

Property & Business Interruption - Underwriting & Claims

March 6, 2019

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Jubilee General Insurance



- Hina is a fine young lady, at school she excelled in academics as well as extra curricular activities. She was a fine debater and had won numerous debate competitions.

Which if these statements about Hina is more probable.

- A) Hina is a bank teller
- B) Hina is a bank teller and a human rights activist.



Main Goal Of This Session

To understand:

“The Principles of Business Interruption Underwriting”

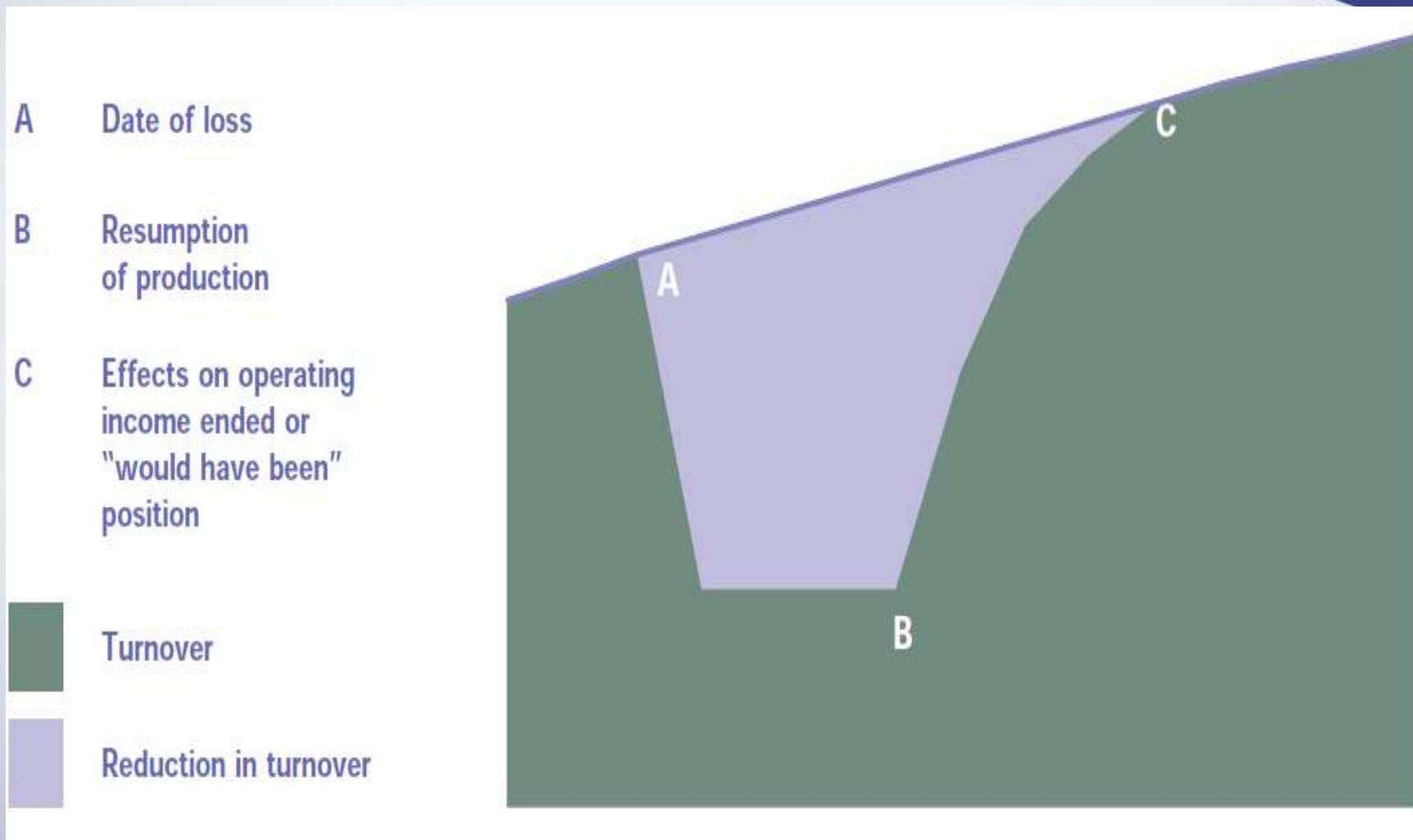


Effects Of A Fire On A Business





Effects Of A Fire On A Business





What Can Business Interruption Do Against These Effects?

- Pay Bills To Maintain Business (Rent, Rates, Interest Payable, Insurance, Etc.)
- Meet The Cost Of Remaining Employees
- Notice And Redundancy Payments
- Increasing Costs Or Extra Costs (Subject To An Economic Limit)
- Restore The Net (Trading) Profit



Purpose Of Business Interruption Insurance

The Purpose Of **Business Interruption Insurance** Is To Indemnify The Insured Against The Effect Which Damage To Property Has On The Income Of The Business.



Subject Matter Of Business Interruption Insurance

TURNOVER

GROSS PROFIT



Subject Matter Of Business Interruption Insurance (Contd..)

Gross Profit refers to that part of the insured's turnover which is at risk following destruction or damage at the insured's premises (excluding variable costs)



Subject Matter Of Business Interruption Insurance (Contd..)

