The Chartered Institute of Loss Adjusters

Spotlight on: BI and the Small Print

CILA BI SIG

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Poll Question

What date was COVID-19 added to the Health Protection (Notification) Regulations 2010?

A. 25 February
B. 20 March
C. 5 March

Objectives

- Underinsurance:
  - When underinsurance arises and the questions to ask.
- Gross profit vs gross earnings:
  - How to identify which is more appropriate.
- Interaction between master and local policies:
  - What happens when two policies interact, and what are the lessons learned from such claims?

Underinsurance

Underinsurance

Basis of Cover & Extent of the Problem

60% Gross Profit

25% Gross Revenue

15% Increased Cost of Working

43% Underinsured

50% Average inadequacy

Underinsurance

Why is this a Problem?

Policy Holders recover only part of their loss

Insurers receive insufficient Premium

Inequitable position of involuntary subsidisation

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Underinsurance

Why & How is Underinsurance so Common?

Misunderstanding the calculation of gross profit	Failing to proportionally increase the GP declaration aligned to MIP	Insured seeking to estimate their perceived Maximum Loss
Not considering planned growth over the indemnity period	Deliberate attempts to keep the premium low	Misunderstanding the declaration requirements
Ignoring trend and failing to project forward over entirety of MIP	Indemnity period too short	Failure to appreciate the impact of a loss where multiple sites exist

Underinsurance

Remedies

Pre Loss - Declaration linked policies

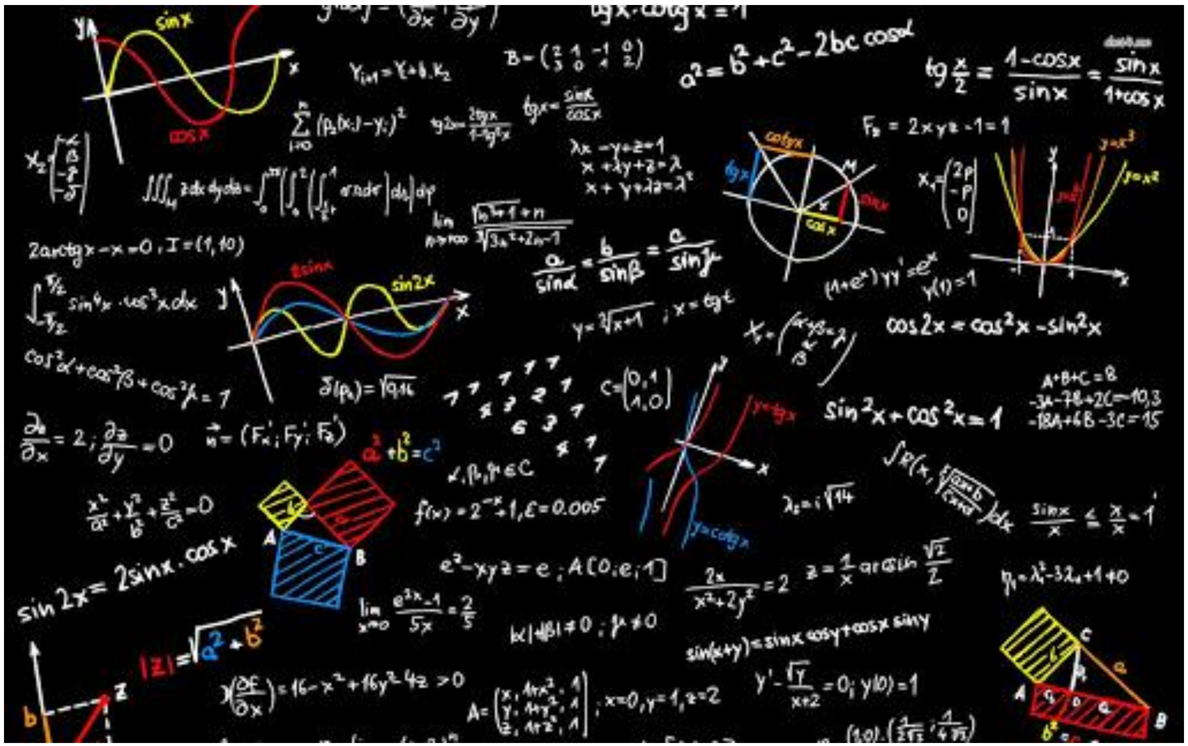
Pre Loss – BI review

Pre Loss – ‘Over Insure’

