

Loss prevention standards

Calculating a Specified Suppliers Extension Limit – Business Interruption Risk Management Guidance

As dependency on suppliers becomes more important to an Insured, purchasing a Specified Supplier Extension to an Insurance Policy becomes more of a necessity. Calculating a Specified Supplier Extension Limit is therefore an important issue for many businesses trying to manage their true exposure



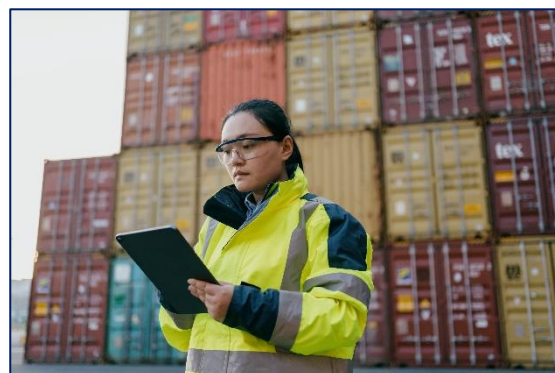
Calculating a Specified Supplier Extension Limit



Introduction

To enable many businesses to concentrate on their core activities and main areas of expertise, manufacturing activities, specific processes, raw materials, work tasks and other services can be contracted out to 3rd parties or 'Suppliers'. As dependency on Suppliers becomes more important to an Insured, purchasing a Specified Supplier Extension to an Insurance Policy becomes more of a necessity.

What is the impact if this Supplier cannot fulfil their commitments to the Insured?



Calculating a Specified Supplier Extension Limit is therefore an important issue for many businesses trying to manage their true exposure. As a result, careful consideration needs to be given to the limit calculated as:

1. If it is too low, then there will be insufficient cover.
2. If it is too high, cover may not be granted at all or if it is granted the premium cost could be excessive.

Note: Insurers base their charge on the limit selected.

It should also be stressed that as this is an extension to the main policy cover provided, e.g. Insured Profit, Revenue etc., for the extension cover to operate correctly and as desired, the main policy cover provided must also be correct and adequate.

Factors to Consider

There are several factors which can be considered to assist in the calculation of a suitable extension limit. This will involve obtaining the appropriate information from the Insured. Some suggestions of questions are as follows:

1. To what extent is the Insured dependent on the Specified Supplier?
 - a. How much of the turnover/profit is created using their products or services?
2. Is there any time of the year when the loss of this Supplier may be more critical than normal?
 - a. Are the business activities seasonal?
3. What locations or facilities does the Specified Supplier have? For example – Do they have a single premises or multiple premises, providing the required item(s) for the Insured?
 - a. Does the Specified Supplier have any other sites that can assist the Insured?
 - b. Does the Specified Supplier utilise subcontract suppliers themselves?
 - c. Does the Specified Supplier hold separate warehousing of the items the Insured requires?
 - I. Is this in a building/area away from the principal site?
 - II. Is it located in a location that would be unimpacted by a common/the same loss event as **impacting the 'principal site'**?
 - III. Is this quantified and factored into the Business Continuity Plans?

LOSS PREVENTION STANDARDS

4. In the event of a significant incident, how long would the Specified Supplier need to recover its business activities to support the Insured?
 - a. This question relates directly to Question 3 above in regard to multiple locations supporting the supply chain to the Insured.
5. Does the Specified Supplier have Business Continuity Plans in place?
 - a. What provisions are there in their recovery plans that support and protect the Insured?
6. Are there any contract terms in the agreements or arrangements between the Insured and the Specified Supplier that may assist continuance of supply or compensate for a failure/partial failure to supply?
7. Can the Insured obtain appropriate alternative supplies from other companies? If so:
 - a. **Is this documented as part of the Insured's Business Continuity Plans?**
 - b. How long will this take to arrange?
 - c. Is there sufficient capacity at these alternate locations?
 - d. Are there any specification alterations, regulations or quality controls that may need to be made or complied with in using the alternative supply?
 - e. What additional cost may be involved in the use of this alternative supplier?
 - f. **Will the Insured's customers accept this alternative supply?**
 - g. **Will this impact the Insured's reputation?**
8. **Does the Insured have buffer stocks of the Specified Supplier's goods at their own premises or elsewhere that will keep them operating for a time?**
 - a. Is this duration quantified and factored into the Business Continuity Plans?
9. Are there alternative products that the Insured can produce to maintain the revenue streams and profitability in a different way?
10. How does this all relate to the policy cover?
 - a. For example, will **the interruption period caused by the loss of this Specified Supplier exceed the client's Maximum Indemnity Period?**