2 Ways of Arriving at The Gross Profit

Listing The Insurable Amounts From The Accounts (“Additions Method”)

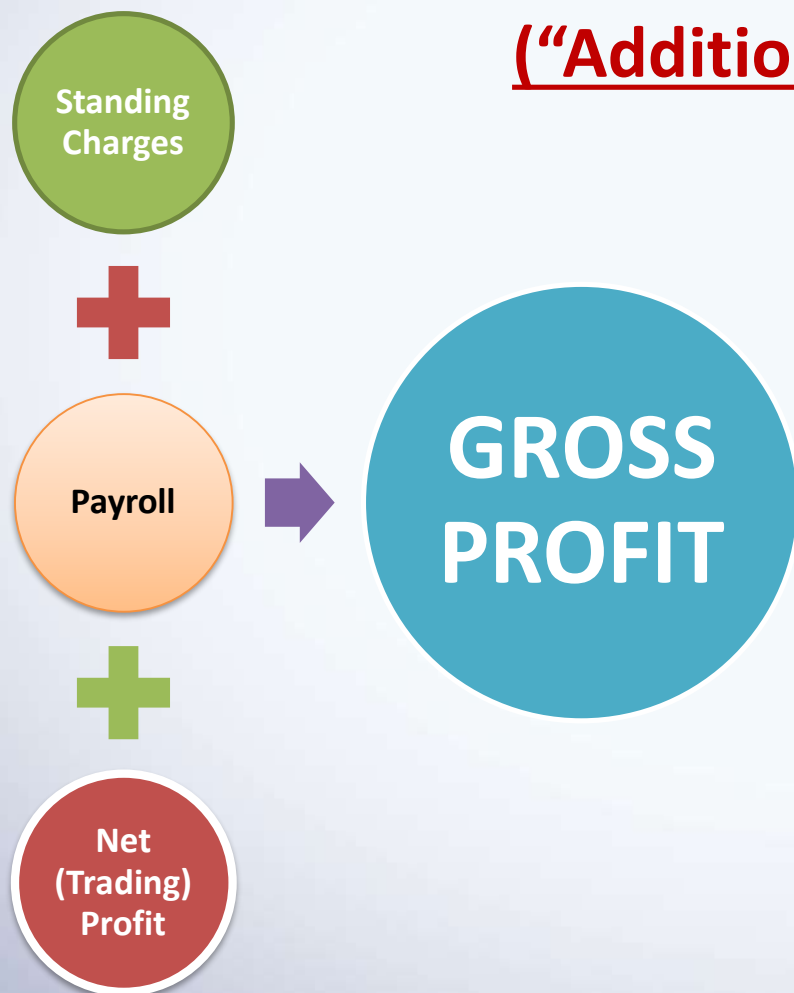
OR

Turnover – Non Insured Items (as e.g. variables)
 (“Difference Method”)



Subject Matter Of Business Interruption Insurance (Contd..)

("Additions Method")



Note:

The items to be covered have to be listed in the policy and the amounts have to be totaled from the Accounts which requires a constant check on the items included.



Subject Matter Of Business Interruption Insurance (Contd..)

("Difference Method")



Gross Profit is understood to be the amount of turnover less the amount of the directly variable expenses

OR

The amount by which the sum of the turnover and the value of the closing stock shall exceed the value of the opening stock and the specified working expenses



Subject Matter Of Business Interruption Insurance (Contd..)

Example

Company A is showing the following figures in their accounts for the financial year ending 31 December 2018:

Opening Stock	Rs. 1,500,000/-
Work in Progress	Rs. 4,500,000/-
Raw Materials	Rs. 4,000,000/-
Package / Carriage	Rs. 2,000,000/-
Payroll	Rs. 6,000,000/-
Standing Charges	Rs. 5,000,000/-
Net Profit	Rs. 3,000,000/-
	Rs. 26,000,000/-

Turnover	Rs. 23,500,000/-
Closing Stock / Work in Progress	Rs. 2,500,000/-

Can you calculate the basis for the Gross Profit of Company A using Additions & Difference methods?



Subject Matter Of Business Interruption Insurance (Contd..)

ADDITIONS METHOD

Payroll	
Standing Charges	
Net Profit	
GROSS PROFIT	

DIFFERENCE METHOD

Turnover	
+ Closing Stock / Work in Progress	
- Opening Stock / Work in Progress	
- Variable Expenses	
GROSS PROFIT	

Remember – The Cover provided by the policy is known as Gross Profit



Subject Matter Of Business Interruption Insurance (Contd..)

ADDITIONS METHOD

Payroll	Rs. 6,000,000/-
Standing Charges	Rs. 5,000,000/-
Net Profit	Rs. 3,000,000/-
GROSS PROFIT	Rs. 14,000,000/-

DIFFERENCE METHOD

Turnover	Rs. 23,500,000/-
+ Closing Stock / Work in Progress	Rs. 2,500,000/-
- Opening Stock / Work in Progress	(Rs. 6,000,000/-)
- Variable Expenses	(Rs. 6,000,000/-)
GROSS PROFIT	Rs. 14,000,000/-

Remember – The Cover provided by the policy is known as Gross Profit



Subject Matter Of Business Interruption Insurance (Contd..)

How Does a BI Policy Look Like?

- Standard Fire Policy (BI) or Standard 'All Risks' Policy (BI)
- Specification
- Schedule
- If Applicable: Premium Adjustment Clauses, any Special Clauses or other Extension Wordings



Meaning of the Sum Insured in Business Interruption Insurance

The Total Sum Insured is ...

- maximum liability
- basis for premium calculation (as in property!)

Setting the sum insured is the responsibility of the insured!

