inotes
Newsletter from India's Leading Insurance Broking House
September 05

Summary

India Insure The risk managers

Message from the Editor

Dear Readers,

On July 26th, 2005, the nation watched helplessly as the citizens of India's commercial capital, Mumbai, waged a courageous battle with nature. The agony and the losses suffered by these hapless victims has been presented and written about in vivid detail in the media.

While India has seen a series of natural calamities over the last few years - the Tsunami, the Gujarat and Latur earthquakes, super cyclone in Orissa, the floods in Gujarat, cyclonic storms in Andhra Pradesh – the recent calamity in Mumbai has been decidedly different.

For one, the others had more tragic consequences – loss of life far outweighed loss of property. The Mumbai floods saw a reversal of this trend, with thousands of crores of property losses being reported. Further, the recovery of losses through Insurance cover has received a lot more attention this time. Insured losses as a proportion of total losses are much higher than earlier and several steps have been taken by Insurers, Surveyors and the IRDA to mitigate the hardship of the insureds.

We dedicate this issue to discussing the various facets of Floods, their aftermath and how to manage a flood-like situation if and when we are exposed to it. Our Product section focuses on Business Interruption Insurance – a cover which is suddenly attracting a lot of attention – thanks once again to the Mumbai floods!

One hopes industry will, as a fall-out of this calamity, opt for adequate, and not just the cheapest available cover, for their critical assets. After all, when disaster strikes, CEOs will want to know how best to recover the losses, not how much premium was saved last year.

Warm Regards

V Ramakrishna
Editor – ***inotes*** & Managing Director, India Insure

The Fury of the Floods

… the aftermath and how to protect yourself better

While the fury of nature unleashed itself across Maharashtra during the last week of July 2005, the entire nation waited with fingers crossed for the floods to abate. 94.4cm (37.1 in) of rain lashed down on Mumbai on a single day. India's previous heaviest rainfall, recorded at Cherrapunji in the northeastern Meghalaya state, was 83.82 cm (33 in) and fell on July 12, 1910. In comparison, London receives about 28 in of rain per year.

The bustling activity in Mumbai, the industrial capital of India came to a grinding halt. While those directly and indirectly affected were desperately trying to recover from the sudden deluge, panic buttons were pressed at all the Insurance offices. Over 25000 claims have been reported amounting to around Rs. 2600 crores.

ENORMITY OF THE LOSS:

While the estimates received from the Insurers suggest the losses to be in the range of Rs. 2600 crores, the All India Association of Industries (AIAI) has revised its earlier estimates of losses due to the floods from Rs. 2,500 crores to Rs. 5,000 crores excluding man-days lost. These estimates cover only Mumbai, Thane, Raigad and Ratnagiri districts and exclude districts like Pune and Sangli-Satara, which have also seen severe flooding in the subsequent days. Among industries, the pharmaceutical and chemical industry has lost more than Rs. 500 crores, textiles around Rs. 400 crores and engineering & allied industries over Rs. 200 crores. Losses to the transport sector could range anywhere between Rs. 300 - Rs. 500 crores. Touted as the 'Manchester' of India, Bhiwandi, the powerloom capital of the country accounts for six lakh powerlooms - a third of the country's installed capacity with job-work accounting for 70 per cent of the work undertaken. The flooding has severely damaged more than 2.50 lakh powerlooms - losses could amount to over Rs. 600 crores.

WOES OF THE INSURED AND INSURER

Insurance companies have been unable to conduct proper surveys due to heavy water logging - in many cases, surveyors could not reach the spot of incident. There also has been a shortage of surveyors.

This could probably have been overcome by the Insurance companies getting together and having the surveyors distributed to each locality and if possible the closest to where the Surveyor resides.

The customers had, in addition to facing the fury of the floods, to continue with the misery of having to retain the damaged items until the surveyors' visit. There also have been claims reported where all necessary documents supporting the policyholder were washed away.

On the industrial front, maximum claims have been made for stocks lying in godowns and on account of flood affecting the buildings, plant and machinery. Disposal of stocks like food grains etc also has been a major problem for the granaries.

To ease the hardship faced by both the Insurer and Insured, IRDA has come forward and enhanced the In house survey limits of Insurers from Rs.20000 to Rs.50000 for losses arising specifically from these floods.

HOW DOES THE FLOOD COVER OPERATE IN INDIA?

Fire Policies: The fire policy has an inbuilt cover for losses arising out of Floods. However, the Insured has the option of availing a discount for opting out of the cover.

Motor Policies: Flood is an inbuilt peril in the Motor policy

Transit policies: Transit policies (All risks) have an inbuilt cover for losses arising out of a flood

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Business Interruption Cover

(Technical terms appearing in this article have been explained at the end of the article)

Torrential rains flood a city and force a hospital to evacuate all patients and shut down for a week. An event like that of September 11 and the entire area is cordoned off forcing business establishments to shut down for a fortnight. A major fire necessitates a factory / hotel to be closed down for normal operations for a month.

