Insurance aspects of business interruption

Jeremy Lewis of AON examines the benefits that insurance can bring to the business continuity plan.

When considering the creation of a disaster recovery or business continuity plan (BCP) the natural tendency is to focus on the effects of the obvious 'catastrophe' risks: incidents of fire, flood, explosion, major theft or malicious damage.

The essential adjunct to such a narrowly focussed BCP is of course properly designed business interruption insurance. However, all of a company's activities and everything its directors or employees say or do can create balance sheet threatening risks. As the purpose of business continuity planning is to better safeguard the company's turnover or income, the job will be only half done if the whole gamut of risk is not reflected in the contingencies provided for.

Business continuity planning should be incorporated within the process of risk review: risk assessment, risk management, business continuity planning, and risk transfer/risk financing.

All of these should themselves be subject to continual review and refinement as activities, technology, the economy and legislation changes.

The object of this article is to consider how various forms of insurance can support and complement a BCP.

Objectives

The only purpose of risk assessment, risk management and risk transfer policies is to ensure as far as possible that a company or organisation can continue to trade after any 'catastrophe' event while minimising the impact on shareholder value, reputation or customer base.

A holistic risk assessment of 'worst case' events of any kind could identify a need for all or some of the following, assuming that 'obvious' insurance covers such as property damage, business interruption, public & products liability are already in place:

> Modern business interruption insurance makes the process of cover design almost foolproof

- product guarantee/recall;
- product contamination;
- crisis containment;
- environmental impairment liability; and
- professional indemnity.

While the risks protected by these more esoteric forms of insurance would not impair a company's physical capacity to trade, leaving factories or other facilities intact, it is just such intangible risks which can have the most serious repercussions, particularly on share price. The financial impact on Railtrack, for example, of Hatfield and other incidents of recent years has been far wider than the cost of repairing track and infrastructure.

An assessment of where insurance sits within the risk management process for a particular organisation must start, therefore, with the nature and activities of that organisation. The implications of a total loss by fire of a remote factory will not be the same as those generated by an incident in facilities to which the public has access (theatres, railways, sports arenas etc) when the incident is also the cause of injury or loss of life.

Asset risks

As suggested earlier the natural inclination in assessing risk is to start with the security of assets. For a high percentage of companies its physical assets or premises are either the means of generating income or are instrumental in its generation. Manufacturing industries are obviously dependent on their plant and equipment while service companies, such as City solicitors and other professional advisers, have operational dependence on IT equipment and the premises in which it is housed, those premises also having a PR benefit as the operation's public face.

Straightforward insurance of assets against their reinstatement, while important, will not however guarantee a company's survival if the client base or trading opportunity has been lost in the hiatus which follows a disaster (fire, terrorist bomb, natural catastrophe – the latter an increasing threat for certain parts of the UK in recent months).

It is in these circumstances that business interruption insurance, coupled with the recovery/emergency action identified in the BCP, can make the difference between success and failure of any contingency planning.

Modern business interruption insurance has evolved to make the process of cover design almost foolproof, even for complex risks. Whether one is insuring against loss of profit or loss of revenue cover is typically arranged on the basis of an ingoing estimated profit or revenue figure subject to provision of an actual profit or revenue declaration at the end of the insurance year. This ensures that the insurer is guaranteed the correct premium for the risk to which he was exposed while avoiding the feared application of the 'average' condition (the reduction of claim payments in proportion with any underinsurance). As a further plus, such policies will give a loss limit equivalent to 133.33% of the estimated profit or revenue figure to allow for unbudgeted upturns in business.

More bespoke designing of policies relates to the indemnity period insured (the period following insured damage over which the profit or revenue claim will be paid). It is in this area that business continuity planning and insurance must meet. Where the BCP has identified back-up facilities ('hot-start' technical sites, spare capacity in other premises, short delay plant and equipment suppliers) the indemnity period can be fixed with greater certainty of reflecting a realistic maximum period of interruption or downturn.