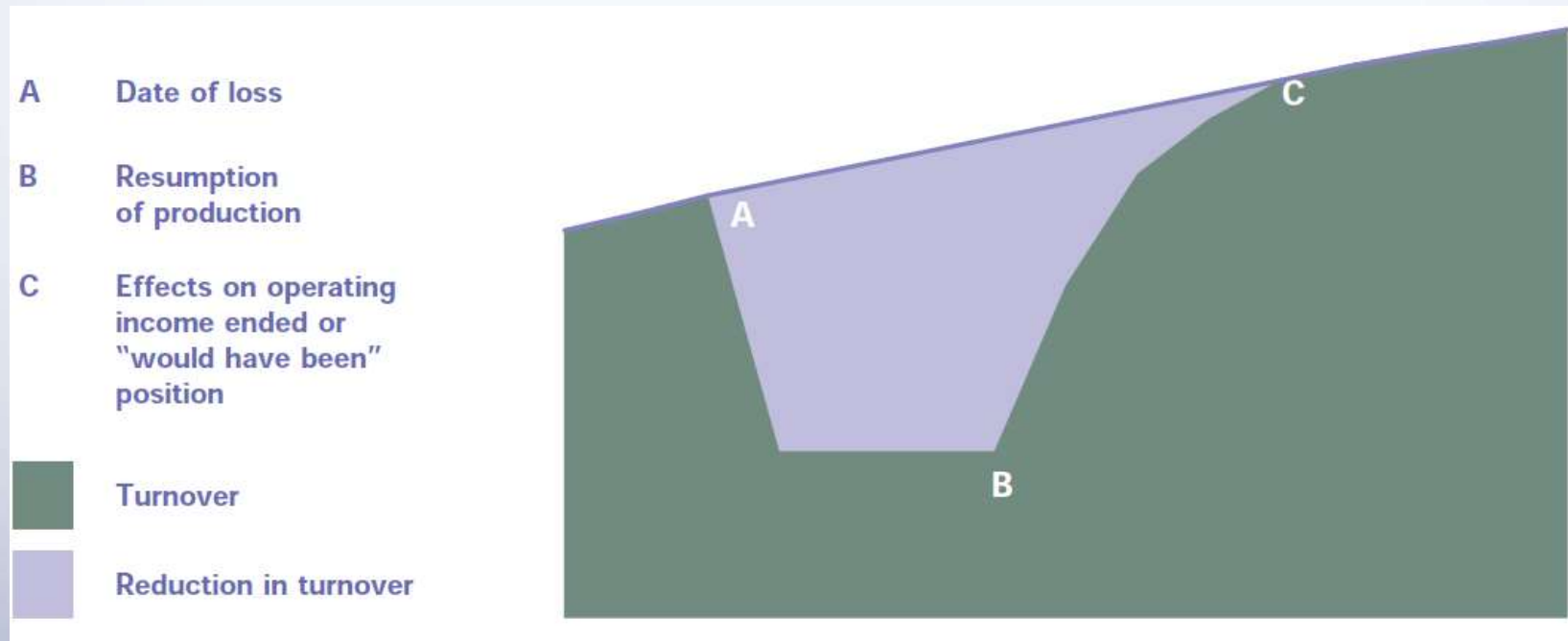
If the TSI stipulated in the policy is too low, the insured will receive less than full settlement of the claim!



Meaning of the Sum Insured in Business Interruption Insurance (Contd..)

The TSI must not only cover

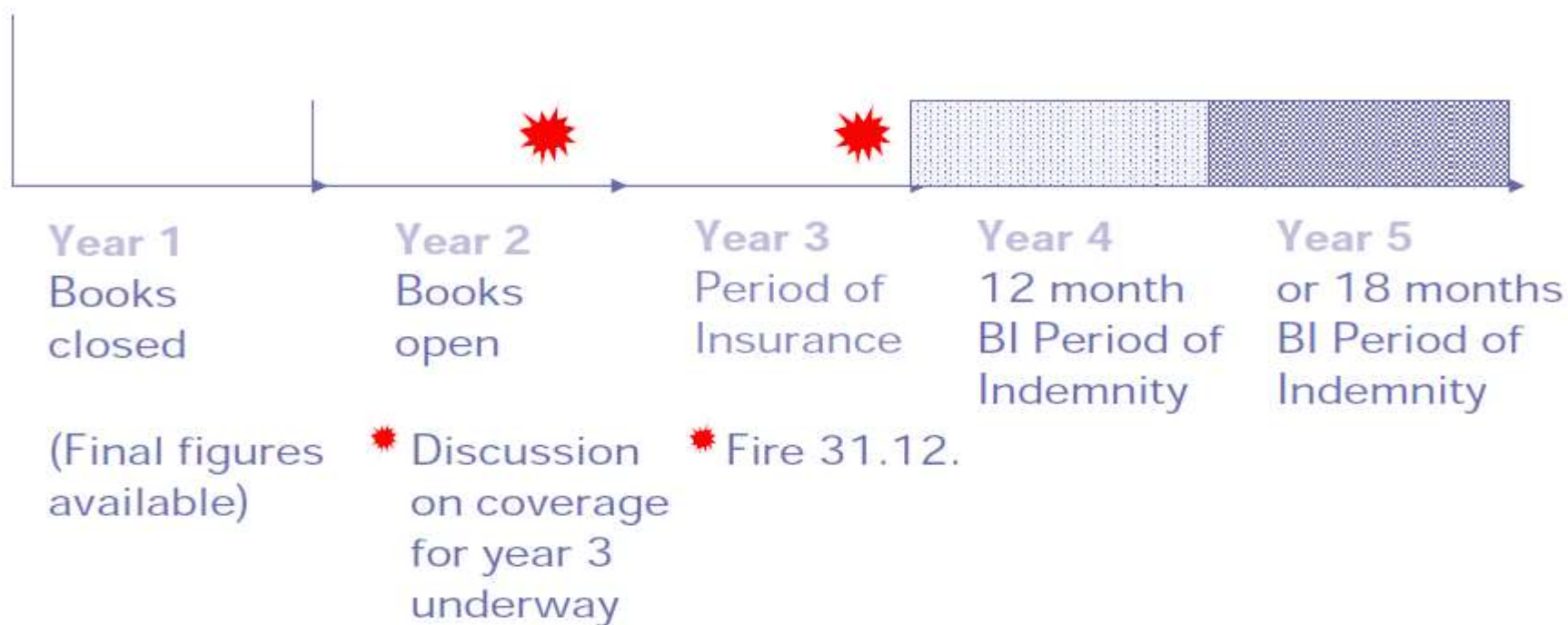
- the expected Gross Profit for the period of insurance but the Gross Profit until the turnover has reached the level at which it would have been had the incident not occurred.
- Otherwise the Insured might face a gap in insurance coverage!





