

# Scope of B.I. Coverage

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# LENGTH OF INDEMNITY PERIOD

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In the event of severe damage, the indemnity period should be sufficient for the following:-

- Structural investigation of building
- Removal of debris
- Preparation of plans and drawings
- Obtaining planning permission
- Inviting tenders from contractors
- Review of tenders and awarding contract
- Construction work
- Ordering, fabrication, installation and commissioning of plant and equipment
- Regaining lost customers

# AVERAGE

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The policy is subject to the following wording:-

“Provided that if the amount of the indemnity by this item be less then the sum produced by applying the rate of gross profit to the annual turnover (or to a proportionately increased multiple thereof where the maximum indemnity period exceeds 12 months) the amount payable shall be proportionately reduced”

Now consider a company which had an annual gross profit of S\$1 million for the financial year ending 31 December 2001. The policy is renewed on 1 January 2002 with a 24 months indemnity period.

If there is no trend, the sum insured needs to be S\$2 million. However the position is much more complicated if the trend of the business is upwards. If the business has for example a 10% trend the gross profit can be projected as follows:-

2002	S\$1,100,000.00
2003	S\$1,210,000.00
2004	S\$1,331,000.00

What should the sum insured be for the current policy?

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Considering that a loss could occur on the 30 December 2002, the interruption period would then be 2003 and 2004 during which the prospective Gross Profit is S\$2,541,000.00 (S\$1,210,000.00 + S\$1,331,000.00).

Because of difficulties in estimating the future trend of the business, the policy can be arranged so that it has a return of premium clause. This would enable the client to base the sum insured on the high end of their projections for trend with the security of knowing that the trend is less than expected, the additional premium can be returned.

# Departmental clause

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## Definition:-

“If the business is conducted in departments, the independent trading results of which are ascertainable, the provisions of the basis of cover in respect of any item on gross profit will apply separately to each department affected by the damage, except that if the sum insured by any item of gross profit is less than the aggregate of the sums produced by applying the rate of gross profit for each department of the business (whether affected by the damage or not) to the relative annual turnover (or to a proportionately increased multiple thereof where the maximum indemnity period exceeds 12 months), the amount payable will be proportionately reduced.”

# Accumulated stocks clause

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## Definition:-

“In adjusting any loss, account will be taken and an equitable allowance made if any shortage in turnover resulting from the damage is postponed due to the turnover being temporarily maintained from accumulated stocks of finished goods in any warehouse or depot.”

# Accumulated stocks clause

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## Key features:-

- **Indemnity period starts with damage**
- **Allowance is made at end of maximum indemnity period, if necessary, if either:**
  1. Policyholders stock still reduced
  2. Interruption continues but has been mitigated by use of stock.



# Alternative trading clause

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## Definition:-

“If during the indemnity period, goods are sold, work is done or services are rendered elsewhere than at the premises for the benefit of the business either by the Insured or by others on their behalf, the money paid or payable in respect of such sales or services will be brought into account in arriving at the turnover during the indemnity period.”

# Alternative trading clause

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- **Relevant case law**
  - City Tailors v Evans (a Lloyd's underwriter) 1921.
- **Deals with the situation where one branch sees an improvement if another is out of action**
  - e.g. retailers when nearby branch to damaged location takes up customer trade
  - e.g. manufacturers able to complete orders from other factory in group

# Salvage sale clause

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## Definition:-

“If following damage giving rise to a claim under this section, the Insured hold a salvage sale during the indemnity period the proceeds of the sale will be taken into account in calculating the reduction in turnover.”

# Salvage sale clause

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## Key points:-

- It is vital to record the achieved turnover and cost of goods sold during the sale from the outset.
- The salvage sale turnover is deducted from turnover achieved in the indemnity period.
- This has the effect of increasing loss of turnover and thus loss of gross profit
- Any profit achieved in the sale is then deducted from the loss of gross profit.

# Principles of Business Interruption Insurance

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# Accounts refresher -What is a P & L account?

