Loss Prevention Standards

Business Interruption Insurance

Indemnity Period and Maximum Indemnity Period

Understanding the importance of accurately calculating the time an organisation may be out of business and need financial support if an incident occurs. Often underestimated, this needs to account for many crucial factors.

Business Interruption Insurance – Indemnity Period and Maximum Indemnity Period

Introduction

One of the most important decisions an organisation will make is calculating the Maximum Indemnity Period (MIP) for your Business Interruption Insurance policy. It is the maximum length of time your organisation will be covered for financial support after an insured incident which results in interruption to the business. Not being properly covered has serious consequences to getting your business back on its feet, so it is vital to take into account a range of factors when deciding the length of an organisation's MIP.

Understanding the Basics of MIP

The fullest length of time an organisation can receive financial support after an incident prevents it from trading is determined by the MIP. If your MIP runs out before your business is back to strength, it could struggle to fully recover, or even cease trading.

The MIP can be set for as long as the business requires, or the insurer will agree to, but normally the starting period is 12 months – going up in 6 or 12-month increments, i.e. 12, 18, 24, 30, 36, 42 months. Inadequate MIPs can be a frequent cause of underinsurance due to organisations underestimating the time it will take for their business to fully recover following a loss, so it is essential that appropriate consideration is given to this exercise.

Advice and guidance should be sought from risk and insurance professionals. But it is important to know that the final responsibility for deciding the correct MIP belongs to the organisation taking out the policy. To understand the duties owed by an Insurance Broker to an Insured when placing Business Interruption cover, see the legal ruling *Eurokey Recycling Limited v Giles Insurance Brokers Limited (2014)*.

How the MIP is Defined

It is important to understand how the MIP is defined by the policy.

Indemnity Period

"The period during which The Business results are affected due to the Damage, beginning with the date of the Damage and ending not later than the Maximum Indemnity Period."

Maximum Indemnity Period

"The number of months stated in The Schedule (unless amended in any Additional Contingency)."

In practice, this means the insurance policy will cover the business interruption losses starting on the day the incident (i.e. damage) occurs and ending at expiry of the MIP.

Let's say the damage occurred on 1 June, for example:

- With a 12-month MIP, the insurance will cover the business interruption losses incurred up to 31 May of the following year (but not beyond that date)
- With an 18-month MIP, the insurance will cover the business interruption losses incurred up to 30 November of the following year (but not beyond that date)

Extensions to the cover (known as Additional Contingencies) may have shorter MIPs and if so, these will be stated in the policy schedule.

Deciding the Duration of the Maximum Indemnity Period

There are two main starting points for estimating the MIP, but both have their limitations. In this guide, we discuss other factors that should be considered as well before arriving at the final length of the MIP.

1. Using the default 12-month MIP

While 12 months is always the starting point it should not be seen as a default position. In the majority of cases it is rarely sufficient to rebuild the premises, let alone fully recover the business.

2. Matching the time to rebuild the premises

In a lot of cases the MIP is set at the time to rebuild the premises. However, while a property might take 18 months to rebuild, your MIP needs to take into account the time needed to fully recover the business after the organisation has returned to the rebuilt property.

Even in cases where the business has continued trading from temporary premises or sub-contracted work out, it is unlikely that they will have been able to retain all of their customers/profitability. Some recovery time is often needed once the business has moved back into the rebuilt premises.

The MIP should be long enough for the business to fully recover back to the same financial position they would have enjoyed had the loss/damage not occurred.

Rebuilding the premises

In most cases, businesses want to return to the same premises following reconstruction/repair. They might own the premises, or the property is conducive to their business because of its nature, location, etc. Even for rented properties, contracts may stipulate that the tenant must return to the property providing the premises are rebuilt within a given timescale.

The time it takes to rebuild any property is affected by a wide range of factors, including:

- age
- size
- complexity
- construction materials/methods
- listed status
- location (centre of a city, remote, isolated site, etc.)
- style of building (terraced, semi-detached or detached)
- any trade-specific requirements (e.g. hygiene requirements for food production, etc.)