While the above examples are hypothetical, the potential situations they discuss are distinct possibilities. Business interruptions do happen! A situation like the recent floods in Maharashtra has thrown several industries out of gear. An industrial godown storing seasonal raw material required for production has been completely submerged leaving the material unfit for production - procuring additional raw material may take another couple of months. While the physical loss of material was for about Rs 25 lakhs, loss of production has resulted in financial losses worth crores of rupees!

There are times when a business flow is interrupted and the owner makes a seemingly simple request to an insurance provider: "***Pay me for the sales I would have had.***"

How then would they make up that lost income?

It is possible to be financially prepared for this kind of business crisis through a little known type of insurance cover called **business interruption insurance**. This insurance usually is sold in tandem with property coverage

Coverage is generally provided for the "period of restoration", which is usually considered to be the period which would be required to rebuild, repair or replace the damaged property at the described premises with reasonable speed and similar quality. It usually commences with the date of such damage or destruction and it is not usually limited by the date of expiration of the policy

What does Business Interruption Insurance cover?

Business Interruption Insurance compensates you for:

- Profits you would have earned, based on your financial records, had the disaster not occurred.
- Operating expenses, such as electricity, that may be incurred even if the main business activities are temporarily stalled.
- Some policies cover expenses incurred from operating out of a temporary location while the original premises are being repaired.

The Business Interruption Policy can also be extended to cover loss of profit to the insured due to:

- Accidental failure of public electricity/ gas/water supply
- Damage to customer's premises due to perils covered under Fire Policy
- Damage to Supplier's premises due to perils covered under Fire Policy

How much do you insure for?

The sum insured under the Business Interruption Policy should represent the **gross profit** of the **indemnity period** selected.

The gross profit should represent the net trading profit plus insured **standing charges** (fixed charges). The list of standing charges to be insured have to be specified. Gross profit can be insured on one of the following basis

i. Turnover basis

ii. Output basis

iii. Difference basis

iv. Revenue basis

The sum insured should correspondingly be increased if the indemnity period is more than twelve months giving due consideration for variations and trends

Pricing:

In India, the rates are governed by the Tariff and is primarily dependent on the Fire / Machinery policy rate - with the turnover, nature of process *(batch or continuous)* and the indemnity period having a bearing on the premium payable.

Conditions for a claim to be tenable:

1. An insured peril must cause direct physical loss to the property at the premises covered;
2. The covered loss must cause a necessary suspension or interruption of operations; and
3. The business income loss must be caused by the suspension or interruption.

Case Study:

One of the top manufacturers of mobile telephones supplying a global market, where demand peaked recently at approximately 450 million units a year, faced a serious obstacle. A small **fire** at a key microchip unit left a hole in the already constrained production

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Business Interruption Cover .... Contd. from # 02

of a unique 45-cent radio frequency microchip. The chip was distinctive, and there was no alternative supply. The resulting interruption to production caused the telecoms manufacturer to lose more than 4 million units of sales worth nearly $200 million in profit.

Claim Valuation:

It is important to note that there is no prescribed or accepted formula for the determination of the actual loss payable under business interruption insurance. The method employed, however, should test the past experience and the probabilities of the future, and the loss should be determined in a practical way, having regard for the nature of the business and the methods employed in its operation. Further, it should give practical effect to the intentions of the parties, and the purpose of the insurance, as evidenced by the terms, conditions, and provisions of the policy.

Thus, the insured's books and accounting system are not the only determining factors in this situation. Nevertheless, they are not irrelevant and will be given such weightage as practical judgment dictates.

Terminology:

Gross profit: The sum produced by adding to the Net Profit the amount of the insured Standing Charges, or if there be no Net Profit the amount of the Insured Standing Charges less such a proportion of any net trading loss as the amount of the Insured Standing Charges bears to all the Standing Charges of the business.

Standing charges: Those charges which continue to be incurred and are not reduced in the same proportion as the reduction in turnover eg. Rents, insurance premium, advertising expenses etc

Indemnity period: Is the maximum length of time likely to elapse before the loss or damage can be reinstated and the earnings of the business restored to their pre-loss situation

Turnover: The money paid or payable to the Insured for goods sold and delivered and for services rendered in course of the business at the premises.

Revenue: The money paid or payable to the insured for work done and service rendered in course of the business at the premises.

The Fury of the Floods....... Contd. from # 01

Engineering policies:

Flood is an inbuilt peril in the CAR / CECR / CPM / EEI policy.

The Boiler explosion and Machinery breakdown policies do not cover the losses arising out of a flood

Householders and Shopkeepers policies: Flood is an inbuilt peril in the Fire section of these policies

LOSSES UNINSURED:

Deletion of cover: The major uninsured losses have arisen in cases where the Insured has opted to delete the risk of flood from the Fire policies as a method of premium savings.

