Contingent Business Interruption

– *An Increasing Global Claims Risk*

July 2008

Background:

Major catastrophes, such as the 9/11 terrorist attacks, hurricane Katrina and, more recently, the Chinese earthquake have caused the insurance market to question the ability of current insurance policies to meet unanticipated exposures: significant gaps in traditional business interruption insurance cover and more specifically with regards to contingent business interruption (CBI) losses have been identified, raising awareness of a fundamental need to ensure the exposure is more clearly understood and financial risk is minimised.

As an insurance cover, CBI has been around in various guises for many years. The standard 'all risks' policy with a 'material damage' proviso has been extended over time to take into account the ever widening risk profile, to a point where insurers and risk managers are now obliged to consider the development of more innovative ways to reflect the escalating mitigation needs of the market. With the increasing awareness of possible gaps in cover, companies are beginning to review their approach to risk exposure, both upstream as complex global supply chains are becoming more common, and downstream as customer demands intensify.

In the recent Risk Manager 2008 Survey, the "ability to pay claims in the event of a disaster" was ranked by risk managers as the third most important current risk. The threat of unanticipated exposure is clearly considered a major issue for the market going forwards.

Loss adjusters who play an integral part in the validation and settlement of a claim are also reviewing their contribution. One area of focus is that of claim quantification methodology (CQM) where the introduction of a pre-planned claim evaluation process, with guaranteed market support, would generate confidence and alleviate concerns regarding unanticipated risk exposures.

This paper explores how CBI has evolved over recent years; why it is such a hot topic in today's market and considers the specific issues involved from various perspectives – the insured, the insurer and the loss adjuster.

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Something Old, Something New:

Business interruption as an insurance risk is of course not new. However with the rapid evolution of tight supplier/customer dependency and the progressive escalation of exposure levels along the way, significant extensions to the standard 'all risks' insurance policy have developed and, when triggered by damage to a third -party's property, manifest as suppliers or customers dependency claims within the generic category of Contingent Business Interruption (CBI).

The cover is used by an insured when one or more of four main situations arise:

- When there is dependency on one or more supplier for materials.
- When they are dependent on one or more manufacturer or supplier for most of their merchandise.
- When they are reliant on one or more business to purchase the bulk of their products.
- When a neighbouring business is integral to attracting customers to the insured's business.

As CBI insurance is triggered by damage to a supplier's place of business, the insured does not have full control over the progress of the claim; this is the critical difference between CBI and BI insurance and a growing area of concern for many organisations.

A Changing Market:

Today's manufacturing and industrial marketplace is rapidly changing. It is now based on an integrated supply chain model, reliant upon truly global sourcing across borders, with a growing focus on the efficient management of cost and margins. With increasing global competition, the sophistication and scale of out-sourcing components and sub-processes has grown rapidly - encompassing many countries and industries.

An escalation in supply chain arrangements involving the booming low cost developing economies (often located in the third world) and related developments in global materials sourcing and supply have resulted in an integrated

and heavily dependant manufacturing industry that faces a wide range of potential new exposures related to the following factors:

- The increasingly complex nature of global client contracts with penalties for failure to supply at all or on time and the increasing risk that a customer will permanently move their business even after a relatively short disruption period.
- The supply of bespoke components from distant markets.
- Complex international transportation and logistic issues.
- Contractual issues when trading in multiple jurisdictions.
- Shifting supply bases – often to achieve economies of scale.
- Exclusive supply arrangements for all or part of the manufacturing process - with a risk of production being affected indefinitely should the source be compromised, with no alternative readily available supplier.
- 'Just in time' and 'Just in sequence' inventory management, creating a 'hair trigger' situation accentuating the risk of a supply interruption, leading to major losses.

These issues can create a highly efficient "steady state" supply when all goes well, and yet store the potential for disaster with major component outages, should the supply chain become blocked or disturbed.

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The Insurance Response:

Given the above, coupled with the rising incidence of major catastrophes that have occurred in recent years, Contingent Business Interruption insurance has become increasingly important to the insurance market. Indeed, the absence of adequate coverage (as many companies have found to their cost) can be significant. Exposure to this assortment of 3rd party related risks has resulted in organisations reviewing the adequacy and effectiveness of existing policies – indeed, should a disaster occur, does senior management understand what they need to do to mitigate the risk and ensure minimum business disruption to their existing supply chain and consequent financial loss?

