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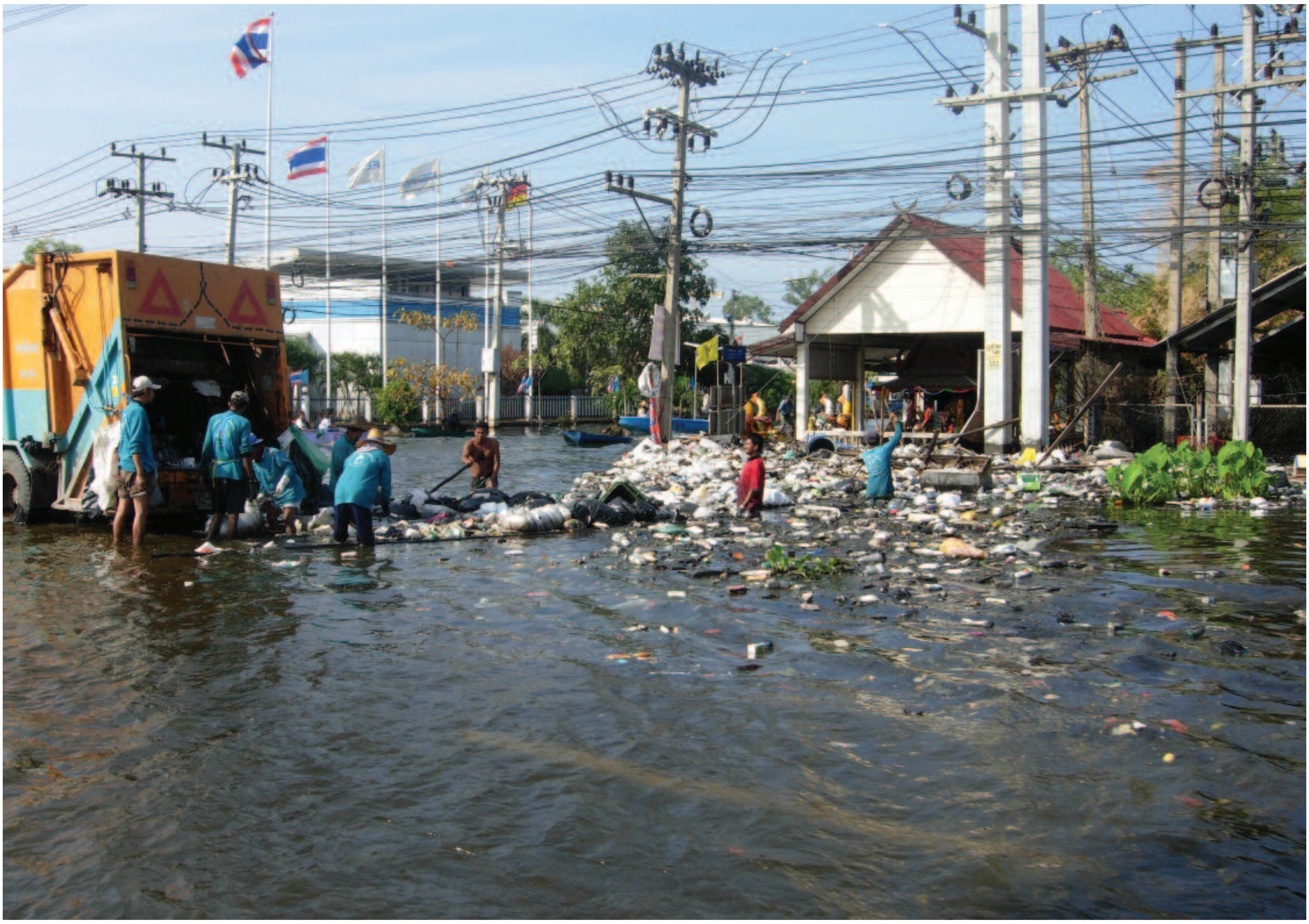