Other factors that may increase rebuilding time include:

- decontamination and site clearance
- the design process for the new building
- current building regulations
- approval from the local planning committee
- any environmental requirements – even properties built only 10 years ago may have to meet new standards on being carbon neutral or having rainwater harvesting/retention to reduce the flooding risk
- overcoming local objections

- access issues to the property
- issues arising if the site of the loss is considered a crime scene

Trading from alternative or temporary premises

Some businesses, such as small offices, or small industrial units with a trade counter (for example a plumbers' merchant), can normally move to alternative or temporary premises fairly easily. Within a relatively short period of time of the loss occurring, e.g. three months, business can be re-established and bringing in some income whilst the original property is being rebuilt.

For other businesses, alternative premises are not practical, for example, for food and pharmaceutical production which require licensed hygienic premises. It can take as long to fit-out a new property as it does to rebuild the original premises. Similarly, hotels and multiplex cinemas cannot easily trade from temporary premises.

Sub-contracting

Where alternative or temporary premises cannot be set up, this can possibly be mitigated by sub-contracting business out to other companies. However, these are likely to be competitors, and much will depend on the nature of the product. For example, it may be possible for a cake manufacturer to sub-contract to a competitor, but the organisation may find this unacceptable if it involves sharing 'trade secrets' like their recipes.

Machinery replacement

Some businesses, such as manufacturers, use specialised computer-controlled machinery and plant, or bespoke equipment which can be expensive and/or built to order. These may have a long lead time, for example 6 months to replace a single machine. When multiple machines are involved, it is likely that replacements will take considerably longer.

When it comes to older machines, there may be additional delays in sourcing replacements, for example, whether the original manufacturer still exists or whether second-hand items are acceptable.

Additional time should be factored in to install, commission and run-in any new machines to a point where the customer is satisfied with the quality of the product. It could take from a few weeks to even months, and some industries require validation periods and consistent product quality runs before trading again.

Given such things as long lead times, it may be that replacement machinery is not/cannot be installed until the premises are rebuilt and protection systems are in place, so it can be 18 months or more before the business is ready to resume, let alone supply any customers.

Customers

The loss of customers following damage/loss incident will also impact recovery, especially for businesses reliant on one or a small number of customers for a significant amount of their turnover. It can take a long time to get their business back or to replace them with other customers.

Marketplace

Recovery is also impacted by the number of competitors to the organisation and how easily customers change suppliers.

- An organisation may recover relatively quickly, if they have few competitors or are in a specialist market where competitors would struggle to increase production easily
- It will take a lot longer to recover or replace lost business, if there are a lot of competitors and customers can easily move business

Suppliers

While often not as critical as other aspects, consider how long it would take to replace damaged raw materials or stock that might be damaged during the loss. There may be limited supplies or long lead times for replacements, particularly for businesses who hold large inventories.

Validation, certification and quality assurance

Some businesses, once premises are rebuilt, may need to spend time on such items as securing appropriate validation, product consistency and agency certification. This is particularly important in manufacturing businesses where there could be exposure to human life, e.g. food or pharmaceutical industries.

Seasonality

Some organisations rely on a significant amount of their business at one time of the year or another:

- Christmas, in particular, accounts for a significant amount of retail and food sales so, for example, damage to a mince pie warehouse in the run-up to Christmas would have a far bigger impact to sales than any other time of year
- Another example is a seaside hotel which might achieve 80% of their business in the 6-month period from April to September but only 20% in the winter months of October to March

Businesses with significant seasonal peaks need to have MIPs in multiples of 12 (12, 24, 36 months, etc.). This helps cover the business sufficiently to recover regardless of when in the year the incident/damage occurs.

Let's take a seaside hotel as an example of how to ensure that the sum insured is adequate to cover the potential loss. We'll assume the hotel has an annual revenue of £1,000,000. In a normal year, they receive £800,000 (80%) of their revenue in the 6 months from April to September and only £200,000 (20%) in the 6 months between October to March.

- With a MIP of 18 months, they would be insured for £1,500,000 (£1m x 1.5). However, if the damage occurs on 1st April and lasts for 18 months to September the following year, they would potentially be losing £1,800,000 of revenue. This leaves them underinsured by £300,000
- With a MIP of at least 24 months they would be insured for £2,000,000 (£1,000,000 x 2), which would adequately cover the period – regardless of when the damage occurs

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Additional Information

Relevant Loss Prevention Standards include:

- Business Continuity
- Business Continuity Plan – Testing and Maintenance
- Business Impact Analysis
- 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 66 66.*

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