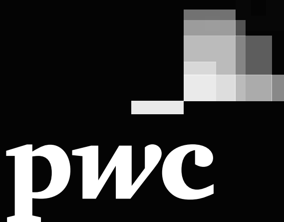
Business-critical Insurance

Identifying those insurances that support the business and its strategy

Guide 2015



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Introduction

The true value of insurance is often only recognised as a consequence of a major loss. At other times, insurance can be viewed by boards and business units as just another cost overhead, where value is judged by securing the lowest premium. Businesses may fail to appreciate the value of insurance in supporting the overall strategy of the organisation and the achievement of its objectives. As a result, insurance can be unfit for purpose and when losses occur, may fail to meet the expectations of the organisation.

The challenge for insurance buyers is raising the awareness of the value of insurance beyond that of a commodity, and articulating how individual insurance covers can contribute to the financial strategy and financial modelling of the organisation. The result would be a more carefully targeted and strategically aligned approach to insurance design and buying that supports the risk appetite of the business and maximises the value of insurance cover, rather than simply minimising the cost.

This paper proposes that individual insurance covers can be classified as follows:

- Optional
- Mandatory
- Business critical.

This paper will describe the three types of cover, set out a framework for categorising individual insurance covers and demonstrate the importance of mapping business-critical insurances against the context of key corporate finance thresholds.

In '*Efficacy of Business Insurance*' (Airmic, 2014), Airmic detailed the importance of business insurance and the steps organisations can take to ensure insurance acts as an effective risk-financing mechanism. The framework detailed in this paper develops this guidance, placing certain business-critical insurances as key contingent assets where the risk evaluation would centre on what level of loss, reputational damage or business interruption could lead to financial jeopardy or even collapse. This in turn emphasises the need for a greater level of due diligence during procurement.

Categories of insurance

The table below describes three categories of insurance and the procurement considerations for each category.

	Optional	Mandatory	Business critical
Definition	Insurance used to reduce or manage risk exposures, but does not critically affect business performance	Insurance that is legally or contractually obligatory, or required by regulators	Insurance that is critical to the company's operations
Examples	• Cover for risks that the company is willing to take, but might place externally if this is financially viable • Cover bought as a benefit to its employees, such as employee benefits group health coverage, which potentially could be self-insured.	• Cover compulsory through statute and regulation, e.g. employer's liability • Cover required as part of a supplier contract • Cover required as membership of a trade body	• Cover against insured events that could lead to balance sheet damage, business interruption, withdrawal of liquidity, failure to secure critical supply contracts, loss of key customers and other threats that are so severe they could seriously jeopardise or even threaten the viability of a business • Cover where a failure or lack of appropriate insurance cover can lead to a drop in the organisation's reputation in the eyes of critical stakeholders, e.g. banks. This is seen in the situation where an organisation is looking to dispose of a subsidiary, but a lack of appropriate cover for long-term liabilities within that subsidiary means negotiating with an acquiring company is difficult
Procurement considerations	• Service and value for money, i.e. the transfer of risk / reward from the balance sheet versus self-insuring • Company risk appetite	• Price • Limits and deductibles • Terms and conditions • Continuity • Contract structure, e.g. cancellation and reinstatement clauses	• Efficacy • Insurer credit rating • Insurer relationship

Determining which insurance covers are business critical

When evaluating whether an insurance cover is business critical, an organisation should consider the scenario where a loss occurs and the claim is declined or delayed.

Figure 1 demonstrates the relationship between financial business metrics and possible losses covered by insurance policies, and can be used by organisations to plot the criticality of various insurances against real financial thresholds relevant to the organisation. *Figure 1* includes three example losses plotted onto the chart. The potential business consequences for each if the insurance coverage for that loss were to fail are outlined in the following section.