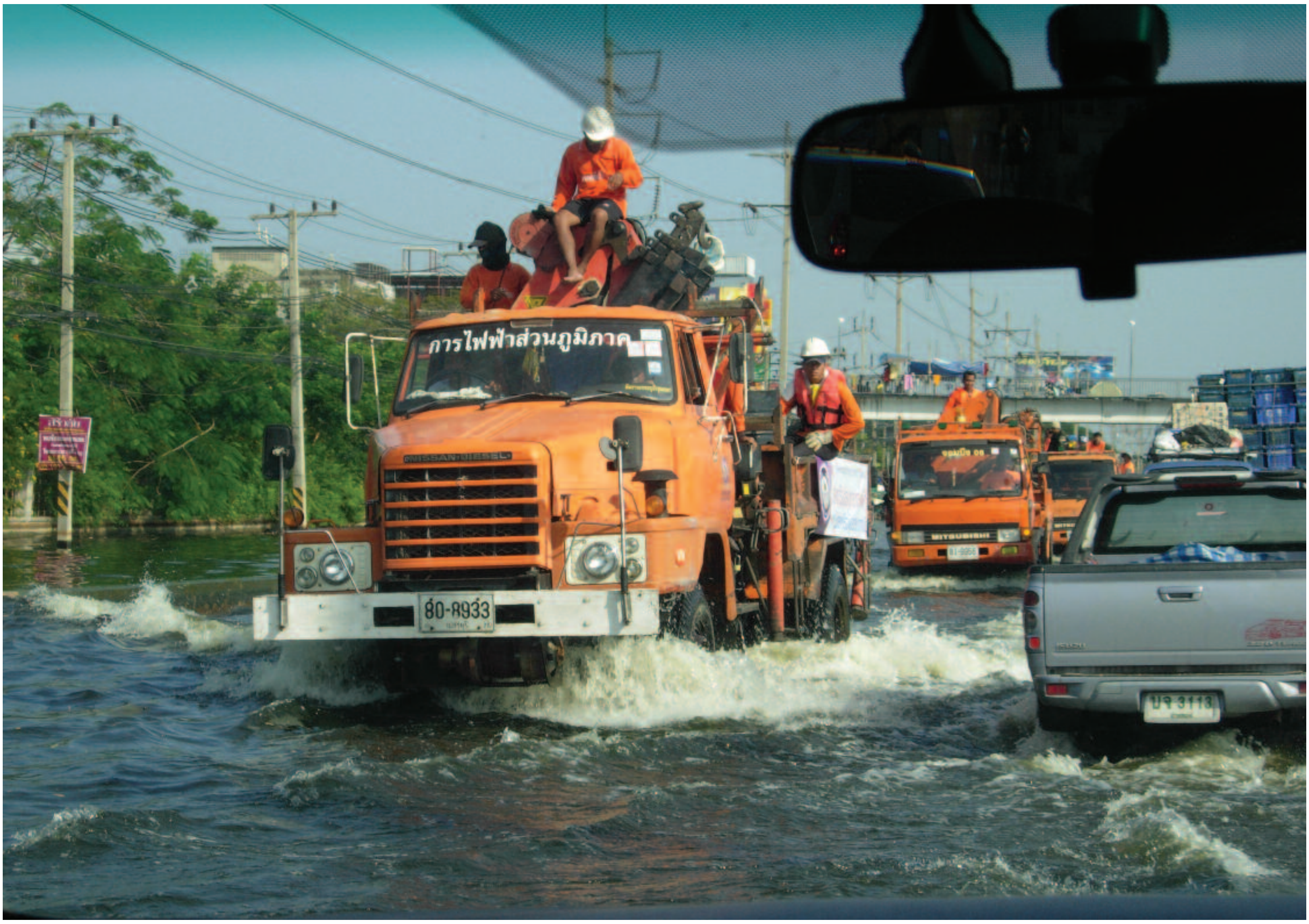
MAJOR CLAIMS SPECIALISTS