Setting the Sum Insured in Business Interruption Insurance (Projection)

TSI Is Based On Past Figures, But Must Be Valid Into The Future





Setting the Sum Insured in Business Interruption Insurance (Projection)... Contd.

The insured must take the following factors into consideration for the evaluation of the sum insured:

- General rate of inflation (or deflation)
- Past performance of the business
- Plans for future expansion (or contraction) - incl. some “non-quantifiable” factors such as competitor’s behaviour
- Maximum period the company needs to recover in case of a loss



Setting the Sum Insured in Business Interruption Insurance (Projection)... Contd.

What are the adjusted Gross Profit figures of **Company A** in the years listed below?

Gross Profit 2018	
Plus 10% Trend in 2019 incl. Inflation	
Plus 10% Trend in 2020 incl. Inflation	
Plus 10% Trend in 2021 incl. Inflation	



Setting the Sum Insured in Business Interruption Insurance (Projection)... Contd.

What are the adjusted Gross Profit figures of **Company A** in the years listed below?

Gross Profit 2018	Rs. 14,000,000/-
Plus 10% Trend in 2019 incl. Inflation	Rs. 15,400,000/-
Plus 10% Trend in 2020 incl. Inflation	Rs. 16,940,000/-
Plus 10% Trend in 2021 incl. Inflation	Rs. 18,634,000/-

EXPECT
ED
GROSS
PROFIT
2021



Setting the Sum Insured in Business Interruption Insurance (Premium Adjustment)

What happens if the insured's projection did not materialize and he paid much more premium than actually needed ??

Does he have the right to claim a return premium?

... and ...

How can underinsurance be avoided?



Sum Insured For BI In The Policy

2 Ways To Agree On BI Sum Insured

Sum Insured Basis (“Provisional Premium”)

OR

Linked Basis (“Declaration”)



Sum Insured For BI In The Policy (Contd..)

Sum Insured Basis (“Provisional Premium”)

- Insured agrees on a TSI in excess (“buffer”) of the assessed amount for the period of insurance
- 75% provisional premium is paid at inception
- Insured supplies details on Gross Profit actually earned in the year of insurance when accounts are available
- Final premium is calculated and insured pays difference or receives a refund (usually maximum 1/3 of the 75% provisional premium paid)



Sum Insured For BI In The Policy (Contd..)

Linked Basis (“Declaration”)

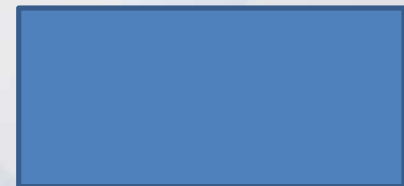
- Insured provides an estimate of Gross Profit for the period of insurance
 - Insurer provides cover for this amount plus one third, i.e. up to 133.33% of estimate
 - Premium is paid on the estimated TSI, and adjustments are made as above
- ... but most important ...
- Average does not apply up to the 133.3% Limit, all losses to be paid in full up to this amount



Sum Insured For BI In The Policy (Contd..)

Company A – What Would Be The Sum Insured/Limit Of Indemnity Based On The “Provisional Premium” Method And On The “Declaration-Linked Basis” Method?

Gross Profit 2018	Rs. 14,000,000/-
Plus 10% Trend in 2019 incl. Inflation	Rs. 15,400,000/-
Plus 10% Trend in 2020 incl. Inflation	Rs. 16,940,000/-
Plus 10% Trend in 2021 incl. Inflation	Rs. 18,634,000/-





Sum Insured For BI In The Policy (Contd..)

Company A – What Would Be The Sum Insured/Limit Of Indemnity Based On The “Provisional Premium” Method And On The “Declaration-Linked Basis” Method?