Post Loss - Proportionate reduction

Underinsurance

Getting Gross Profit Right



Underinsurance

Getting Gross Profit Right

Financial Year Ended 31 December 2019	
	£GBP
Sales	8,000,000
Cost of Sales:	
Opening Stock	1,000,000
Purchases	2,000,000
Direct Wages	2,000,000
Packaging	500,000
Closing Stock	(500,000)
	5,000,000
Gross Profit	3,000,000

Gross Profit Declaration	
	£GBP
Sales	8,000,000
Cost of Sales:	
Opening Stock	1,000,000
Purchases	2,000,000
Closing Stock	(500,000)
	2,500,000
Gross Profit	5,500,000

Underinsurance

Proportionate Reduction

Financial Year Ended 31 December 2019			
		£GBP	
Sales		8,000,000	
Cost of Sales:			
Opening Stock		1,000,000	
Purchases		2,000,000	
Direct Wages		2,000,000	
Packaging		500,000	
Closing Stock		(500,000)	
		5,000,000	
Gross Profit		3,000,000	

Uninsured Working Expenses are Purchases adjusted for stock.

What is the correct proportionate reduction to apply to an adjusted loss?

A) 45%

B) 50%

C) 55%

Underinsurance

Proportionate Reduction

Financial Year Ended 31 December 2019			
		£GBP	
Sales		8,000,000	
Cost of Sales:			
Opening Stock		1,000,000	
Purchases		2,000,000	
Direct Wages		2,000,000	
Packaging		500,000	
Closing Stock		(500,000)	
		5,000,000	
Gross Profit		3,000,000	

Methodology:

Sales £8.0m
Less opening stock £1m = £7.0m
Less purchases £2.0m = £5.0m
Add closing stock £0.5m = £5.5m

Insurable Gross Profit = £5.5m
Sum Insured based on Accounts = £3.0m

Adequacy of Sums Insured £3.0m / £5.5m = 55%

Underinsurance = 1 – 55% = 45%

Proportionate Reduction = 45%

Gross Profit vs Gross Earnings

What's the difference?

Heading	Gross Profit	Gross Earnings
Indemnity Period	Max. Indemnity Period	Period of restoration (plus 30-90 days in some cases)
Sales Shortfall	Reduction in Turnover (until normal sales levels restored)	Reduction in Turnover (until end of repair period)
Extra Expense / ICW	*"the additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in sales caused by the physical loss"* - Economic limit - Same length as the indemnity period	*"reasonable and necessary extra expense incurred by the insured during the period of liability"* - No economic limit - Cover terminates when rebuilding has been completed
Stock	Finished goods loss included	Finished goods loss excluded

Calculating profit

Financial Year Ended 31 December 2019	
Description	**£GBP**
Sales	10,000,000
Cost of Sales:	
Opening Stock	1,000,000
Purchases	2,000,000
Packaging	500,000
Closing Stock	(500,000)
	3,000,000
Gross Profit	7,000,000
Fixed Costs:	
Wages	(2,000,000)
Rent & Rates	(750,000)
Utilities	(250,000)
Stationary	(100,000)
Decpreciation	(150,000)
Bank Charges	(250,000)
	(750,000)
Net Profit	**7,750,000**

Gross Profit
(Top down approach)

Sales – Cost of Sales = Gross Profit

Net profit + Fixed Costs = Gross Profit

Gross Earnings
(Bottom up approach)

Case Study: ABC Ltd

On 31 December, 2018, ABC Ltd *suffered a fire destroying the store. It took 6 months to repair the damage and the store reopened on 1 July 2019 and an additional 3 months for sales to return to pre-loss levels (on 30 September 1, 2019).*

For simplicity, we will assume the store' generated sales of £10,000 per month prior to the Loss. After the repairs were complete, the store earned the following sales from July to September 2019:

•July 2019 - £5,000
•August 2019 - £10,000
•September 2019 - £14,000

Further, the Store didn't pay any of its hourly staff until it reopened.