In the event of a CBI claim being triggered, one of the most difficult problems a company faces is their lack of total control and dependency on others to ensure the claim's efficient and effective progression. As a result, some companies are starting to explore how a pre-agreed crisis management process could satisfy their need for a more certain claims outcome.

Even the most minor of disruptions can have huge consequences; not only for companies where major areas of production effectively come to an expensive standstill, but also for insurers who could face substantial accumulation risks from CBI losses; particularly when those risks could be far from transparent and subject to rapid change.

All parties in a CBI claim will face numerous challenges. The insured, for example, will not only be concerned with the financial consequence of business interruption but will need to consider such things as brand protection and client retention; ensuring a speedy resolution of the claim via an accelerated process is commercially critical. Not surprisingly, fear of the unknown inevitably tops the risk agenda for insurers, so as with all claims, there should be no nasty surprises. Accuracy of reserving will be important, but as stated above, the accumulation risks can be significant.

With so many parties involved in an often complex web of supply chain relationships and dependencies, the appointed Loss Adjusters will face many challenges – both technical and political. They need to ensure that, where conflicts of interest and confidentiality issues arise - for example, where the insurance company or loss adjuster represents more than one of the parties involved - these matters are resolved professionally and do not hinder a speedy resolution of the overall claim.

The CBI Claims Solution:

In presenting a claims solution, the adjuster's loss manager must demonstrate entrepreneurial skills, an understanding of strategic loss management and excellent project and market management skills. In addition, the ability to support the detailed forensic accounting requirement – essential to accurately assess the financial impact of the business loss - and access to an international claims infrastructure that matches the global nature of the supply chain are vital.

It is essential to ensure that the early stages of the claims process are successful. Working in partnership with insurers, loss adjusters can assist with policy interpretation and advise on the extent of policy cover available, after ascertaining the losses solely attributable to the incident. From first notification of a loss they are involved at the highest levels with the customer, liaising with relevant parties to mitigate the loss. Restrictions on access to the premises of the affected supplier or customer could limit the ability of the loss adjuster to assess the impact within the wording of the insured's policy and it is in these situations that the loss adjuster's depth of knowledge and experience across a number of industries on a global level is crucial.

Assessing the extent of the physical losses and the ramifications this will have on the policyholder's business is key to providing insurers with accurate and timely information. This approach assists in setting initial reserves, monitoring progress, controlling costs throughout the duration of the claim, assessing the economics of the policyholder's actions and, ultimately, agreeing settlement on a sound financial basis in accordance with the policy terms.

For example, Crawford & Company's ability to understand how large losses should be settled comes from years of experience of working with clients who have had such claims, establishing an understanding of the client's distinct needs and leveraging its global claims expertise.

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Professional Claims Quantification:

However, in this rapidly changing marketplace, where there is an urgent need to understand more clearly a company's risk exposure, it is the introduction of a pre-loss claims quantification methodology (CQM) that can provide all parties with the increased element of certainty that is currently missing. Indeed, when considering policy coverage requirements, companies should take steps to prevent the occurrence of contingent business interruption risks or to reduce their impact, particularly in terms of the financial exposure for 3rd party impact events outside of their control. Pre-determining their dependency on other suppliers and establishing whether alternative suppliers are available would help them to understand the possible impact of other businesses on their own operations and would conventionally form part of a corporate business continuity plan.

A recent UK-led initiative involved Crawford working with a blue chip company to pre-assess their risk financing needs and tailor a programme to improve the cost effectiveness of their risk management programme. Crawford worked closely with the client to create greater certainty in their approach to a clearly defined loss evaluation programme and pre-agree the methodology to be used in the event of a disaster.

Summary:

This paper illustrates the need for more detailed consideration of CBI risks and suggests the need for detailed pre-planning wherever possible to mitigate its impact.

Recent experience has shown that major CBI losses have the potential to result in significant losses - that can often cause both the Insured and the (Re-)Insurers to lose confidence in the insurance policy's ability to respond appropriately to the claim. This in turn leads to recrimination and blame which then seriously hinders the management of the loss.

Crawford's experience has been that, where an appropriate claim quantification methodology can be pre established and supported by the market, then any subsequent CBI claim can be handled more collaboratively and swiftly. Process innovation such as this, when coupled with new policy wordings, can only show the insurance industry in its best light, as being responsive and forward looking.