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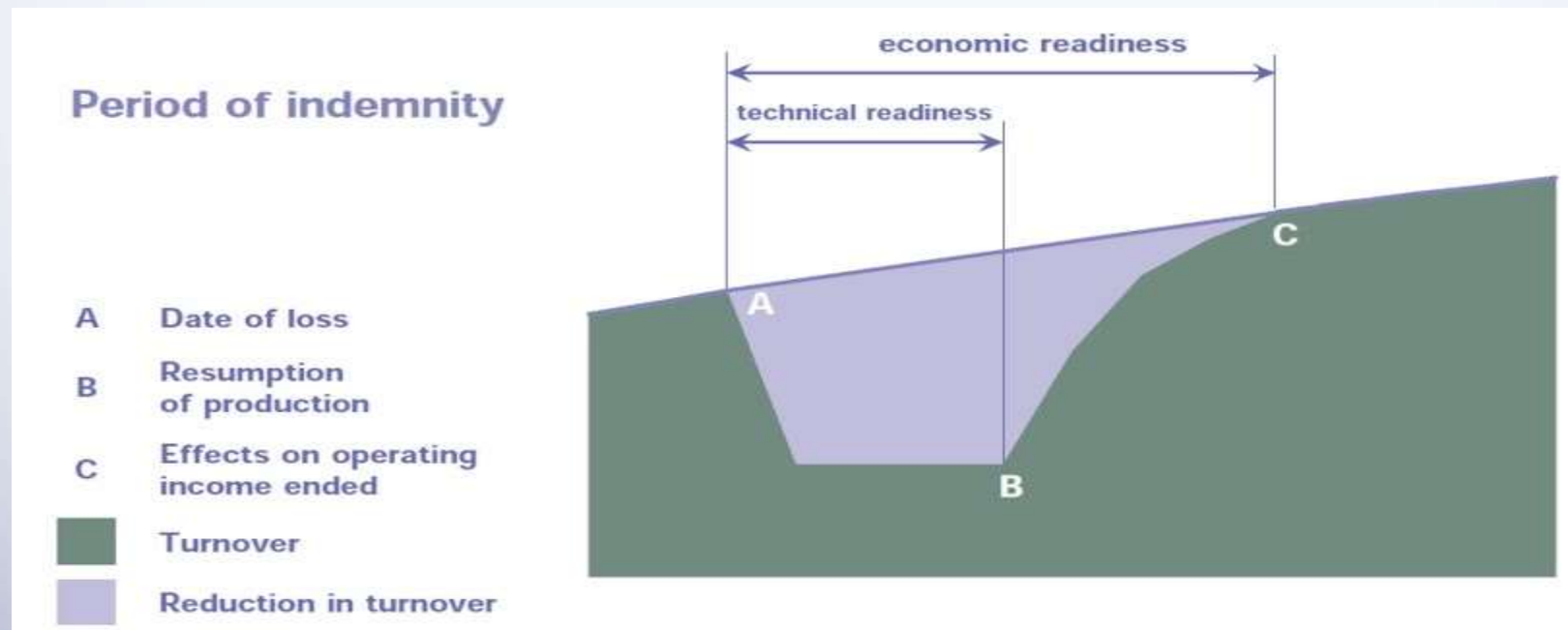
Rs.
21,000,000/-

Rs. 18,634,000/-
LoL @ 133.33% =
Rs. 24,845,300



Indemnity Period / Maximum Indemnity Period

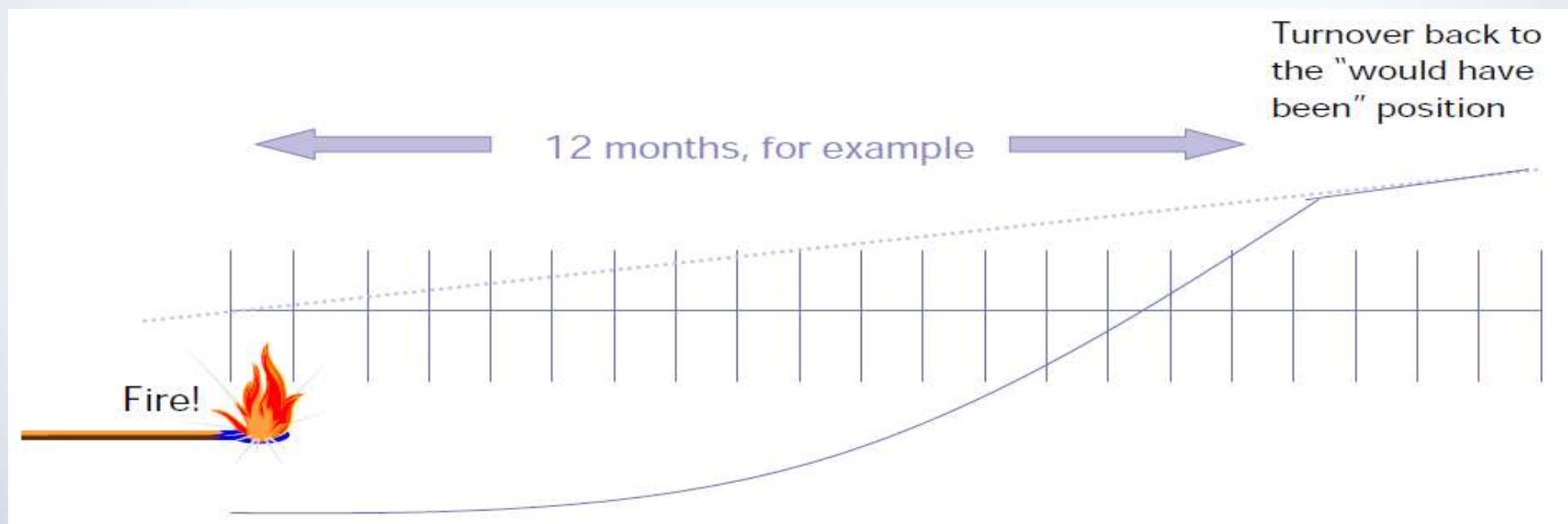
- The period beginning with the occurrence of the incident and ending not later than the Maximum Indemnity Period thereafter during which the results of the business shall be affected.
- The **Maximum Indemnity Period** (number of months) is stated in the specification of the policy, the usual minimum being 12 months.





Indemnity Period / Maximum Indemnity Period (Contd..)

Indemnity Period begins on the date of the insured physical damage causing the interruption ...



... and continues until Turnover has reached the level it would have been had no damage occurred (or until indemnity period expires)!



Indemnity Period / Maximum Indemnity Period (Contd..)