Contingent Business Interruption Insurance Insights

The 2011 Thai Floods

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The severe floods in Thailand in 2011 had a devastating impact on the country, leaving over 800 people dead and millions affected. In addition, thousands of businesses were hit by flooding, notably in five mega industrial estates in Bangkok which were flooded to a depth of up to three metres. The companies affected spanned a range of industrial sectors including car manufacturers, hi-tech industries, textile manufacturers, distributors and retailers.

We worked with policyholders in Thailand, including property owners, retailers, distribution companies, chemical companies and suppliers to the IT industry, to help them with the recovery process. This involved looking at their policy wordings, mapping the claims against the cover that was available and managing the claim preparation and presentation process with the client and all other stakeholders to successfully settle the loss.

As a result of our work in Thailand we identified a number of key issues relevant to dealing with Contingent Business Interruption (CBI) claims and learned some valuable lessons.

WIDE AREA DAMAGE

In Thailand, one of the biggest problems was the wide area damage involved. The supply chains servicing the main companies affected by the floods were extremely localised and highly inter-connected and these suppliers also suffered major disruption as a result of the floods. So a company's ability to operate and trade was affected not only by the damage caused by the flood to its own operations, but also to its suppliers and/or customers.

Companies found themselves hit by a combination of flood damage to their own property, infrastructure damage, a displaced workforce unable to reach the workplace, interruptions to public utilities such as power and water supplies, together with disruption to both the supply chain and to customers. And because of the complexity of the localised supply chains in the five industrial estates, business interruption losses have been generated as a result of damage to a customer's own suppliers.

The case of Orient-Express Hotels Ltd (OEH) v Assicurazioni Generali S.p.A. (2010) has been much quoted by insurers and reinsurers in respect of wide area damage issues arising from natural catastrophe events (Nat Cats) such as the Thai floods causing controversy in the claims adjustment process. The case revolves around the use of the 'All Other Circumstances' clause in the Business Interruption (BI) insurance policy and the interpretation of the 'But for the Damage' test in evaluating the recoverable loss. Consequently, the BI resulting from the wider area damage is potentially excluded from the loss recoverable from insurers unless the CBI extension(s) to policy cover provide the insured with an indemnity for losses of this nature. It seems somewhat perverse that the more extensive and wide spread the damage caused by a Nat Cat, the less the insured is likely to recover from their insurer in respect of the BI loss sustained.

By way of example, the application of the OEH case principles created a difference of USD 20 million in the adjustment of a client's BI loss. This resulted in litigation in Thailand to determine whether the English law principles applied by insurers in respect of wide area damage would be upheld under Thai insurance law. This case was ultimately settled by negotiation with insurers.

In our view, the 'All Other Circumstances' clause was never intended to be applied to negate BI cover following damage to insured property. The implications of the OEH case need to be better understood by policyholders, brokers and insurers and effective solutions found to ensure the risk transfer process is effective and complete where wide area damage is present. Unfortunately, the insurance industry still has not found an acceptable solution to this problem and consequently the same wide area damage issues will be faced in the future when a Nat Cat impacts a country where insurance is purchased as the risk transfer mechanism.

CONTINGENT BUSINESS INTERRUPTION

The insurance solution to many of these issues, in theory, is CBI cover.

This cover is provided by extension to Property Damage/Business Interruption (PD/BI) and will typically include cover for Denial of Access, Public Utilities and Supplier & Customer losses.

However, in the case of the Thai floods, there were a number of issues that meant that recovery of losses under CBI extensions was severely limited. Many of the CBI extensions for Thai policies were written on the basis of limited perils, namely fire, lightning and explosion - there was no cover for flood. Even though the main PD/BI wordings were generally on an All Risks basis, the CBI extensions were only for limited perils. As a result, the Insured had little, or no, CBI cover, resulting in substantial uninsured losses.

GAPS AND OTHER ISSUES

Gaps in coverage and other problems caused by policy wordings have also been highlighted by the losses in Thailand. For example, Denial of Access cover will only meet losses arising from damage to property in the vicinity of the insured premises. The term 'vicinity' limits cover to damage arising within a given distance of the insured premises, although the wording may not actually define the distance.

Interpretation of clauses has been another issue. In Thailand, we were faced with arguments over whether a flooded road was a damaged road in the context of Denial of Access. If the wording specifically refers to 'damage' to property in the vicinity, then water lying on the surface of a road may not constitute damage, and courts have upheld this view. Then there is the problem of low limits. The local Thai policies either had limited perils cover for the CBI extensions, or they had very low sub-limits, as low as Baht1,000,000 (about GBP20,000).

In addition, there is often a restriction on the duration of the indemnity period provided in respect of CBI extensions such as Denial of Access or Loss of Attraction, which are typically limited to 30-days from the date of damage. In Thailand the flood waters remained in situ for more than 90-days creating further uninsured losses.