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- Record of the business activity
- Over a certain period
- Usually a year – not necessarily
- Record of turnover (not receipts) in period
- Record of cost (not expenditure) in period
- Indication of profit or loss in the period
- Adjusted to time period

# Accounts refresher

## Constituents of a P & L account

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- **1 – Turnover**

- also known as (aka) “sales”, “income”, “revenue”
- nb. Becomes turnover at moment of sale, not receipt of cash

- **2 – Cost of sales**

- aka “cost of goods sold”, “direct costs”, “manufacturing costs”, “VARIABLE costs”

- **3 – Gross profit (1 minus 2)**

- aka “contribution”, “margin”, “profit on manufacture”

- **4 – Overheads**

- aka “fixed costs”

- **5 – Net profit (3 minus 4)**

## Accounts refresher calculation of rate -of gross profit

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- A key equation number 1:-

$$\text{Turnover} - \text{Cost of Goods Sold} = \text{Gross profit}$$

- A key equation number 2:-

$$\text{Rate of Gross Profit} = (\text{gross profit/turnover}) \times 100$$

Note – See policy for specific definition in each case



# Methods of calculating gross profit - one

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<b>sales</b>			240,000
(or turnover)			
<b>cost of sales</b>	opening stock	16,000	
(or cost of goods sold)	plus opening work in progress	3,000	
	plus purchases	120,000	
	plus wages	50,000 <sup>0</sup>	
	less closing stock	-20,000	
	less closing work in progress	<u>-5,000</u>	<u>-164,000</u>
<b>gross profit</b>			76,000

# Methods of calculating gross profit - two

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<b>sales</b>			240,000
(or “turnover”)			
<b>cost of sales</b>	opening stock	16,000	
(or “cost of goods sold”)	plus opening work in progress	3,000	
	plus purchases	120,000	
		0	
	less closing stock	-20,000	
	less closing work in progress	<u>-5,000</u>	<u>-114,000</u>
<b>gross profit</b>			126,000

# Methods of calculating gross profit - three

<b>sales</b>			240,000	
(or “turnover”)				
<b>cost of sales</b>	opening stock	16,000		
(or “cost of goods sold”)	opening work in progress	3,000		
	plus purchases	120,000		
	plus wages	50,000		
	plus factory rent, rates, & services	20,000		
	plus factory power, heat, light	5,000		
	delivery	6,000		
	plus factory repairs and renewals	1,000		
	less closing stock	-20,000		
	less closing work in progress	<u>-5,000</u>		
<b>gross profit</b>			<u>196,000</u>	-
			22,000	
			<u>44,000</u>	

# Calculation of rate of gross profit for BI Policy

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- **The policy formula:-**

**Turnover** (plus closing stock and work in progress)

—

**Uninsured Working Expenses** (plus opening stock &  
opening work in progress)

=

Gross Profit

**Rate of Gross profit = (gross profit/turnover) x 100**

Note – See policy for specific definition in each case

# Uninsured Working Expenses

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1. All Purchases (less discounts received)
2. Carriage, packing and freight
3. Bad debts
4. Others as specified

N.B.2 The words and expressions used in this definition shall have the meaning usually attached to them in the books and the accounts of the insured.

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## Accounts for last financial year preceding fire

Purchases	S\$ 480,000	Turnover	S\$1,200,000
			0
Wages	S\$ 432,000		
Overhead	S\$ 200,000 ) Rate of gross		
S			
Net profit	<u>S\$ 88,000</u> ) profit 24%		
	<u>S\$ 1,200,000</u>		<u>S\$1,200,000</u>
			<u>0</u>

## Accounts for 12 months during which a 50% reduction in sales has resulted from the fire

Purchases	S\$240,000	Turnover	S\$600,000
Wages	S\$216,000	CL Claim	
Overheads	S\$200,000	R.G.P. X Reduction in turnover	
Net profit	<u>S\$ 88,000</u>	(24% x 600,000)	<u>S\$144,000</u>
	<u>S\$744,000</u>		<u>S\$744,000</u>

Reduction in Turnover – S\$500,000 x R.O.G.P. 24%	S\$120,000.00
<u>Add</u> : Increase in Cost of Working	<u>20,000.00</u>
	S\$140,000.00
<u>Less</u> : Savings in overheads	<u>10,000.00</u>
Adjusted Loss	<u>S\$130,000.00</u>

**The accounts for the year of the interruption would then be as follows:-**

Purchases	S\$280,000	Sales	S\$700,000
Wages	S\$252,000	Consequential loss claim	S\$130,000
Overheads	S\$190,000		
Additional expenditure	S\$20,000		
Net Profit	<u>S\$88,000</u>		
	<u>S\$830,000</u>		<u>S\$830,000</u>



# **Emirates Insurance Association**

## **Seminar**

### **Catastrophe Response Planning and Loss Control**

**(Pre-loss and post-loss activity)**

**20th April 2006**

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## A Truism:

The Material Damage and Business Interruption aspects of any commercial claim are closely inter-related and ideally should not be addressed in isolation.

