



AICOW – Am I Bovvered?

LBIA / IIL Joint Lecture

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Lloyds Old Library, One Lime Street, London, EC3M 7DQ

Before getting onto the title of my talk, let me just say I am very honoured to have been invited to address you. The success of this event over the years, at least in terms of numbers of attendees, has been repeated today.

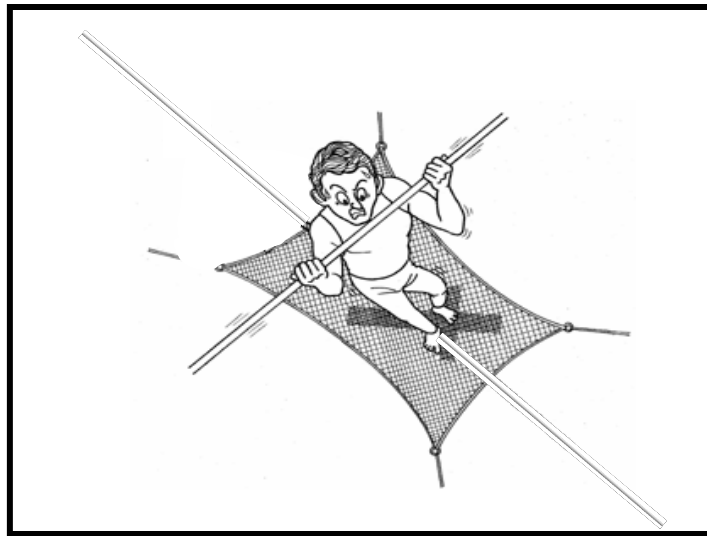
I was asked to address you on the subject of Additional Increase in Cost of Working. My first thought was that it was a very limited, or should I say finite, topic. On reflection, and having researched the matter with others, I now believe there is plenty to consider.

But then I still have a nagging doubt that I have not been invited to merely tip-toe through some of the finer technical aspects of AICOW. This is, after all, a short lunch time lecture to a broad spectrum of people within the insurance market. Maybe you want me to illustrate some specific cases where claims have been paid under AICOW, and then we can all decide for ourselves whether we, or our clients, or our customers, need to purchase AICOW cover.

I will indeed, illustrate my talk with some examples, but I do not think the matter is quite so straightforward in terms of considering the need for AICOW cover.

Today's Chairman, Paul Maynard, recently addressed the LBIA on the question of the Interdependency Clause. He identified a reluctance on the part of the market to underwrite this risk, and thus limits were being imposed even though the extent of the risk could readily be determined. This seems to be in distinct contrast to AICOW. I am not aware of any great reluctance to provide this cover, admittedly it is always subject to a limit, but I believe it is not disproportionately expensive. Should we deduce from this that the insurer's experience is that

there is little risk associated with AICOW cover, and in turn therefore, that it's not really necessary to purchase the cover in the first place?



Why the picture of the tight-rope walker? You've probably all guessed that the safety net represents AICOW cover. I think it's more subtle than that however. The mere presence of the safety net provides our tight-rope walker with an added degree of confidence that allows him to achieve more. He doesn't have to fall off and into the net to prove its worth.

So what is AICOW? Clearly from the name it is an extension of the basic ICW cover under a BI policy. Yet you often hear, or at least I do, discussions that suggest that expenditure incurred by a policyholder following a loss should be treated as either ICW or AICOW as though these two are discrete or mutually exclusive - which they are not.

There is no standard recommended wording for AICOW cover. Here are three examples of wordings that I have recently seen. The key common phrases would appear to be:

-beyond or in addition to item 1(b).....
-necessarily and reasonably incurred.....



- during the Indemnity Period
- to avoid or diminish the reduction in turnover

So it's expenditure similar to ordinary ICW but which cannot be paid as ICW. The fact that the link with Turnover (and some wordings even say AICOW's must be for the sole purpose of avoiding or diminishing a reduction in turnover) is still there, would tend to indicate that it's just cover for the uneconomic element of what would otherwise be ICW's. But then why would a business wish to incur uneconomic expenditure and, moreover, if it does so is it reasonably and necessarily incurred? Those who have gone into print on this topic (e.g. Riley and Hickmott) give examples of businesses that might wish to do so. They are:

- i) Those in competitive industries, where future profitability depends on continuity of production and who operate on low margins, e.g. milk, bakery, laundry.
- ii) Those who can subcontract to others in the same industry e.g. printers, ice cream manufacturers, dry cleaners, milk processing, cheese and bacon factories.
- iii) Those likely to incur disproportionately higher costs maintaining the business e.g. boarding schools and colleges.

In this latter example Riley refers to pupils and staff having to be accommodated in hotels – clearly the age of the luxury portacabin had not dawned.