It is unlikely all the above information will be readily available and some of it may not be obtainable at all. However, a combination of what is obtained may prove valuable in selecting a more appropriate Specified Suppliers limit than merely using the answer to Q1 above. This is often selected, and in some cases leads to requests for 100% extensions of this nature. It is very unlikely that this level of cover is ever going to be required.

An Example

As an example of the calculation that may be needed, please consider the following which has been constructed merely to explain the use of the above information in a more practical way. The names of the Company and its products are fictitious:

A Company produces a range of garden barbecue equipment and accessories. As part of their Business Continuity Planning process they have investigated their raw material supply arrangements and dependencies. Most of the components/raw materials can be easily sourced elsewhere, but they are particularly concerned about one line:

- 40% of their Estimated Insured Profit is earned from 1 product - The Big Burger Burner.
 - This is a barbecue coated with a special material “Bugaway”, which when heated, produces a smell that is guaranteed to keep away all flies and insects in a 10-metre radius from the barbecue.
- The Company obtain “Bugaway” from a single supplier in the UK.
- Discussions with that supplier have found it will take them 9 months to recover from a major interruption at their single manufacturing site and recommence supplies normally to the Company.
- Alternative sources of similar materials can be arranged from overseas within 4 months, but this will cost the Company an extra £25,000 per month (additional cost of material and transport arrangements).
- The Company hold about 1 months supply of “Bugaway” in stock

The Company are worried about this level of dependency and have asked for a Specified Suppliers Extension and guidance in setting a suitable limit for this supplier. The policy records show that BI cover is written on a declaration linked basis with a Sum Insured on Estimated Insured Profit of £5,000,000 with a 12-month Maximum Indemnity Period.

Suggested Calculation of potential loss and Specified Suppliers limit needed therefore as follows:

- Month 1
 - No loss. The Company have supplies on site to keep manufacturing.
- Months 2-4
 - 3 months loss of production and so perhaps sales of the Big Burger Burner, whilst alternative supplies are arranged.
 - So, $3/12$ (period of loss) \times 40% (Big Burner sales) \times £5,000,000 (annual “profit”) = £500,000
- Months 5-9
 - Production (and sales) reinstated with alternative supplies at £25,000 extra per month
 - So, $5 \times$ £25,000 = £125,000
- Month 10
 - After month 9 the normal situation should be reinstated as the original Specified Supplier should have recovered.
 - Therefore, no further loss

Total Expected Loss and therefore Specified Supplier Extension limit required is = £500,000 + £125,000 = £625,000

If expressed as a percentage this would be 12.5%. The Insured might choose to ask for 15% to allow for a little safety factor perhaps.

It is assumed for the purposes of this fictitious example that: -

- The loss was confined to the product directly affected.
 - This is not always the case, as inability to supply one product may affect the sale of others for many reasons.
- Production and sales are at a constant level throughout the year.
 - This probably is not the case in reality.
 - Some businesses may lose a whole season's sales if the loss occurred at the wrong time.
 - Consider this case where the product is BBQ's – Spring and early Summer may in fact be peak season.
- Production and sales resume at pre-incident level without loss of customers.

For many reasons the Insured may decide to increase their Maximum Indemnity Period on the policy. Assuming that **the circumstances relating to the "Bugaway" supplier remain the same, then the total amount lost under this example** should not change. However, if a percentage limit is selected for this extension, then this may need to be adjusted as the total business figure lost is now a smaller percentage of a great BI total.

For example, if the MIP is increased from 12 months to 24 months, the total BI amount insured is now £10,000,000, instead of £5,000,000. The percentage impact of a £625,000 loss is now halved:

- i.e. $\frac{£625,000}{£10,000,000} \times 100 = 6.25\%$.

Again, allowing for a little safety factor, the Specified Supplier Extension Limit could perhaps be rounded up to be 7.5%.

Checklist

A generic Calculating a Specified Supplier Extension Limit Checklist is presented in Appendix 1 which can be tailored to your own organisation.