# Contents:

1. Advance Planning
2. Catastrophe Response
3. Conclusions and Lessons to be Learned

# Advance Planning:

## Exposure of risk portfolio to catastrophe

Over the past 10 years or so the industry has experienced the three most Expensive natural disasters of their type:

- The Kobe earthquake in 1995
- The South Asian Tsunami in 2004
- Hurricane Katrina in 2005

Other high profile examples in the last 18 months include:

- Hurricane Ivan
- Mumbai floods in India

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# Advance Planning:

## Policy Cover

### The basics:

- Catastrophe modeling
- Regular communication and consultation with:
  - Risk managers of multinational Insureds
  - Brokers
  - Cedants
- Reinsurance arrangements in place
- Claims control criteria agreed
- Policy wordings in place – both local and master policies
- Policy wordings distributed to nominated providers
- Funding and routing of interim payments and settlements agreed

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# Advance Planning:

## Liaison with local co-insurers & cedants

- Review and, if appropriate, revise their contingency plans
- Ascertain staffing resources and experience with catastrophes
- Obtain copies of local wordings
- Identify their existing loss adjusters and other service providers
- Agree method of funding payments on account and settlements having due regard to local fiscal regulations

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# Advance Planning:

## Regional and environmental demands

- Factors that could hinder investigation and reinstatement, delaying business recovery
- Accessibility of the risk
- Regional availability of labour and construction materials
- What suitably qualified and experienced local adjusters and/or alternative service providers are available?
- Need to consider contingency measures to mitigate such difficulties

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# Advance Planning:

## Selection and requirements of nominated Loss Adjusters

### Criteria:

- Regional and global resources available and committed in event of Catastrophe
- Size and experience of Cat team
- Nominated senior personnel
- Emergency contact details
- Claims handling protocols
- IT support and communication technology
- Reporting requirements and thresholds for short format reports
- Formal Catastrophe Plan presented and in place

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# Advance Planning:

## Loss Adjusters

### Key considerations:

- Network resources
- Team selection
- Team structure
- Phased response planning
- Team experience – quality vs. quantity
- Regional demands
- Continuity of business at home

# Catastrophe Response:

## Communication, Transparency and Trust

From the outset there should be well defined lines of communication between  
The various parties in the risk transfer process.

These include:

- Reinsurers
- Global Insurer
- Local Insurer
- Brokers
- Insured
- Loss adjuster

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# Catastrophe Response:

## The Material Damage / Business Interruption Dynamic

The Material Damage and Business Interruption aspects of any commercial claim are closely interrelated:

- Inefficient handling of a Material Damage claim often results in higher Business Interruption losses.
- Conflict of interest may arise where the two elements are covered by different insurers and/or handled by different adjusters.
- It is essential to seek co-operation at an early stage.

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# Catastrophe Response:

## The Insurer

### Claim management and handling:

- Prompt mobilization of adjusters from panel according to:
  - Geographic criteria
  - Resourcing and ability to respond
- Early response to policy issues arising and confirmation of policy liability where possible.

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# Catastrophe Response:

## Payments on Account

Funding by payments on account:

- establishes cooperative relationship with policyholder
- promotes recovery
- minimize Business Interruption

Flexibility:

- the MD / BI dynamic
- openness to pragmatic solutions

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# Catastrophe Response:

## The Loss Adjuster

### Immediate Response:

- Implementation of phased response
- Immediate deployment of primary response teams
- Preliminary assessment
- Deployment of secondary Cat teams as required
- Establishment of local infrastructure, telecommunications and IT systems

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# Catastrophe Response:

## Immediate Goals

### Stabilisation:

- Detailed survey and record of damage sustained
- Photographic and/or video records of damage
- Policyholder trust and co-operation
- Clear guidance and agreement on future action plan

### Collation of Financial data:

- Preliminary assessment
- Reserving
- Tactical & strategic review

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# Catastrophe Response:

## Other Specific Goals

### Claim management structure:

- Established lines of communication
- Nomination by Insured of individual(s) responsible for internal management of MD and BI aspects

### Proactive claim management and control:

- Active assistance in claim collation and presentation
- Identification of contractors and suppliers
- Clear timetable for remedial activities



# Catastrophe Response:

## The Bigger Picture

- Experience and Flexibility:
  - The MD / BI dynamic
  - Identification and recommendation of alternative or pragmatic solutions
- Team morale

# Catastrophe Response:

Catastrophe response is a team game from Day One

Best case

The team pulls together leading to swift recovery, minimised Business Interruption exposure and a satisfied Policyholder –

- *Victory in normal time*

Worst case

Poor communication and discord leads to delays in reinstatement, higher remedial costs and increased Business Interruption losses –

- *No result after extra time.....*

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# ***Penalties!***

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**Ian A Watt  
20th April 2006**

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