I am uncomfortable with these examples since I do not see the expenditure as being unreasonable, nor for that matter necessarily uneconomic. Let's just take one example, that of subcontracting to a competitor. Clearly this is going to be expensive, the competitor will want to make at least as much margin as the Insured would have done. Add to that the additional transport costs likely to be involved and the exercise becomes uneconomic on an order by order basis.

But then what if the Insured did not choose to subcontract? If they let down their customers they might well lose the business and turnover in the remainder of the Maximum Indemnity Period



will be adversely affected - unless we are on some U.S. type wording, such loss of G.P. would be payable under the Policy.

The root difficulty is being able to evidence that the expenditure is economic. This might appear straightforward enough but what about a business that:

- Subcontracts some production.
- Rents alternative factory premises to make good some production.
- Rents temporary office accommodation.
- Incurs promotional costs to maintain.
- Works additional overtime.
- Incurs costs to accelerate building repairs.

Even if one were able to determine the turnover generated by each of these measures, and thus whether they were each economic, they may still be interdependent. In the above example subcontracting may be uneconomic but, without it, customers may have received inadequate quantities from the alternative factory. If the customers had been lost the building acceleration costs might have been rendered uneconomic.

The above analysis highlights a couple of important issues which, whilst not strictly pertinent to AICOW, I wish to address.

First of all, I am often asked how one goes about measuring the economics of various elements of additional expenditure. The rule to apply is that all expenditure related to each strategic decision taken with the intention of mitigating the loss should be combined. Thus a decision to occupy alternative production facilities should mean that all associated costs including rental, rates, set up costs, removal costs – in and out, dilapidations, additional travelling / transport, overtime are combined.



Having identified all these costs, there should then be deducted any cost reductions which result from the incident. If there is a loss of rent clause at the risk premises then the ICW is the net additional rental cost incurred. I know I have one ally in this in the form of Gordon Hickmott who states in his book:

*“It is most important to give proper consideration to any additional costs of working. The additional element should be considered by **class of charge** and not merely because the item itself is new. For example if additional premises are rented but there is a reduction in the rent payable at the insured’s own premises the net figure should be brought in as increased cost of working. Sometimes and adjuster or other person treats the rent of additional premises as the increased cost of working in full and deals with the reduction in rent of the insured’s own premises as a saving. This is wrong, the balance only is increased cost of working”.*

I am confident that you will all be persuaded by the intellectual rigour that Mr Hickmott and I have applied and the evidence to support our argument that we have adduced.

Let me just say that all too often I have had cases referred to me where policyholders and their advisers have adopted the contrary view. This is particularly commonplace on ‘ICW only’ covers where there is no provision in the policy for the deduction of savings in overheads. Thus the full rental on alternative premises is claimed with no credit offered for rental savings. The case for this is that the whole rental charge from the new landlord was not previously incurred and is thus additional. A rigorous debate over indemnity and the purpose of the cover could be obviated by a simple change to policy wordings, i.e. insertion of the word “net” in front of the phrase “additional expenditure” wherever it appears. The standard BI wordings have been around for over 50 years. Wholesale changes are not required but a few tweaks would substantially improve matters. CIL A, and in particular its BI Specialist Interest Group, are currently looking to launch an initiative to promote a policy wording review.

Returning now to the main theme, there is the question of how one determines whether the expenditure incurred has been economic. This is surely just a simple matter of applying the Rate of Gross Profit to the Turnover generated by the expenditure. But what turnover is generated by



what decision and how far forward should we look? I believe a more sensible and pragmatic approach is to work out how much turnover needed to have been generated to render the expenditure economic (i.e. divide the ICW by the GP rate). In many cases it will be self evident as to whether this test is satisfied.

There will remain, however, a significant number of cases where the economics are not so obvious. Why would the business wish to proceed with the expenditure in these circumstances? I suggest that there are as many as three answers to this question:

- i) The longer term effects (of not doing so).
- ii) The indirect nature of the result (of incurring the expenditure).
- iii) The risk associated with not doing so.

The longer term effects are likely to be assessed as being the damage that may be done to the reputation and customer base of the business. When it comes to reputation this is really just a form of goodwill, or ability to produce profit in the future. The types of business likely to be wary of damage to reputation are printers and publishers of newspapers or periodicals, and producers of luxury goods or services. They will want to protect their reputation but I do wonder if AICOW actually provides the cover they need or want.

Turning to the indirect nature of expenditure, it is clear that not all costs within the business directly lead to sales. It is also the case that some normal costs, not incurred in the short term, will not have a detrimental effect on sales. At this point I am going to ask if any of you have heard of the Blundell Spence agreement? Fear not, I do not intend to pick on anyone to explain it so be uninhibited, but honest.