Specialist Partner Solutions

Aviva Risk Management Solutions can offer access to a wide range of risk management products and services at preferential rates via our network of Specialist Partners.

Aviva Risk Management Solutions can offer access to a wide range of risk management products and services at preferential rates via our network of Specialist Partners, including:

- Business continuity: [Horizonscan](#)

For more information please visit:

[Aviva Risk Management Solutions – Specialist Partners](#)

Additional Information

Relevant Loss Prevention Standards include:

- Business Continuity
- Business Continuity – Testing & Maintenance
- Business Impact Analysis
- Business Interruption – Indemnity Period and Maximum Indemnity Period
- Business Interruption – Rebuilding Period and Rebuilding Valuation
- Business Interruption Insurance – Committed Costs

To find out more, please visit [Aviva Risk Management Solutions](#) or speak to one of our advisors.

Email us at riskadvice@aviva.com or call 0345 366 6666.*

*Calls may be recorded and/or monitored for our joint protection.

Appendix 1 - Calculating a Specified Supplier Extension Limit Checklist



| | |
|-----------------------------------|--|
| Location | |
| Date | |
| Completed by (name and signature) | |

| | Factors to Consider | Y/N | Comments |
|----|---|-----|---|
| 1. | Is the Insured dependent on the Specified Supplier? (Detail to what extent / % of turnover or profits) | | |
| 2. | Are there any time of the year when the loss of this Supplier may be more critical than normal? | | |
| 3. | Does the Specified Supplier have any other sites that can assist the Insured? | | |
| 4. | Does the Specified Supplier utilise subcontract suppliers themselves? | | |
| 5. | Does the Specified Supplier hold separate warehousing of the items the Insured requires? <ul style="list-style-type: none"> i. Is this in a building/area away from the principle site? ii. Is it located in a location that would be unimpacted by a common/the same loss event as impacting the 'principle site'? iii. Is this quantified and factored into the Business Continuity Plans? | | |
| 6. | Has the length of time the Specified Supplier needs to recover its business activities to support the Insured been calculated? | | |
| 7. | Does the Specified Supplier have Business Continuity Plans in place? | | What provisions are there in their recovery plans that support and protect the Insured? |

LOSS PREVENTION STANDARDS

| | | | |
|-----|--|--|--|
| 8. | Are there any contract terms in the agreements or arrangements between the Insured and the Specified Supplier that may assist continuance of supply or compensate for a failure/partial failure to supply? | | |
| 9. | <p>Can the Insured obtain appropriate alternative supplies from other companies?</p> <ul style="list-style-type: none"> a. Is this documented as part of the Insured's Business Continuity Plans? b. How long will this take to arrange? c. Is there sufficient capacity at these alternate locations? d. Are there any specification alterations, regulations or quality controls that may need to be made or complied with in using the alternative supply? e. What additional cost may be involved in the use of this alternative supplier? f. Will the Insured's customers accept this alternative supply? g. Will this impact the Insured's reputation? | | |
| 10. | Does the Insured have buffer stocks of the Specified Supplier's goods at their own premises or elsewhere that will keep them operating for a time? | | |
| 11. | Are there alternative products that the Insured can produce to maintains the revenue streams and profitability in a different way? | | |
| 12. | <p>Is the Insured's policy cover considered adequate?</p> <p>For example, will the interruption period caused by the loss of this Specified Supplier exceed the client's Maximum Indemnity Period?</p> | | |
| 13. | Additional comments: | | |

LOSS PREVENTION STANDARDS

Please Note

This document contains general information and guidance only and may be superseded and/or subject to amendment without further notice. Aviva has no liability to any third parties arising out of ARMS' communications whatsoever (including Loss Prevention Standards), and nor shall any third party rely on them. Other than liability which cannot be excluded by law, Aviva shall not be liable to any person for any indirect, special, consequential or other losses or damages of whatsoever kind arising out of access to, or use of, or reliance on anything contained in ARMS' communications. The document may not cover every risk, exposure or hazard that may arise and Aviva recommend that you obtain specific advice relevant to the circumstances.

20/05/22 V1.0

Aviva Insurance Limited, Registered in Scotland Number 2116. Registered Office: Pitheavlis, Perth PH2 0NH.
Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

LOSS PREVENTION STANDARDS