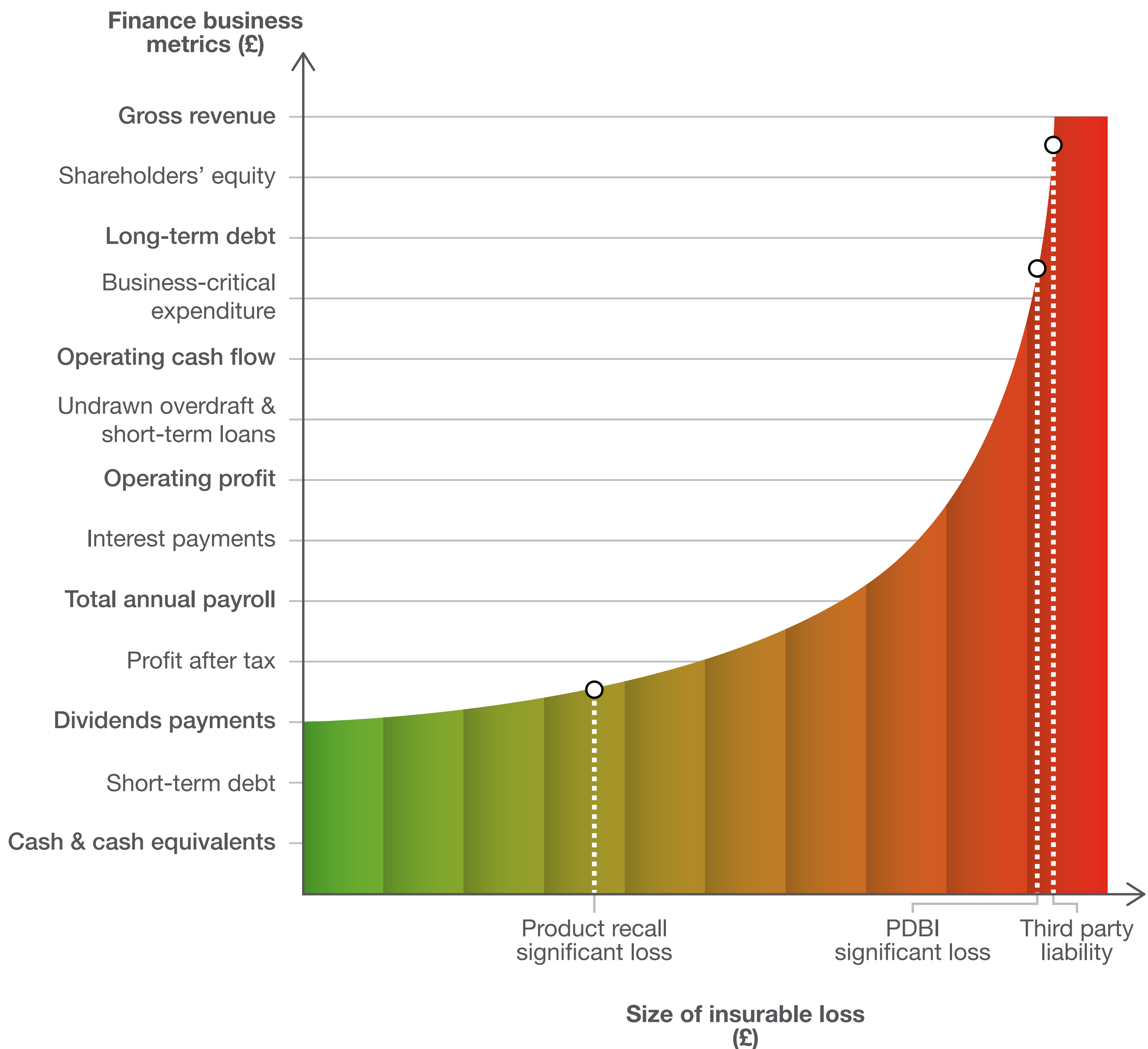
The benefits of using *figure 1* are two-fold:

1. Determine what level / type of loss can undermine the viability of the business, therefore calling for insurance as a critical imperative

2. Consider the implications on the business when financing increasing losses, where insurance is deliberately not taken out.

Figure 1 is illustrative only and organisations will need to prepare an equivalent figures for their business.

Figure 1: Relationship between financial losses and key financial business metrics



The above chart can be used to plot individual insurances versus financial consequences in the event the insurer doesn't meet the customer's expectations during a claim. It is important to note that the chart above is illustrative only, prepared for a 'generic' organisation. Organisations can easily prepare their own version of the chart using readily available data. Insurance managers should consider the following when preparing their own chart:

1. The financial metrics listed on the y axis will not be relevant to all organisations, or a variation may be more appropriate, e.g. 'business critical expenditure' may refer to R&D costs or marketing costs, etc.

2. The values for each financial metric listed on the y axis should be readily available, e.g. within the annual report and accounts, or obtainable from corporate finance.

3. Thorough and accurate loss forecasting data is required when plotting the x axis. Organisations should consider the types of loss likely to impact the business, the expected value of that loss, and whether the loss would need to be financed within one financial period or spread over a number of periods.

4. The financial and corporate structure of the organisation will impact on the business consequences of financing an uninsured loss. Specific considerations could include the liquidity, leverage and borrowing facilities, etc.

The practical use of this chart is illustrated in the following three examples, describing the financial and accounting strain that can be placed on the organisation in the event of a significant loss where insurance does not respond as needed. Organisations can use the chart to understand and communicate whether an insurance cover is critical to the business, in the context of the organisation's business metrics, moving the conversation away from premium reduction and focus on the real value of the coverage to the organisation.

Loss scenario 1 - Property insurance

When purchasing Property Damage and Business Interruption (PDBI) cover, an organisation should plot the maximum probable / possible loss (MPL/EPL). Whilst the immediate effect of an incident might be recognised, the full potential of a loss can take time to emerge and subsequent investigations may also cause delays before a claim payment can be settled in full or in part. However, following an incident, organisations may require cash urgently – for example, to cover the increased costs of funding a temporary site, to keep staff on the payroll while revenue is negatively affected, to replace urgently required stock, or to reinstate or make safe a property. Access to funds can allow management to focus on running the business in challenging times without having to worry excessively about where the funds to do this are coming from.

