BUSINESS, INTERRUPTED:

A review of Business Interruption Risk in Corporates

Stefan Swanepoel: FASSA, FFA, CERA, FIRMSA

If there is one event that generally could result in a corporate risk manager ending up in the same position as Winona Ryder in the movie the title was borrowed from, it is the entire business standing still.

Business Interruption (BI) is the inability of a business to fulfil its primary purpose, its *raison d'être*, either partially or completely. This inability typically stems from a significant event such as a catastrophic fire or critical machinery breakdown. However, with the level of complexity in today's larger organisations coupled with high levels of vertical integration and complex global supply-chains, the interruption could stem from a range of events outside of the business.

Although the risk of interruption effectively touches several strategic risks, it seldom makes it onto strategic risk registers within organisations, or at least as a single outright risk. The primary reason for this – insurance. Once a risk is deemed as insured, it is deemed properly mitigated. However, the previous sentence raises several questions:

- Does insurance genuinely mitigate the impact?
- Is the cover purchased sufficient?
- Are other treatments of the risk possible and preferable?

In the remainder of this article we will discuss how these questions relate to actuarial and other input in assisting business in the strategic management of BI risks.

From a fundamental perspective, insurance indemnifies the insured against a specific peril. Excluding the impact of cover conditions and deductibles, it can be argued that if a business receives their gross profit for the period of interruption as well as a contribution to the explicit costs of recovery through (Additional) Increased Cost of Working ((A)ICOW) covers, they are in the same position as they would have been had the event not occurred, not so?

Emphatically, no. Generally speaking, the business exists because they saw a need in the market for their product and aim to provide the product at a (profitable) price which the market is willing to pay for it. The inability of the business to continue providing the product creates an impact well beyond the agreed gross profit that the sales would have achieved. Irretrievable loss of market share, creating demand for alternative products, fines and penalties and loss of supply contracts are all very real events that will not be mitigated by insurance pay-outs.

Other than the events described above, insurance contracts often have specific terms and conditions that can be fairly onerous. Time-based deductibles, co-payments, critical exclusions, application of average and underwriting capacity limits all impact on the final payment received versus the true value of the interruption.

It is therefore clear that BI (including (A)ICOW and to a lesser extent Cyber – but that is a whole new conversation on its own) insurance should sensibly only be a last resort treatment for residual risk. A more formal and structured approach would be:

- Understand the interruption recovery process for a range of critical events.
- Integrate various stand-alone Business Continuity, Business Resilience, Disaster Recovery and other related plans that address a part of the risk.
- Properly understand the cost profile related to the recovery process.
- Carefully mitigate the overall interruption where financially feasible.
- Utilise internal and external, existing and contingent means to reduce the overall recovery process.
- Insure as much of the residual risk for BI as is sensible and monitor cost efficiency of purchase.

Although the above steps represent a multi-disciplinary approach, actuaries have a significant role to play in this space. With the process as set out generally being focused on the pre-loss assessment of the risk, the inherent volatility and various critical paths and moving parts (e.g. supply chain) require an understanding of stochastic mathematics and integrated modelling techniques.

In addition, integrating the various measures in place to ensure minimal overlaps or fill glaring gaps require the ability to understand complex modelling environments. Finally, relaying the physical processes into financial terms and allowing the comparison of various options and value of the residual risks, all speak to actuarial capabilities more than any other profession.

There are, however, some material caveats or speed-bumps to the successful involvement of actuaries (other than our perceived cost in a typically non-actuarial environment). The most significant being: helping the business understand that the BI risk environment is more complex and dynamic than is the general view. Companies often relegate business continuity measures to operational or engineering personnel, who, whilst experts in what they do, seldom have a comprehensive view of the full risk.

This gives rise to mitigation programmes that focus on specific areas. Without proper consolidation and integration, these measures could negatively impact on each other, or potential cost savings through combined measures would typically not be realised.

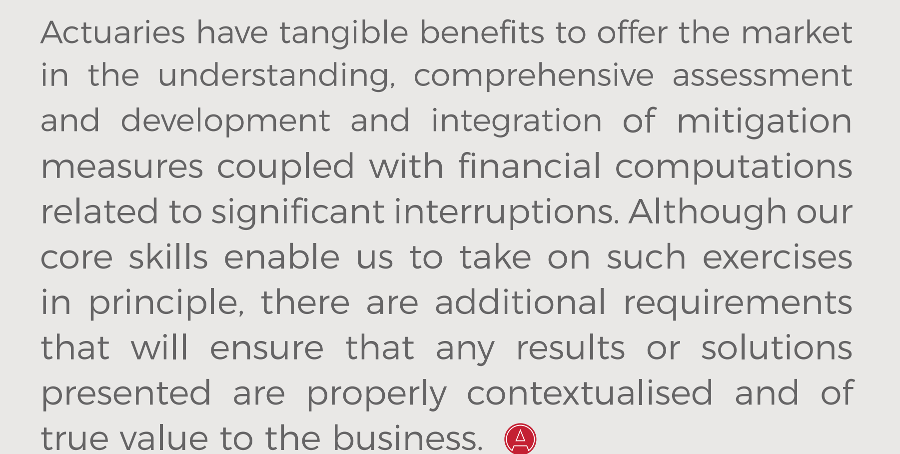
Furthermore, BI insurance purchase requirements and terms are generally based on relatively standardised evaluation methods applied by insurance underwriters. Although their experience in loss events that lead to insurance claims (or claim disputes) is indispensable, their perspective is quite specific to assessing the potential for claim payment under the cover as set out, as well as the specific measures that will reduce the probability and severity of claims.

This creates a further challenge to actuaries wishing to contribute. Understanding the basic operational profile and material risks, challenges and process bottlenecks is important to allow ease of information flow and integration during the review process.

Having a "basic working knowledge" of the business' operational profile also assists in understanding the approach, role and limitations of insurance underwriting in the greater risk environment. We don't have to be process engineers or insurance surveyors, but we do need to understand the main risk and operational differences between a foundry and an airline, beyond the obvious.

A final challenge considers the common view by the business that the "value" of the risk is related to the premium payable for cover, which is generally quite inexpensive in relation to the risk (deemed to be) transferred. This creates an environment where the true importance of continuing operations and the full impact of an interruption is often not fully understood or appreciated.

Unfortunately, this often leads to the situation that the true cost of an interruption is only understood when it is too late. Claim disputes, average and outright repudiations, coupled with material impacts on the business long after the interruption has ended are often examples of the business not understanding their exposure, nor the true protection (and inherent limitations) offered by insurance.



Actuaries have tangible benefits to offer the market in the understanding, comprehensive assessment and development and integration of mitigation measures coupled with financial computations related to significant interruptions. Although our core skills enable us to take on such exercises in principle, there are additional requirements that will ensure that any results or solutions presented are properly contextualised and of true value to the business.