I will explain, if you will allow me, by quoting from the seventh edition of Riley – I do this because there are some delicious ironies:



“Another aspect of this matter to be considered is the possibility of fire or other damage occurring at a group’s administrative head office separate from manufacturing premises. If there is any possibility of damage at the central administrative offices having an adverse effect on turnover, or causing increase in cost of working, at any groups member’s premises it is essential to include the head office premises in the overall business interruption insurance of the group and obtain cover for the interdependency. The serious nature of the loss which such a contingency can cause is illustrated by a Press report in January, “..... Mr. Robert Maxwell yesterday report a massive profits increase for his Pergamon Press Company. He said that but for a serious fire at the head office in July the total for both sales of £11 million and profits of £2,350,000 would have been even higher”. Even where damage at the head office would appear to have no discernible effect on the business of the group, insurers agree that reasonable increased costs are payable as a claim under the group policy (including the head office premises), because it is accepted that the central administrative function is a necessary part of the overall group activities. This is known in the United Kingdom as the “Blundell Spence” agreement”.

Now I have cheated a little because the Seventh Edition was published in 1991 and Robert Maxwell died in November that year. That Maxwell was a crook does not invalidate the point.

My concern lies in the fact that the Blundell Spence agreement is one of the few instances of the market agreeing an interpretation or application of a principle. That principle was determined by the FOC who no longer exist. The nearest modern day equivalent is probably the Property Claims Forum but by no means all insurers subscribe to this group as the formation of BUNPIG following the Buncefield explosion illustrated.

The Blundell Spence agreement highlights that certain costs which it would be difficult to



demonstrate are economic are nevertheless acceptable as ICW. The cost of maintaining those functions say at an alternative site are covered. My own experience suggests there may be costs at a sales generating site which increase, or are reasonably expended, as a result of an incident when, under normal trading conditions they are not considered necessary. The most obvious is security. A fire damaged site attracts additional interest, may be dangerous, and thus needs to be protected. Two such examples readily spring to mind. In the aftermath of the Buncefield explosion many itinerants were attracted to the area looking for rich pickings. More dramatically following the floods of 2007, people were seen swimming from submerged car roof top to submerged car roof top on their way to looting an electrical warehouse. How they proposed to make off with their treasure (n.b. electrical goods) was not clear, but it does illustrate the added vulnerability of a site post incident. It is by no means certain that something will go wrong but, is it really in anyone's interest for the business to try to keep going whilst taking a degree of risk which was not present prior to the incident?

Finally what about other types of cost that fall into the category of risk. Perhaps the best example I can use to illustrate this is that of the customer threat. I have spoken on this topic many times. The nature of much business nowadays is that contracts do not include specific fines / penalties provisions. Where large organisations, such as retail chains, have a limited number of suppliers, those suppliers can be heavily dependent on the retailer as a customer. In this aftermath of an incident retailers are not always sympathetic.

With large deductibles their suppliers extension cover may not be called on. In order to remain a supplier, the insured may be required to fund a scheme to make good the retailers current and future losses. It was, to the best of my knowledge, suggested to a major biscuit manufacturer that such costs were not covered as ICW, although they might be covered as AICOW. That such expenditure might be totally uneconomic seems highly unlikely. The more critical test is, call the retailers bluff and determine who pays if you lose. As far as I can see any GP loss within the M.I.P. will form a valid head of claim.



A more clearly contingent type of expenditure is that incurred on Plan 'B' of the mitigation strategy. Whilst Plan 'A' looks good, do we want all our eggs in one basket. Should not some funds be expended on a contingency plan?

In a similar vein, do we need to wait for planning permission before we order the steelwork for the reinstatement of the factory / warehouse? If the steelwork is on the critical path for reinstatement, why not order on a contingency basis and, if necessary, pay a cancellation fee if the plans have to be revised. Clearly the cancellation fee is uneconomic, quite possibly totally uneconomic. With no turnover saved or generated it probably falls foul of both ICW and AICOW wordings, but I believe it could be covered under the "Roberts-Lloyds agreement" taking this venue for part of the name.

I do hope that so far I have already given you much food for thought. In the main I have highlighted a number of types of cost that might not be accepted as being covered as ordinary ICW.

Before drawing my conclusions let me provide you with some examples of expenditure that have been paid as AICOW beyond the security, customer retention and contingency expenditure that I have already illustrated.

Security

Abortive acceleration

Marketing – re-branding

Customer incentives

Improved systems e.g. data systems

Building a new road

But not M.D. underinsurance.



Conclusion

Many decisions to incur additional expenditure can be shown to be economic, and claims experience seems to confirm this. But I put it to you that this is to some extent because of the AICOW safety net being there. Notwithstanding this, there will be businesses that want to incur uneconomic expenditure, plans won't always come off, and who were Blundell and Spence? I wouldn't want to walk that tight rope without a safety net. As my namesake said..... *"You got to ask yourself a question "do I feel lucky?". Well, do you PUNK"?*

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