Business Interruption: Another policy which has still not caught on with all the industries is the Business interruption cover. "Business interruption" insurance is intended to compensate the insured for the income lost during the period of restoration or the time necessary to repair or restore the physical damage to the covered property (read more about *Business Interruption Insurance* on page 2 of this issue).

THE WAKE UP CALL:

Its time to shake off the myth that only those near a water body could be affected by floods. There is every possibility of any low lying area / basement of a high rise building getting inundated through river- or rain-water.

The STFI cover as it is normally called covers losses arising out of the vagaries of nature like **S**torm, **T**empest, **F**lood, **I**nundation, Cyclone, Typhoon, Tornado and Hurricane

While a **Flood** arises due to the overflowing of excess water from the confines of a water body, it may also be caused by excess precipitation due to natural disturbances. **Inundation** is the accumulation of water in a normally dry area.

A quick review of the Insurance policies is required to ascertain how well prepared you are for such an event. Please do a check on

- Whether all the Assets are insured
- Whether the STFI (Storm, Tempest, Flood and Inundation group of perils) cover has been opted for
- When was the last valuation of Assets carried out.
- Whether the policies have been taken on a Reinstatement Value *(the cost of replacing the property with an identical one in the event of a loss)* basis and the Sum insured declared denotes the Reinstatement Cost.

Risk Management - *Being Prepared For Floods*

What is a Flood?

A flood occurs when a body of water rises and flows onto normally dry land. Floods are a natural and inevitable occurrence along rivers and streams, and can happen anywhere.

The following checklist is designed to help you prioritize preparedness, response, and recovery procedures. These procedures, which can help you limit damage to your property and business, can be incorporated directly into your emergency preparedness plan.

Emergency preparedness : Before the Flood

- Establish an emergency Preparedness Plan (EPP) that takes prevention, emergency response and disaster recovery into consideration. If an EPP is already in place, review and update it as needed for flood readiness.
- Designate an Emergency Coordinator and an EPP Team. Assign responsibility to specific employees for advance arrangements and flood emergency response, including removal of stock and equipment.
- Practice your evacuation plan. Ensure that all employees know the safest route to high, safe ground.
- Keep a list of all vendors' and key customers' telephone numbers and other important contact information available and secured.
- Keep insurance information and contact names and numbers in a safe place. This information will expedite the claim process in the event of a loss.
- Try to control the flow and direction of water around critical areas of your operation. Direct water underground or to areas away from the building. Your local flood control district, government association, or contractor can provide assistance with erecting retailing walls and diverting water flow.
- Install a sump pump; have a backup available in case the main pump fails.
- Make sure windows at ground level are watertight. Window covers that can be bolted in place are most effective in keeping water out.
- Keep emergency equipment (such as portable radios and flashlights) in working order. Portable, battery-powered radios are essential in an emergency. Tune in to local stations and follow emergency instructions.
- Keep materials on hand that will help prevent water damage. Materials such as sandbags, plywood, and plastic sheeting can be used to protect property.
- Do not pile sandbags too close to the walls of the building. Wet bags can exert excess pressure on the foundation, resulting in significant structural damage.

Emergency Response: During the Flood

- Move valuable papers and other contents to higher elevations or remove them from the premises altogether.
- Back up computer files and store them in a water tight container off premises.
- Remove all chemical paints, oils, cleaners, flammable liquids, etc. from the premises. Doing this will not only prevent them from causing damage to the rest of the facility, but will also safeguard the health of the individuals involved in clean-up operations.
- Bring outdoor possessions inside, or tie them down securely, to keep them from being washed away.
- Anticipate the possible impact upon suppliers and customers. Make arrangements for routing inventory and deliveries to another facility until flood waters have subsided.

  Stock up on high- demand items if suppliers are also susceptible to flood damage, because delivery schedules may be disrupted.
- Turn off all utilities at the main power switch and close the main gas valve if evacuation is imminent. Do not touch electrical equipment unless it in a dry area and you are standing on a piece of dry wood while wearing rubber-soled boots or shoes and rubber gloves.
- Remove electrical motors and control panels from large equipment that cannot be moved, following prescribed removal procedures and electrical safety techniques.

Emergency Recovery: After the Flood

- Before entering the building, check for structural damage.
- Watch for animals that may have chosen the structure as a refuge to escape the floodwaters.
- Determine that all electrical hazards are controlled.
- Drain and clean basements. After the flood waters have subsided, begin draining the basement in stages, about a third of the water volume each day. Pumping out water too quickly may cause structural damage.
- Clean damaged property. Flood waters may have transported sewage and other hazardous materials.
- Document the damage.
- Begin salvage operations.

Disclaimer

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