THE “TEN COMMANDMENTS”

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Failing to ask the right questions of clients - not just at inception but regularly thereafter - can give rise to serious problems. Yet despite the fact that many of these problems are eminently avoidable, experience has taught me that as many as 70% of businesses may be underinsured. The main objective of our first session at the masterclasses was to set out a number of simple lessons for getting BI cover right. These “Ten Commandments”, as I have called them here, are by no means a panacea. However, they should act as a useful checklist and, when given proper consideration, should put your client in a far stronger position if they ever need to make a claim.

1 - Remember the material damage proviso

You may think that this is stating the obvious, but it is a point so fundamental that, without it, everything else is academic. Every broker ought to know that material damage cover must be in place for a client to be able to claim under his or her BI policy, yet we have come across more than one case where it was not.

Brokers gloss over this BI basic at their peril, as it leaves the client totally exposed and them on the wrong end of a potential negligence claim.

2 - Understand the difference between turnover and earnings

All BI claims commence with calculations of loss of income, however careful consideration should be given to whether cover for that loss is based on turnover or revenue.

Certain types of business are clearly better served by Gross Revenue cover. This is particularly true of professional services firms (e.g. accountants or solicitors) which carry a large amount of work in progress based on hours, and which may not invoice clients until some time after fees have actually been earned.

As a consequence, what they really seek is cover for lost earning capacity or output during the indemnity period (e.g. for time lost during recovery) rather than lost turnover.

One can appreciate how the same might be true of other businesses, and a clear understanding of the difference between turnover and earnings is the crucial yardstick by which to judge the appropriate type of cover.

3 - Make sure your client knows what you mean by Gross Profit

One of the most common reasons for underinsurance is also one of the easiest to avoid, and that is the failure to ensure that the definition of Gross Profit (as understood by the client) actually matches the policy definition. It is quite astonishing the number of times we have encountered this problem, the root cause of which is usually a simple failure to ask the right question (or at least to qualify it with an appropriate explanation).

A typical policy will define Gross Profit as the amount by which a) the sum of the amounts of turnover and closing stock shall exceed b) the sum of the amounts of opening stock and uninsured working expenses (e.g. purchases and discounts received).

However, Gross Profit as shown in a client’s accounts may be after deduction of expenditure (such as wages), which is not listed as an uninsured working expense under the policy and, unless that is clearly explained and understood, serious problems can arise.

4 - Give careful consideration to the appropriate length of indemnity period

In my experience, the maximum indemnity period is often set woefully short. The reasons for this are numerous but generally boil down to a client’s over-optimistic analysis of the situation, particularly in terms of the time required to reinstate premises and their ability to maintain customer goodwill.

Clients occupying listed or tenanted buildings, or who are reliant on specialist stock or machinery, for example, will often find that crucial elements of the recovery process are entirely outside their control. Clients might also find that even the most loyal customer (although happy to continue doing business with them) will split future orders with other suppliers - the interruption having crystallised in their mind the risk to which they themselves became exposed.

In practice, a 12-month indemnity period is frequently insufficient and knowledgeable brokers will counsel caution when discussing what is appropriate, ensuring that the client fully understands the risks involved.

5 - Looking forward far enough when setting sums insured

Failing to look far enough into the future when setting sums insured is another common mistake. All too often, the inexperienced broker will focus solely on Gross Profit anticipated for the period covered by the policy, neglecting to take into account that the effects of a loss can extend beyond the end of that policy term.

The underlying principle should be to imagine the indemnity period commencing on the last day of the period covered by the policy. Thus, taking the example of a 12-month maximum indemnity period for the sake of simplicity, the proper timeframe for consideration is not one, but 2 years from policy inception. In this instance, the sum insured should equate to the maximum Gross Profit anticipated for any continuous 12-month spell during that 2-year timeframe.

For a client whose business shows a steady upward trend in profitability, the correct approach can be summed up in even clearer terms: simply consider lost Gross Profit for the maximum indemnity period, commencing on the last day of the policy.

6 - Beware seasonality!

With 18-month indemnity periods becoming increasingly common, this is a further issue of which brokers should be aware. Annual figures may conceal seasonal trends - bumper periods of trade of which more than one might be encompassed by the maximum indemnity period. Failure to take this into account, when determining the appropriate indemnity limit, is yet another reason for under-insurance.

7 - Use a "declaration-linked" policy specification

The simplest way to avoid the risks of underinsurance described above is to exclude the underinsurance proviso altogether i.e. by using a declaration-linked policy[1]. Given the rate at which a business' circumstances can change, the flexible protection such policies provide is hugely valuable and we have yet to come across a case where a declaration-linked specification would not have proved beneficial.

8 - Consider additional ICW cover

Normal BI policies will contain an Increased Costs of Working clause to cover expenditure reasonably incurred in order to mitigate a loss. The general principle (often referred to as the "economic limit") is that insurers will pay no more than a pound to save a pound. However, we could cite numerous examples where clients would have benefited from further protection to cover additional, "non-economic" expenditure.

Additional ICW cover is especially important for organisations where disruption, however substantial, is likely to have a negligible effect on turnover. Take, for example, a trade association whose income is derived from a levy on its members. A fire destroying its offices would have little or no impact on its business in terms of turnover, but may nevertheless result in huge costs for temporary premises.

Neither should it be forgotten that additional ICW cover can bring with it substantial benefits to other businesses. It can prove an incredibly valuable and flexible tool in the recovery process, essentially buying extra breathing space and the freedom to take action without having to justify those decisions immediately in terms of cost-effectiveness[2].

9 - Make sure the policy covers all appropriate locations

Whilst it is right and proper to look at each location individually for the purposes of evaluating maximum liabilities, actually insuring separately is quite a different matter. When assessing the risk of losses arising at various locations, it is vitally important that all the interdependencies of sites and functions are taken into account and recognised within the policy terms.

The objective is simple enough: to ensure that losses are recoverable across the whole business, not just the specific premises suffering the damage. It is vital, therefore, that proper consideration is given to understanding, for example, the potential impact of a Head Office or warehouse loss on retail outlets, or the co-dependency of manufacturing and distribution divisions at separate locations.

10 - Evaluate risks right along the customer/supply chain

Particularly in the manufacturing sector, the assembly of a finished product may rely on the delivery of components from numerous sources. It may only take one of those component suppliers to suffer a loss for the impact to be felt considerably further down the chain than just the immediate customer. Customer's supplier, supplier's supplier, loss of attraction, goods in transit, showrooms and exhibitions - the relevance of all these extensions and others should be considered. They are vital to determining appropriate cover, yet it appears that they are rarely investigated to the fullest extent.

A re-cap of BI fundamentals...

Have you ensured that material damage cover is in place?

Do you appreciate the distinction between turnover and earnings?

Have you applied that understanding correctly to policy choices?

Do all parties clearly understand the meaning of Gross Profit, as defined in the policy?

Have you taken all the necessary factors into account when advising on the appropriate length of indemnity period?

Have you looked far enough forward when setting sums insured?

Have you considered the possible effects of seasonal trends on sums insured?

Are you using a declaration-linked policy specification?

Have you considered the need for additional cover for Increased Costs of Working?

Does cover recognise the interdependencies of business functions carried out at separate locations?

Have you given proper consideration to the need for policy extensions?

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[1] Premiums are adjusted at the end of the policy term according to declarations of actual Gross Profit (NB this is not the same as having a policy on a Sum Insured basis and making declarations!)

[2] The irony is that this supposedly "non-economic" expenditure can end up being very economic indeed, insofar as it can often result in a substantially quicker recovery.