Function:

- The Maximum Indemnity Period is the maximum cover under the policy
- Note! Cover does not cease when the buildings are restored and production has begun anew, but when turnover has reached the level it would have been (had the loss not occurred).
- The business interruption premium rate usually varies according to the length of the indemnity period chosen



Indemnity Period / Maximum Indemnity Period (Contd..)

Factors Influencing The Stipulation Of The Maximum Indemnity Period





Indemnity Period / Maximum Indemnity Period (Contd..)

The Sum Insured Has To Be Adjusted Proportionally As Soon As The Maximum Indemnity Period Has Been Stipulated:

COMPANY A:	
Sum Insured On The "Declaration-Linked Basis" For The Period Of Insurance 2020 (Indemnity Period 12 months / 100%)	Rs. 16,940,000/-
Indemnity Period 06 months (100%)	Rs. 16,940,000/-
Indemnity Period 18 months (150%)	Rs. 25,410,000/-
Indemnity Period 24 months (200%)	Rs. 33,880,000/-

The Indemnity Of The Insurer Will Be Limited Either By The Sum Insured Stipulated In The Policy And Evaluated As Set Out Beforehand Or By The Time Agreed To Represent The Maximum Indemnity Period.



Rate of Gross Profit (RGP) – BI Indemnification

- The rate is the key to BI insurance.
- It determines how the loss of gross profit due to reduction in turnover is calculated.
- Formula for calculation the Rate of Gross Profit (RGP) =

$$\frac{\text{Gross Profit (most recent financial year)} \times 100}{\text{Turnover (most recent financial year)}} = x \%$$

RGP 2018 for Company A - 60%

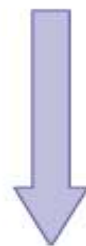
This Percentage Is The Rate Of Gross Profit And Is Applied To The Amount Of Turnover Lost. The Amount, After Necessary Adjustments, Is The Business Interruption Insurance Indemnity.

RGP X Amount of Turnover Lost = BI Indemnity





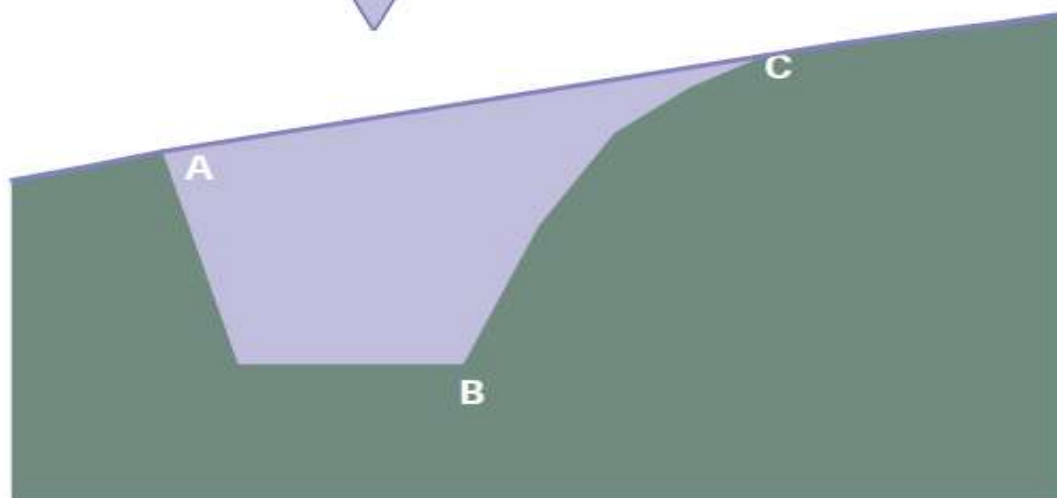
Rate of Gross Profit (RGP) – Contd..

Rate of Gross Profit x Reduction in turnover = indemnifiable
Gross Profit



- A Date of loss
- B Resumption of production
- C Effects on operating income ended or "would have been" position



-  Turnover
-  Reduction in turnover

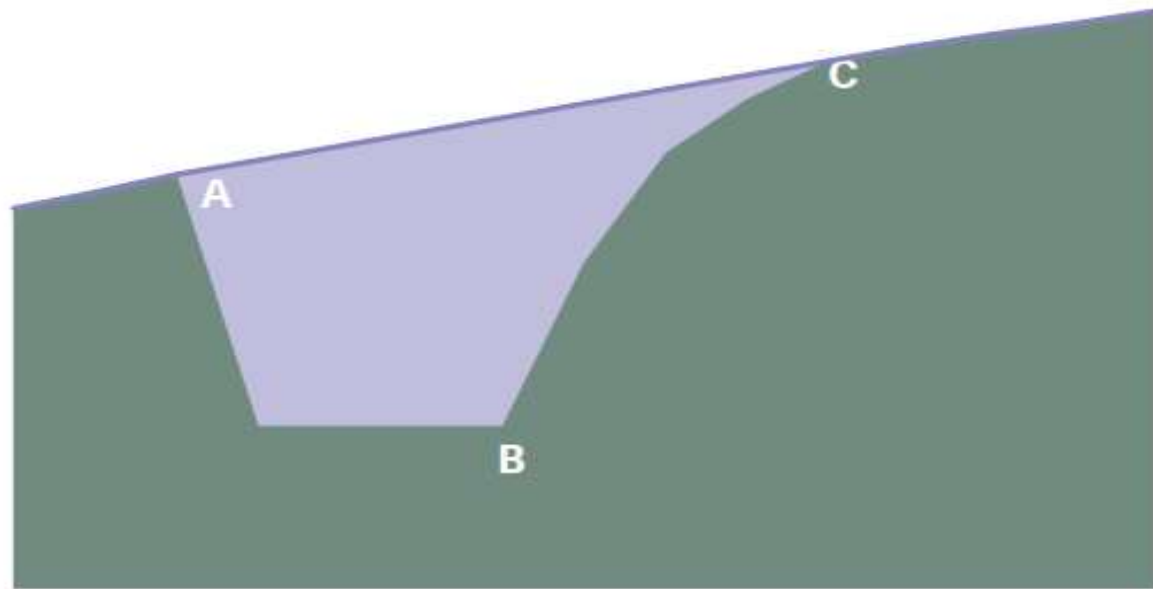




Rate of Gross Profit (RGP) – Contd..