Our example chart demonstrates that a significant PDBI claim can be more than the operating profit of a business. Any write-down in claim value could consequently significantly dent the **annual operating profit**. Restoring the business may require the use of cash reserves, and the subsequent **cash flow** strain may require emergency use of any **undrawn overdraft** facilities. It's not uncommon for the size of the significant loss to be greater than the sum of available cash and undrawn overdrafts, possibly leading to the inability to make **dividend** payments. Short-term loans to cover delays in receiving insurance claim payments are less readily available today, leading to potential significant cash flow strain on the organisation.

This possible chain of events leading to an increased in-year cash flow strain and ultimately difficulty maintaining dividends demonstrates the importance of PDBI cover efficacy. Focusing on trying to save 10% of the premium spend for this cover could have a lesser effect on cash flow and a less material business consequence in times of 'business as usual'.

The organisation can also consider the cash flow impact of paying **deductibles** and aggregate deductibles, both which will be dependent upon the risk appetite of the organisation, by comparing the cash flow impact of the deductibles against the other cash flow metrics considered above.

Property assets and insurance on these can be linked to key **loan covenants**. A business where cash is constrained due to insurance failure or delay may find itself in breach of loan covenants around key ratios such as the ratio of net profits to loan interest (interest cover), possibly increasing the cost of the debt or even putting the debt at risk of being recalled by the lender.

Loss scenario 2 - Product recall liability cover

A significant product recall claim would include the immediate cost of recall, the replacement of products, the payment of compensation, and the annual accounting and business impact on the organisation. Depending on the scale and nature of the recall, these costs may be spread over several years, and there will be uncertainty both in the value and timing of claim payments.

A failure in cover passes the cost of the recall and the uncertainty attached to it back to the business. Although cash payments are expected to be spread over several accounting periods, there may be short-term accounting implications as the loss must be immediately recognised, e.g. disclosure may be required in the notes to the accounts, leading to increased nervousness amongst investors. The failure of insurance to respond may immediately lead to a need to recognise the loss on the balance sheet as a business liability, reducing in-year **accounting profit** and ultimately **shareholders' equity**.

Although the total cost of recall may be spread over several years, cash flow strains will affect accounts over multiple years. This may result in a dampening effect on profits for an extended period, in addition to increased business uncertainty around the size and timeframe for future claims. Ultimately, the business might be unable to maintain dividend payments and service short-term debt, possibly leading to an increase in interest payments.

Loss scenario 3 - Third party liability cover

In the event of a claim being made against the business, there will be reliance on the insurer to pay the upfront legal costs for defence, which will start immediately and could span several years. In our example, the potential quantum of a single loss is larger than the business's *shareholders' equity* and therefore is material to the organisation.

The business is reliant on the insurer to pay the claims to protect significant aspects of the balance sheet and even a negotiated settlement will likely have a material impact on the organisation, restricting resources that would otherwise be available to grow the business, e.g. comparing the size of the expected loss against typical **payroll** spend demonstrates that a possible insurance failure may restrict investment in key talent. Similarly, comparing the potential loss against **business-critical expenditure** such as research & development or marketing costs demonstrates the potential risks to those critical activities.

Key considerations for business-critical insurance procurement

These examples above demonstrate that typical expected losses can be compared against other business metrics to understand the importance of an insurance cover responding as expected. Where certain insurance covers are identified as underpinning the business and its ability to continue operating, the key procurement consideration should not always be price, but rather the insurance efficacy. As detailed in '*Efficacy of Business Insurance' (Airmic, 2014)*, "*insurance will act as an effective risk financing mechanism when coverage, contract and claims certainty are fully aligned with client expectations*".

To ensure that business-critical insurance meets client expectations, Airmic recommends that organisations consider the following:

1. **Select appropriate limits and sums insured,** which can help avoid the business consequences outlined above, whilst taking into account the risk appetite of the business.

2. **Undertake legal review of policy wordings,** to ensure coverage certainty and remove uncertainty over any contract terms, e.g. basis clauses and warranties.

3. **Scenario test anticipated events and the policy wording,** including testing the adequacy of the policy limit.

4. **Agree an effective disclosure process with the insurer,** ensuring that the insurer is engaged with the process and requests further information when necessary.

5. **Agree claims-handling procedures and protocols** in advance of claims, which can avoid disputes and delays in claims settlement.

6. E**stablish crisis management and rapid response plans,** which will respond in the event of significant loss, irrespective of whether insurance is in place

Further practical guidance on the above can be found within Efficacy of Business Insurance (Airmic, 2014).

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