The business recovery process in Thailand was also hampered by delays as local insurers were fearful of taking decisions that might not be supported by their reinsurance panel. There was a rigorous claims audit process that came much later in the claims process than would normally expected to be the case. This may have been driven by the fact that local fronting insurers had low retentions and were concerned that any commitment to release interim payments needed to be fully supported by their reinsurers. We have seen that this dynamic still occurs in jurisdictions where claims control clauses are not permitted and the local insurer has the obligation to deal with the policyholder's claim.

There was also concern about the level of under-insurance in Thailand. Some of the property and machinery sums insured were checked two or three times, by the policyholder, the loss adjuster and then experts appointed by reinsurers. As a result, some property damage claims, generally the easiest part of the claim to settle, took 12 months or more to conclude.

LESSONS LEARNED AND SOLUTIONS

There are many lessons to be learned from the problems encountered in Thailand in relation to CBI claims.

- It is clear that insurance is not able to cover every risk or possibility of loss. Insureds have to be realistic about what insurers will be prepared to cover. Cover for supply chain exposures such as insolvency of suppliers or regulatory issues may be available, but at a relatively high price. Some losses may be uninsurable. In the case of the Thai floods, sometimes described as the 'slow tsunami', Governments began issuing travel warnings two to three weeks prior to the flood waters arriving in Bangkok, advising their citizens not to travel to Thailand.

  These travel advisory notices led to a 'fear' of travelling to these locations, which was not borne out of insured physical damage in the vicinity of the insured premises, thus resulting in further uninsured losses for hoteliers, tourist attractions and others.

- On the issue of limits for CBI, it is clear that policy sub-limits need to be looked at carefully to make sure that they are adequate and ensure that the extension will respond in the appropriate circumstances. CBI extensions are too often simply seen as bolt-ons to the main PD/BI cover, but they are valuable add-ons that require reasonable limits.

- It is also important to check that the CBI wording follows the main policy coverage, ideally on an All-Risks basis. The local policy wording needs to be appropriate because even on major global insurance programmes, there can still be issues with regard to the application of Difference In Conditions/ Difference In Limits (DIC/DIL) clauses to bridge the gaps in local policy wordings.

- Indemnity periods need careful consideration. Some companies, such as on the distribution side or retailers, were able to recover their business relatively quickly once the flood water had abated, roads were cleared, and they had cleaned their facilities. For other businesses it was a different story.

  The loss of customers can take a long time to recover. Around 18 months after the Thai floods, some companies were still operating at just 70% of their pre-loss capacity and it took more than two years before some of the companies were back to full pre-loss capacity. Some only had an 18 month indemnity period, leaving them uninsured for significant losses.

- To address the issue of Denial of Access claims being rejected by the courts, such as those related to the Thai roads being under water, non-damage Denial of Access clauses should be added to CBI extensions.

- Customer supply claims can be particularly difficult when dealing with a third party who may be under no obligation to provide information about the nature and extent of damage to their premises. One solution might be to build clauses into supplier agreements to make sure that there is some partnering and co-operation in the event of a CBI claim.

CONCLUSION

All parties need to agree the extent of the CBI cover required. Insurers need to be transparent about how cover will operate in the Nat Cat environment and the broker has to ensure that its clients understand the limitations of cover prior to incepting or renewing cover, and certainly before a Nat Cat event tests the shortcomings of the policy purchased.

One of our clients in Thailand supplies components to the IT sector and instigated a pro-active risk management approach to protecting its assets. They suffered severe flood damage in 2011 and the Thai insurance market withdrew flood cover at the client's first renewal, midway through the recovery process. In order to give their customers confidence about their ability to continue to supply in the event of a further flood, they have redesigned their production flow and invested USD 5 million in flood defences around their own property. In addition, all the critical and expensive equipment was moved up to the first floor of the building whilst offices were relocated to the ground floor.

Insurers are always concerned about accumulation of risk when it comes to Nat Cats. This is particularly true when it comes to CBI. Insurers will want to find out as much as possible about an insured's suppliers - the physical location of suppliers, proximity to each other and the insured and whether they in a Nat Cat zone.

Insurers' concerns over accumulation of risk mean that an insured will never get the full limit of the main policy for a CBI extension. But if the insured is looking for a meaningful limit, then it will have to be able to provide a reasonable amount of data to secure the cover. In effect, the higher the CBI policy sub-limit asked for, the greater the underwriting data required.