Company A suffered a reduction in turnover of Rs. 6,000,000/- following an insured material damage in 2018. Which would be the indemnifiable amount?

-
- A Date of loss
 - B Resumption of production
 - C Effects on operating income ended or "would have been" position
-  Turnover
-  Reduction in turnover







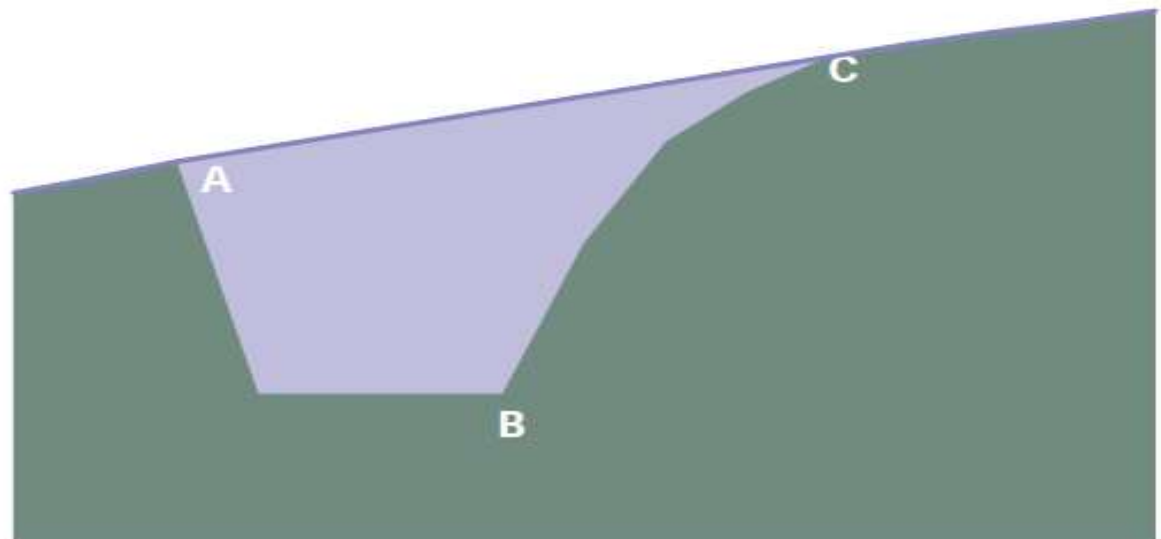
Rate of Gross Profit (RGP) – Contd..

Company A suffered a reduction in turnover of Rs. 6,000,000/- following an insured material damage in 2018. Which would be the indemnifiable amount?

Rs. 3,600,000/-

-
- A Date of loss
 - B Resumption of production
 - C Effects on operating income ended or "would have been" position

-  Turnover
-  Reduction in turnover





Increased Cost of Working

- **I**ncreased **C**ost **o**f **W**orking is an additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or reducing the shortfall in turnover during the indemnity period.
- An insured's increased cost of working will be covered by insurers as long as it does not exceed the **economic limit**.

- Formula for Economic Limit:

Rate of Gross Profit x **Reduction in Turnover avoided by increased cost of working**

- Example, **Company A:**

Rate of Gross Profit → 60%

Increased Cost of Working → Rs. 2,800,000/-

Avoided Turnover Reduction → Rs. 4,000,000/-

Economic Limit → 60% x Rs. 4,000,000/- = Rs. 2,400,000/-

The insured must pay the remaining Rs. 400,000/- himself



Material Damage Proviso

No claim is admitted under a business interruption policy unless the interruption has been caused by material damage for which property insurers have accepted liability, or would have accepted liability, but for operation of deductibles.

The material damage proviso is a vital feature of BI insurance, because :-

- it secures for the BI policy the protection of all the conditions, clauses and warranties stipulated in the material damage policy. Without such proviso the relevant wordings of the material damage policy would have to be incorporated into the BI policy itself;
- it allows the BI insurers to follow the material damage insurers in their views on the cause of the loss. In other words, once the latter acknowledges liability the BI insurers will follow suit without engaging in further investigation.



Material Damage Proviso (Contd..)

Note:

- Material Damage and BI are intended to go together. In case of breach of warranty there will be no payment under either policy!
- A small material damage loss may well be within the deductible (or excess) of the material damage policy and, thus not payable by this insurance, but it could have a serious impact on the production, resulting in huge legitimate claims under the BI policy.



Contingent Business Interruption / Customers & Suppliers

BI following property damage at specified customers or suppliers:

Why Is It Important?

- Increasing Dependency Amongst Industrial And Medium Sized Companies (“Just In Time” Production)
- One Important Customer May Make The Difference
- Alternative Suppliers May Need Lead Time For Special Requirements
- The Larger The Company, The More Complex Its Trade Relationships



Contingent Business Interruption / Customers & Suppliers (Contd..)