Case Study: ABC Ltd

Reduction in Turnover:

Month	Expected Sales	Actual Sales	Loss of Sales
	[a]	*[b]*	*[a] - [b]*
Repair Period:			
January	10,000	-	10,000
February	10,000	-	10,000
March	10,000	-	10,000
April	10,000	-	10,000
May	10,000	-	10,000
June	10,000	-	10,000
Gross Earnings Form	**60,000**	**-**	**60,000**
Store Reopened:			
July	10,000	5,000	5,000
August	10,000	7,000	3,000
September	10,000	9,000	1,000
October	10,000	10,000	-
Gross Profit Form	**100,000**	**31,000**	**69,000**

Case Study: ABC Ltd

CALCULATE RATE OF GROSS EARNINGS / RATE OF GROSS PROFITS

Financial Year Ended 31 December 2019	
Description	**£GBP**
Sales	120,000
Cost of Sales:	30,000
Gross Profit	90,000
Fixed Costs:	
Wages	-20,000
Rent & Rates	-7,000
Utilities	-2,000
Stationary	-1,000
Decpreciation	-1,000
Bank Charges	-2,000
Total Fixed Costs	-33,000
Net Profit	**57,000**

Using the “bottom up” approach, what would be the Gross Earnings Rate?

A. 60%

B. 75%

C. 80%

Case Study: ABC Ltd

CALCULATE RATE OF GROSS EARNINGS / RATE OF GROSS PROFITS

Financial Year Ended 31 December 2019	
Description	**£GBP**
Sales	120,000
Cost of Sales:	30,000
Gross Profit	90,000
Fixed Costs:	
Wages	-20,000
Rent & Rates	-7,000
Utilities	-2,000
Stationary	-1,000
Decpreciation	-1,000
Bank Charges	-2,000
Total Fixed Costs	-33,000
Net Profit	**57,000**

Gross Earnings (GE):
Net Profit (£57,000) + Fixed Costs (£33,000) = £90,000

GE Rate: 90,000/120,000 = 75%

Gross Profit (GP):

Turnover (£120,000) – COS (£30,000) = £90,000

GP Rate: 90,000/120,000 = 75%

Case Study: ABC Ltd

BI Loss

Month	Loss of Sales	BI Loss (GP Basis)	BI Loss (GE Basis)
		@ 75%	*@ 75%*
Repair Period:			
January	10,000	7,500	7,500
February	10,000	7,500	7,500
March	10,000	7,500	7,500
April	10,000	7,500	7,500
May	10,000	7,500	7,500
June	10,000	7,500	7,500
Complete Closure	**60,000**	**45,000**	**45,000**
Store Reopened:			
July	5,000	3,750	0
August	3,000	2,250	0
September	1,000	750	0
October	0	0	0
Ramp up period	**9,000**	**6,750**	**0**
Total Loss	**69,000**	**51,750**	**45,000**

Making a choice: Gross Profit or Gross Earnings

Gross profit basis:

- many directly variable costs (manufacturing/retail)
- customer loyalty
- requires time for revenue to reach pre-loss levels

Gross Earnings:

- less comprehensive, lower premium
- unknown / long restoration period

Master and Local Policies

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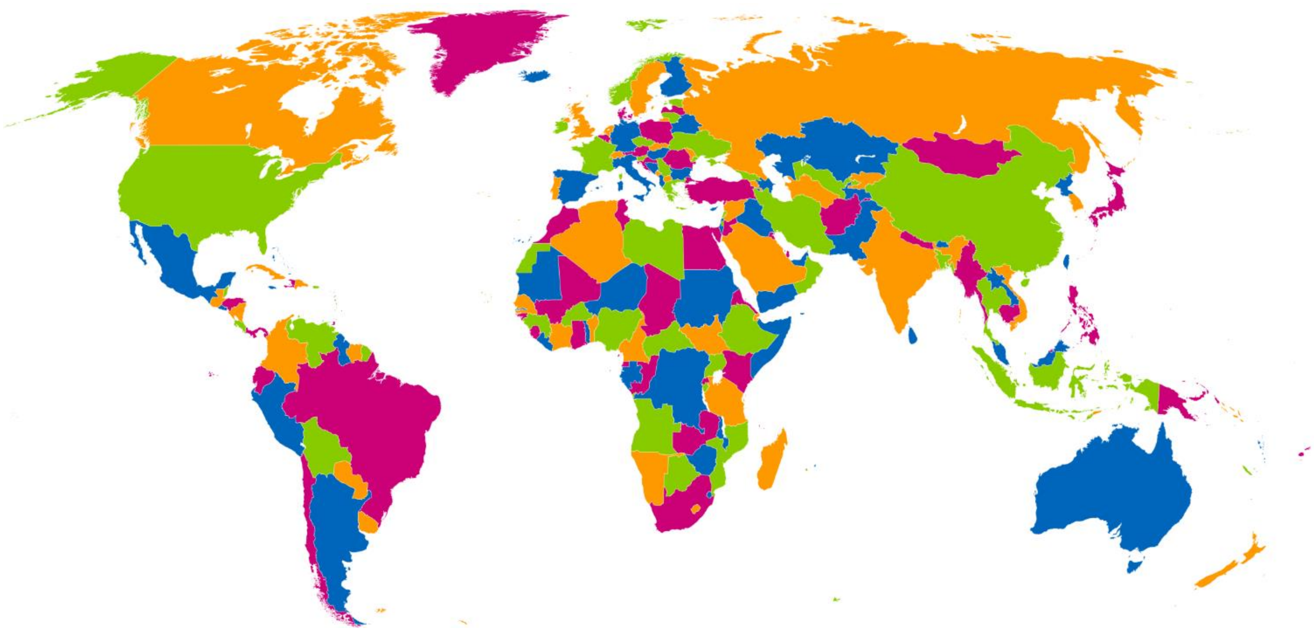
Master and Local Policy

