to the experience of the business before the date of damage or destruction and to the probable experience thereafter had no loss occurred." The aspect of the opinion that troubled the court was the expert's use of a growth rate of 7.76% to project total revenues, which the court viewed as not "representative of RM's historical performance" because RM had experienced a negative average annual growth rate for a span of years and a more modest 3% growth rate for a recent 18-month period. It also faulted the expert for taking into account management's statements that RM's recent acquisition by Manpower had brought new policies and personnel that sparked growth, and that management expected growth would continue. The appellate court found those criticisms of the expert too harsh, however, and reinstated Manpower's expert. The appellate court noted that although the expert's opinion was "not bulletproof," it was sufficiently reliable to be presented at trial, where the insurer's counsel could cross-examine the expert and seek to undermine his opinion in front of the jury.

The "experience of the business" consideration in calculating a BI loss has been the subject of debate and differing approaches, and will likely continue to evolve. For now, it is something to keep in mind for potential discussion with underwriters, particularly if there are new and/or fast-growing operations.

RECOMMENDATIONS

Consideration of both the risks at placement and the potential challenges of claims can mitigate the actual impact and reduce the potential for disputes impacting recovery.

- Reflective of recommendations made by the Chartered Institute of Loss Adjusters (CILA), insurers are increasingly willing to provide a pre-loss commitment to early and substantial interim payments.
- Production-based settlement (output alternative) can be an effective mechanism for multinational manufacturers concerned with calculating a loss at a single plant that could be overwhelmed by wider corporate results.
- Pre-loss business interruption reviews with in-depth scenario planning can not only ensure that sums insured and MIPs are accurate, but also provide a template for settlement in the event of an actual claim.
- A claims preparation clause within a policy will enable buyers to, with the help of experts, ensure that a claim is robust. The fees paid for such a service can then form part of the claim against insurers.

CONCLUSION

PD/BI insurance has demonstrated its importance by way of its longevity, but modern policies continue to adopt a structure that would have been familiar to underwriters in the middle of the last century. It is, however, time for the insurance industry to acknowledge the shortcomings of BI cover and build a better solution for buyers.

VALUES

Getting the values right is critical for all parties, and, while taking the time to calculate correct declarations is recommended, we are perhaps at a point where an alternative approach should be considered. Businesses are obliged to submit detailed annual accounts to legislative authorities, and an alternative underwriting approach based on published values would avoid many of the errors encountered.

INDEMNITY PERIOD

Indemnity periods can only be accurately set with detailed pre-loss work, and, while the open-ended US earnings approach should be commended, the limited post-reconstruction recovery periods are less than ideal. Two changes might be considered: firstly, the option to commence the calculation at either the date of the physical loss or damage, or at the time when the business begins to suffer a loss of revenue; and, secondly, the provision of an unlimited MIP underwritten on the basis of two years' exposure. This will enable insurers to be confident of maintaining premium levels, and will ease insurance buyers' concerns with regard to underestimating exposure.

WIDE AREA DAMAGE

The impact of a punitive application of the "but for" rule remains a threat to buyers in a wide area damage scenario that does not reflect well on the industry. We echo the comments in the 2012 CILA report that *"the market needs to develop a wording that is in line with its intentions and that goes further to meet policyholders' requirements and expectations."*

SUPPLY CHAIN

In many ways, the industry response to increasingly complex supply chain exposures has been commendable, with the development of non-damage policies and a small number of carriers providing cover for all, not just primary, suppliers. Full supply chain cover should, however, be the rule, not the exception, and providing non-damage options within the policy framework (at increased premium) provides an easier option than choosing a new policy.

CLAIMS

Finally, claims — the assertion in a 2014 AIRMIC (the UK association for risk and insurance management professionals) publication*, that "large claims are being contested far more than previously" should be a cause of real concern. Pre-loss claims scenario reviews will always be useful and agreed methodologies will help. The claims promises being offered in respect of early interim payments are welcomed; however, the universal applications of claims preparation clauses ensures that all policyholders can access professional claims preparation resources, and that claims are presented in a manner that allows for efficient and timely settlement.

This report is our contribution to the debate as we seek to improve existing solutions and reshape the industry to address insurance buyers' evolving needs. We have outlined improvements that we believe can and should be made; however, as we progress, the opportunity for a fundamental restructuring of BI policies is becoming clearer and the option of a single business interruption policy that responds to a range of primary covers may prove the overarching solution required.

* *The Efficacy of Business Insurance: Guidance for buyers on achieving greater coverage, contract and claims certainty*, London, July 2014.

DEFINITIONS

Average

If the sum insured is “subject to average” and that sum is less than the value of the subject matter of the insurance, then any claim that is agreed under the policy will be reduced proportionately to reflect the underinsurance.

Declaration-linked policy

At the start of each policy year the policyholder submits an estimate of the gross profit that it is anticipated will be generated during the financial year most close to the period of insurance. The premium at the start of the policy year will be charged on the basis of the estimated figure and will be subject to adjustment up or down at the end of the year. Insurers’ liability is (normally) the estimated gross profit plus a one-third uplift ($133.\dot{3}\%$) that is available in the event that the estimate was too low. There is no underinsurance average clause on declaration-linked policies.

Maximum foreseeable loss (MFL)

The worst loss that is likely to occur because of a single event.

Normal loss expectancy (NLE)

The likely loss as a result of a single event, taking into consideration that existing protection and prevention measures function as expected.

Additional increased cost of working (AICW)

A policy extension that allows recovery of reasonable additional expenditure to avoid or diminish any further reduction in turnover following a loss, even if the amount payable exceeds the savings made.

Gross revenue cover

Cover for gross revenue (or turnover), as opposed to gross profits.

Prevention of access

A policy extension that provides for a loss of profits as a result of the prevention of access to the premises.

Parametric trigger policy

A type of insurance that does not indemnify the pure loss, but agrees to make a payment upon the occurrence of a triggering event.

ABOUT MARSH'S BUSINESS INTERRUPTION CENTER OF EXCELLENCE

The Business Interruption Center of Excellence is a global Marsh project that strives to position Marsh as the advisor of choice in relation to business interruption (BI) risk. Our council of international thought leaders and our global colleague network are working to broaden the understanding of BI risk for all stakeholders, to develop wordings and policies better suited to policyholder needs, and to create solutions that we believe will reshape the industry's approach to BI.

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Notes

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