A Challenge To Underwriting Management Because Of

- Potential Accumulation Exposures With Other Business
- Potential Lack Of Transparency/ Insufficient Information
- Possible Concerns Of The Insured About Confidentiality
- Another Type Of Contingency Planning Analysis
- Pricing Difficulties
- Coverage?



Contingent Business Interruption / Customers & Suppliers (Contd..)

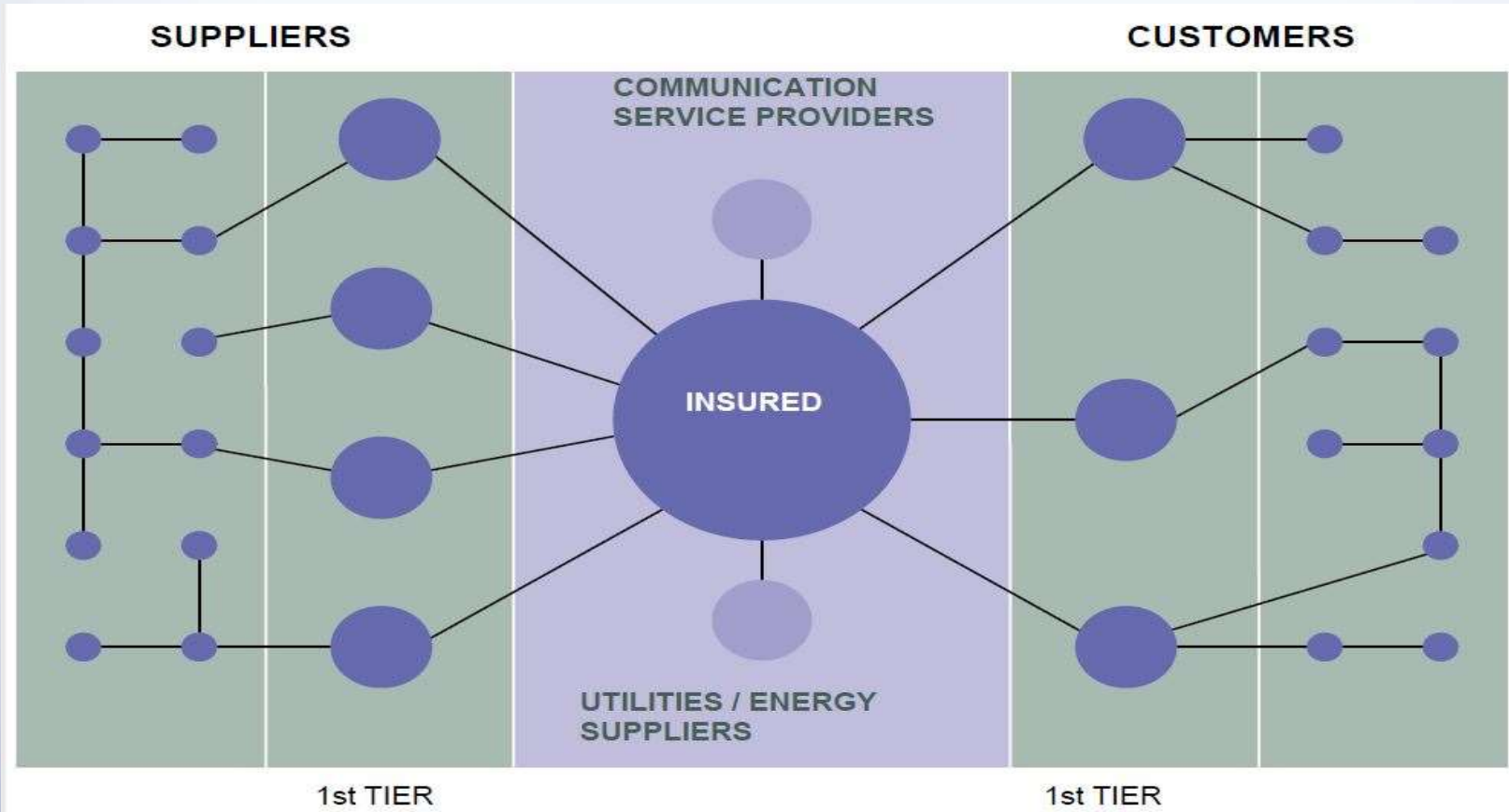
Coverage

- Scope Of Cover Acceptable?/ “Physical Damage Trigger” Required?
- Does The Wording Specify That The (Other) Terms And Conditions Of The Policy To Which It Is Attached Apply?
- Is Maximum Coverage Expressed As A Sublimit (In Amount Or %) Per Named Customer / Supplier?
- If Coverage Is Given For Unnamed Customers/Suppliers, Is The Sublimit (Much!) Lower?
- Other External Dependencies (Utilities) Should Be Listed Separately



Contingent Business Interruption / Customers & Suppliers (Contd..)

CBI Is "By Nature" A Non-transparent Product!





Basic Checklist for Business Interruption Offers

1. Source of Business
2. Name of Insured / Account
3. Location Address(es)
4. Type of Occupancy
5. Protection / Construction Information
6. Material Damage Policy in force?
7. Perils insured against (Should be the same as material damage policy)
8. Type of BI policy? (Is there a "material damage proviso"?)
9. Customer / Supplier / Other Extensions or Sublimits
10. Period of Insurance
11. Indemnity Period
12. Total Sum insured (basis, correspond to IP)
13. Premium / Rate
14. Deductible(s) in days or amount
15. Loss history (5 years at least, MD & BI)
16. Survey available? Information on bottlenecks, contingency planning? Replacement times for special machinery? Maximum Possible Loss (MPL) Estimate, business profitability



THANK YOU !!

QUESTIONS ??