- When does this situation arise?
- Why can it cause issues for adjusters?
- What are the key considerations?
- Resolving and anticipating issues.



Potential issues

- Reporting across jurisdictions.
  - Market expectations.
- Time zone differences.
- Language barriers.
- Lack of local support.
- Difference in conditions and difference in limits.
  - E.g., gross earnings and gross profit coverage.
  - Specific coverage for stock.
  - Inadvertent errors and omissions cover.
- Communication at the central level.
  - Adjusters.
  - Insured.
  - Claims preparers (as necessary).

A case study across borders

- Insured had a local policy in India and master from the UK.
- Loss in India and local adjusters were appointed.
- Some underinsurance issues arose – was unclear as to what exactly had been declared.
- Severe cashflow issues meant interim payments were needed.
- Adjusters submitted an initial report but UK market could not use it – resulted in delays in interim payment.

A case study across borders: Lessons Learned

- Understand local jurisdiction – in India, average automatically applied.
- If adjusters are reporting across jurisdictions, understand any requirements of the local market.
- Clarifying what is part of the declaration and advising on improvements to Insured's processes.
- Supporting clients who may not be used to dealing with insurance matters (which is generally collated centrally).
  - Communicating clearly with insureds key for all parties.

A case study in DIC/DIL

- US outlet of a UK insured suffered flood damage:
  - Loss of income.
  - Loss of stock.
  - Significant rent saving.
- Specific sublimit in US policy severely limited available coverage.
- Gross Earnings cover applied.
- Master policy had GE and GP cover, with the proviso that "*cover will be afforded under either the Gross Profit Item or the Gross Earnings Item (but not both) whichever is nearest in terms and conditions to the Business Interruption cover provided under the Local Policy relevant to the country in which the Incident occurs.*"
- Question raised over how the stock should be treated – the replacement cost was indemnified, but insured argued that the RRP should be indemnified.

Poll Question

How should the stock loss be treated?

A. The replacement cost should be paid only.
B. The difference between cost and retail price of the stock should also be paid.
C. The difference between cost and retail price should be deducted as part of the gross earnings calculation.

A case study in DIC/DIL: Lessons Learned

- Local requirements – e.g., time and documentation required to support interim payments.
- Managing insured's expectations.
  - E.g., local adjuster did not have access to master policy.
  - Local adjuster was also not in a jurisdiction which allowed interpretation of policies by anyone other than insurer.
- Timeliness of response.
- Clarity on the interaction between the two policies.
- Engaging with and involving the local and master insurers.

Conclusions

- Underinsurance:
  - How do we solve the underinsurance issues which are prevalent throughout the market?
  - Importance of pre-loss engagement with insureds and getting the cover right.
- Gross Profit / Gross Earnings:
  - Understanding the key differences between cover (esp. indemnity period).
  - Which one is appropriate for each business? Not always clear cut as depends on type of business.
- Master and Local Policies:
  - Early communication across all stakeholders.
  - Understanding the different elements of cover across jurisdictions.
  - What are the requirements for reporting elsewhere?

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