It is often forgotten that business interruption policies will not only pay for loss of profit/revenue. They will also reimburse any increased costs incurred to mitigate or avoid such loss. This is important in agreeing the key elements of a BCP. Costs incurred in implementing the plan following insured loss or damage (such as additional rents, overtime, outsourced services) will be met by the business interruption policy as long as they are in excess of normal costs and avoid an equal or greater loss of profit or revenue.

Where an organisation derives its income from activities at a large number of geographically widespread locations and therefore has only a proportion of its turnover at risk at any one location, policies subject to a loss limit may be more appropriate. A 'flexible limit of loss' allows the amount insured to be limited to something in excess of the maximum possible loss at the key location. The limit may then be used on any head of claim following a loss, profit, revenue, increased cost of working or even rent receivable.

In all cases policies should be worded to allow for claim payments to be made at monthly or other intervals, thus further alleviating the immediate impact of the trigger event.

Third party risks

If a BCP is sufficiently broad in its scope it will take account of the necessary responses to an incident's effect on other parties.

It is not only through the direct effect on the business that the type of property damage discussed above may damage a company. If the major fire occurs in a building in a predominantly commercial area, the City of London being a good example, any liability for damage to adjacent property could have significant financial consequences if not adequately insured. Neighbouring businesses and their insurers have a possible right of action against any party at fault in allowing their premises to be the seat of a fire.

> Product defects may be a 'killer risk' and the BCP should set out detailed action if there is a trigger event

While this sort of 'collateral damage' has a low order of probability its effects cannot effectively be catered for in a BCP. Insurance of the risk up to a limit equal to the worst case is the only option.

Risks to both balance sheet and reputation reside in many manufactured products. Risk assessments may have identified product defects as a possible 'killer risk' (the cost to Perrier of the benzene contamination debacle was estimated at between £40-£85m) and the BCP should have detailed action to be taken following notification of a relevant trigger event (consumer injury or death, maliciously or accidentally contaminated food or drink products, hazardous faults in electrical goods). Much of the financial pain can be removed or alleviated if appropriate insurance has been bought. Products liability, product guarantee, product recall and product tamper insurances should all be considered in the design of an insurance programme as a support to the BCP response.

The most damaging case for a manufacturer is public knowledge of a defective product or simply a defective batch of a product. It can lead to the disappearance of even established branded products through loss of public confidence. In any event, the General Product Safety Regulations of 1994 require producers to take appropriate action including the recall of a product if there is a risk to consumers. Using the specialist crisis management services of a product recall insurer will allow a swift reaction to the need to recall all or a batch of a product with the insurance also paying for recall related expenses (transportation, warehousing, product disposal, cost of replacing the recalled product, redistribution costs and even the cost of replacing a recalled product with a different product of similar value).

In this example a significant element of the crisis response can be 'sub-contracted', allowing management the time to coordinate press and other comment and maintain the routine running of the organisation.

In service, consulting or advisory firms the third party risk is the major threat to the business. Business continuity planning in those cases should focus heavily on the response to an alleged error or omission in work done for a client. That response will almost invariably be immediate reporting to a professional indemnity insurer. In solicitors, accountants and architects practices and in similar organisations there is both an operational and client driven, as well as regulatory, requirement to carry adequate professional indemnity insurance.

Ancillary benefits of insurance

The clear benefit of insuring the 'killer risks' is, of course, the payment of claims. Insurance, however, also brings other benefits which are of considerable value in the aftermath of a catastrophe and which are not available in the absence of insurance or where risks are self-insured or funded.

Insurance premiums, besides creating an insurer's contractual obligation to pay valid claims, pay also for the services of loss adjusters, forensic accountants and solicitors, depending on the type of insurance affected (property damage, business interruption or liability). The involvement of these professionals at a time of crisis, while avoiding direct expense for the insured organisation, saves significant amounts of management time and effort which can be better directed towards the business itself.

This is an important consideration. However well BCPs have responded and however completely insurance meets the financial consequences of an incident the additional commitment of management time and effort can never be fully recovered.

Hopefully, these few examples show how appropriate insurance solutions can both complement and reinforce a BCP. To provide an exhaustive list of all possible insurance applications would be outside the scope of this article. ■

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