

# Contingent Business Interruption

## Understanding the Risk

Standard Business Interruption (BI) insurance cover relates to the loss of income following direct physical loss or damage to a location of our insured from a peril not otherwise excluded. Contingent Business Interruption (CBI) cover, where this is provided, relates to business income loss incurred by our insured as a result of direct physical loss or damage to a location of a supplier or customer from a peril not otherwise excluded by our insured's policy.

The drive for cost savings and economies of scale coupled with the need for high levels of quality control supporting "lean manufacturing" or serving a 'just in time' delivery concept for components, raw materials, sub-assemblies or products etc. has resulted in a truly global supply chain for many businesses. This multi-country 'business to business' sourcing can be very complex and continued income is likely to be dependent upon an uninterrupted flow being maintained as 'buffer stocks' are reduced to remove capital from the supply chain.

Recent natural catastrophe events such as the 2011 Tohoku, Japan Earthquake and the 2011 Floods in Thailand have focused attention on the detrimental affects to businesses from their suppliers, especially in some industries such as car manufacture and the electronics industry. Manufacturing resilience, especially related to single points of failure, in complex sourcing arrangements from 'first tier, second tier and beyond' suppliers has invariably been overlooked. The financial implications quickly become apparent but businesses need to also consider the wider implications such as their continued market share or their brand image which may be more difficult to re-establish if at all following a prolonged disruption. A key point is that whilst single source suppliers may result in cost advantages, they inevitably bring greater risks that need to be fully understood and controlled.

Management (ERM) approach the scope of the Business Continuity Planning should be extended to include an analysis of CBI exposures.

## Evaluating the Risk

The nature and complexity of CBI risks is very specific to each entity so any evaluation process undertaken needs to reflect the needs of the business. The following roadmap process is provided as a generic framework and each business will need to consider and develop their own methodology. The outcome will be to ensure there is a sound understanding of the critical and high risk suppliers or customers (including site audit/inspection where deemed appropriate), interdependencies, single sourcing, threat assessment, financial implications, mitigation strategies and continuous improvement.

The process needs a high level of commitment and ownership and once established, should receive regular and ongoing review as part of the extended Enterprise Risk Management program to ensure it keeps pace with changes in the business.

## Suggested CBI Assessment Process

### Critical or Key Suppliers

- Identify critical or key suppliers
- Establish what financial due diligence was conducted before awarding a contract
- Establish and document contractual implications in the event of failure to deliver
- Related to above, establish what terms apply in the event of loss due to Force Majeure (see definition below).
- What property insurance requirements are in force and how are these audited for compliance
- Establish what lower tier suppliers feed into identified critical or key suppliers
- Establish and document the type of items (raw materials, sub-assemblies, components etc) are sourced and the average annual value of shipments
- Establish criticality of items supplied
- Establish sole and single source suppliers and values of items shipped
- Are supplier facilities in geographic locations vulnerable to Natural Catastrophes – Earthquake, Flood, Tsunami, Wind

- What percentage of items are supplied from facilities identified as being in Natural Catastrophe zones – consider countries such as:
  - China
  - Japan
  - Taiwan
  - Thailand
  - Mexico
- Just in time and lean manufacturing implications – what buffer stocks are held by supplier, in supply chain or at own site
- How long will buffer stocks last before loss of a key supplier impacts on the business operations
- Establish loss history resulting in supply disruption from key suppliers concentrating on;
  - Cause of loss
  - Length of downtime and financial impact
  - Steps since taken to prevent or mitigate recurrence
- Review geographic location and potential accumulation of risks for critical & key suppliers

### **Risk Mitigation and Control**

- Identify alternative suppliers for critical or key suppliers
- Establish how quickly alternative suppliers can come on stream to meet demand – consider buffer stocks
- Establish Business Continuity Plan (BCP) expectations for critical or key suppliers

- Establish benchmark protection expectations (sprinklers, fire alarms etc) for critical suppliers
- Undertake audits of key or critical suppliers to verify compliance with benchmark standards for business continuity and physical protection expectations

### **Business Impact Analysis**

Based on the information obtained for each critical or key supplier, a review should be undertaken to establish the probability of an incident to occur and quantify the financial impact to the business. The results of the Business Impact Analysis should form the basis of implementing strategies and processes to contain potential interruptions to the supply of critical items.

A high level BCP should form an integral part of the strategy and this should be maintained up to date, subjected to at least annual review/test and communicated to appropriate personnel.

For further information or assistance, please contact your **RMC** Risk Engineer.

### **References**

Insight – Business Continuity Planning  
 Insight – Business Continuity Plan Testing  
**RMC's** Guide to Building a Business Continuity Plan

### **Force Majeure - Definition**

Force Majeure ("greater force") - excuses a party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract.

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