Sub-limits need to be looked at to see if they are adequate, and if they are not, insureds should be prepared for the fact that they will have to provide more information, such as naming customers or suppliers premises.

Ultimately, it is about understanding the risk profile of the company and using risk mapping exercises to identify the risks to be insured, and then ensuring that the policy wording will respond to meet those risks. If not, then risk management strategies will need to be put in place to deal with those exposures.

Insurers could amend policy wordings to address the issue of wide area damage and cap their exposure to Nat Cat events by sub limiting cover for the resultant BI losses. If the cover was broadened to address this issue, the insured could make an informed decision about the amount of cover they wished to purchase rather than being faced with limitations imposed to wide area damage principles.

Perhaps the most important element when dealing with CBI and Nat Cat exposures is pre-planning. We recommend undertaking a stress testing exercise, which involves identifying and exploring loss scenarios with key members of a client's management team. This exercise will explore what the company would do in the event of a major loss and the impact it would have on its ability to function – the loss of customers, how long it would take to replace lost business, sourcing new suppliers and so on.

The aim is to show how a loss might play out and then see what measures would minimise the loss. The company can test the adequacy of the maximum indemnity period, policy sub-limits, and policy wordings. In other words, the stress testing process allows the risk manager to consider how best to address the risk management/risk transfer issues, including, of course, CBI.

ESSENTIAL SUPPLY CHAIN QUESTIONS FOR INSUREDS:

1. What is the process for selecting, approving and auditing new suppliers?
2. What are the company's risk management and audit processes for approved suppliers?
3. How stable is your supply chain? Are there long term agreements with key suppliers or is there flexibility of key material supplies?
4. Have you mapped out critical points in your supply chain, identifying key suppliers and their risk exposures (e.g. to flood)?
5. For each supplier consider: (a) what alternatives you have, (b) how much stock you hold, (c) whether there are any barriers to switching sources of supply, such as customer approval, product licensing, design constraints etc., & (d) whether supply contracts are fit for purpose
6. What is the financial impact of the loss of a key supplier across all affected product lines?
7. Should you implement a loss/risk mitigation strategy together with the expected time line to stabilise supplies following the loss of a key supplier?
8. What is the impact of different threat scenarios such as natural catastrophe events, regulatory closure, political risks, insolvency etc.? What are the loss exposures associated with these scenarios?
9. Do your suppliers have any critical suppliers upon whom they are dependent?
10. What business continuity planning/loss mitigation strategies have been implemented by your suppliers?

About the author

Adrian Brennan is a chartered management accountant and chartered loss adjuster with wide ranging experience in the investigation, preparation and negotiation of claims. He specialises in representing policyholders across a wide range of industry sectors in respect of Business Interruption (BI) and Contingent Business Interruption (CBI) losses. He works with clients to manage the claims process, advises on policy coverage, presentation and loss quantification issues and provides clients with strategic guidance throughout the life cycle of the claim. Recognised as a leading expert in his field, Adrian is a regular speaker and presenter at technical events and conferences on key BI and claims issues. He has an excellent track record of settling the most complex of losses and has been involved in the successful settlement of significant CBI losses in the London insurance market.

Adrian is an Associate of the Chartered Institute of Loss Adjusters (ACILA), a Chartered Global Management Accountant (CGMA) and an Associate of the Chartered Institute of Cost & Management Accountants (ACMA).

ABOUT ECHELON CLAIMS CONSULTANTS

We are a dedicated team specialising in major loss across a wide range of industries. With extensive experience and a reputation for the relentless pursuit and best possible settlement of major loss claims, we save clients time and money.

We take a pragmatic, collaborative, and constructively robust approach to the major loss claims process. We provide parity with the insurer's loss adjusters, ask the right questions and challenge unnecessary claims processes.

We ensure the interests of our clients – not the insurer – drive the claim in order to achieve the best possible settlement.

Find out more about us at **www.echelonccl.com** where you can find more advice on how to deal with major and complex losses and case studies which demonstrate our expertise.

Echelon Claims Consultants
The St Botolph Building,
138 Houndsditch
London, EC3A 7AW
United Kingdom

Tel: +44 (0)20 7558 3230
www.echelonccl.com

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A member of the Jardine Lloyd Thompson Group. Registered Office:
The St Botolph Building, 138 Houndsditch, London EC3A 7AW.
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