This enables the policy to meet its intended claims obligations with regards to both flexibility and timeliness, to the satisfaction of all the stakeholders in the loss.

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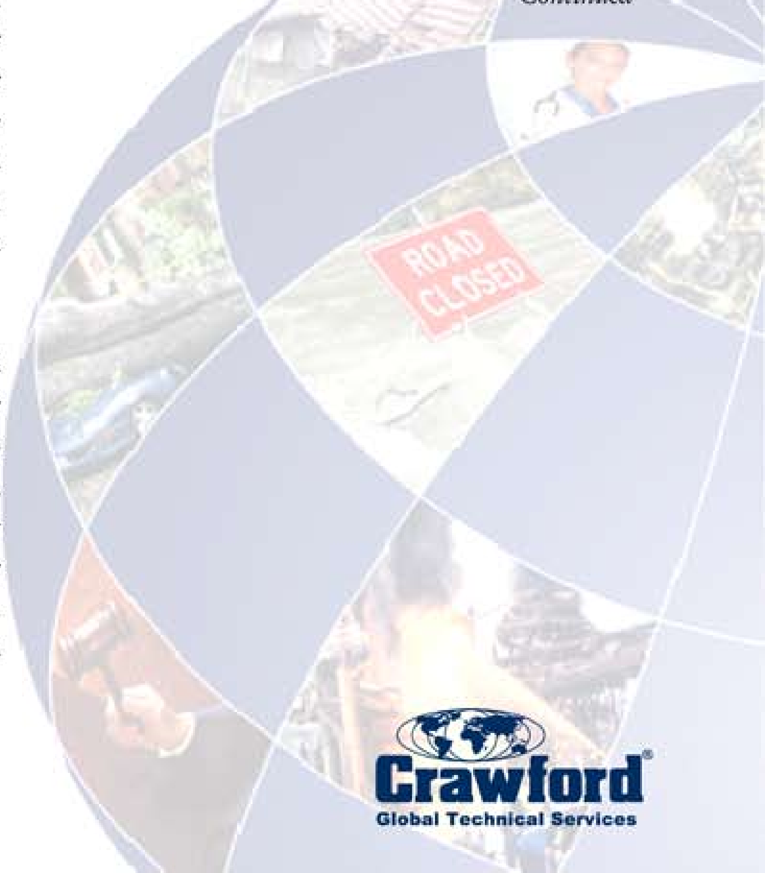

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Client Commentary:

"The risk landscape for Corporations across different industry sectors is rapidly and constantly changing and the dependence on internal/external suppliers is becoming a dominant risk factor in insurance and risk discussions.

In today's digital world, for instances, the Communications, Media and Technology Sector is confronted with physical and non-physical risks which require crystal clearly defined loss evaluation and quantification processes and tools.

We rely on partners who can understand not only industry specific claims and the rational for the evaluation but also focus on driving the efforts towards bespoke and out-of-the-box minded settlement procedures.

Understanding our customers is key. Suppliers exposure has become a dangerous neighbourhood over the last 12 months and material losses incurred in different sectors. Therefore, corporate customers increasingly demand pre-agreed crisis management processes and industry bespoke claims protocols that satisfy their need for risk transfer innovation and claims certainty.

Our experience suggests that Crawford & Company facilitates a better dialogue amongst insurers, corporations and risk advisors because of its successful, industry track record. JLT's Communication, Media and Technology Practice Group uses this dialogue to bring all parties together, to create risk transfer solutions that work for both sides. This is especially important when dealing with suppliers or business interruption exposure and claims, where no standard policies exist, but huge downsides can emerge.

I am delighted to confirm that Crawford's have exceeded our expectations to establish and test processes and tailor-made solutions that address the issue of such unprecedented catastrophe claims".

Peter Hacker, Partner, JLT

About Crawford & Company

Based in Atlanta, Georgia, Crawford & Company (www.crawfordandcompany.com) is the world's largest independent provider of claims management and related solutions to the risk management and insurance industry as well as self-insured entities, with a global network of more than 700 locations in 63 countries.

Major service lines include property and casualty claims management; warranty inspections; integrated claims and medical management for workers' compensation; legal settlement administration, including class action and bankruptcy claims administration; and risk management information services. The Company's shares are traded on the NYSE under the symbols CRDA and CRDB.

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