

# Can Insurance Create Market Incentives for Better Risk Management and Resilience for Small Businesses?

Energy is first among equals in critical infrastructure. When energy systems do not work, arguably neither does anything else. So, the impacts of energy disruptions are far-ranging and the costs extremely high. A 2013 White House study estimated that 2003 and 2012 weather-related outages alone were estimated to have cost the U.S. economy an inflation-adjusted annual average of \$18 billion to \$33 billion. [Economic Benefits of Increasing Grid Resilience to Weather Outages, 2013]

That is certainly one reason why considerable effort has gone into identifying risks and solutions to reduce the risk of infrastructure failures. Despite best efforts, however, there will inevitably be disruptions whether due to aging, accidents or attacks. The one thing we know about the future is that it is increasingly volatile and unpredictable.

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But, disruptions do not necessarily have to cascade into disasters. A backup line of defense is what businesses can do to identify and mitigate the risks of energy disruptions. In general, large businesses have sophisticated risk management practices, deep pockets and diverse locations that make it easier for them to manage the impact of local disruptions. The same cannot be said for small businesses, which are often unprepared to mitigate the losses from an energy disruption — or indeed, most types of disruptions. According to Travelers Insurance, about half of small businesses do not have even a basic business continuity plan. Companies that do have continuity plans do not always test them. The bottom line is that 40 percent of small businesses fail to reopen after a disaster, according to the Institute for Business and Home Safety, and that has the potential for enormous impacts for regional economies.

A number of policy groups look to the insurance industry to drive more investment in resilience — either through incentives for reduced premiums or through requirements for coverage. The industry is clearly a leader in risk assessment and risk management best practices. But do these practices align well with a world in which risk events have higher impact, less predictability and greater frequency. This White Paper explores what role the industry can play in incentivizing small businesses to become more risk aware and resilient:

- Section 1 analyzes available insurance tools and limitations on those tools to achieve resilience missions.
- Section 2 captures on-the-ground perspectives of Aaron Levine, owner of a financial services company, who specializes in creating insurance packages for small business clients.
- Appendix 1 sets out the Travelers Insurance Guidance on Business Continuity Planning.

## Section 1: Does insurance create market drivers for business resilience?

An industry that depends on actuarial tables and probabilities, the insurance industry is struggling to come to grips with a world of volatility and random events. A recent DOE study described some of the difficulties in managing this new risk environment for insurance companies. [Insurance as a Risk Management Instrument for Energy Infrastructure Security and Resilience, Friedman, 2013].

It noted that:

“To be insurable, an event must be predictable in frequency and severity [i.e., assessable], so that an appropriate premium that corresponds to the underlying risk can be determined [i.e., economically viable] and a large number of affected parties can share and diversify the risk [i.e., mutual]. However, due to the lack of historical data, inherent uncertainties posed by some of the phenomena, as well as the changing nature of technologies that are impacted by emerging risks such as cybersecurity and space weather, neither frequency nor severity can be assessed to calculate an appropriate premium that is mutual or economically viable....Despite the mature and large insurance market—\$1.7 trillion or a third of the world’s insurance market—no universal or standardized methodology exists in the United States to measure or quantify the impacts of natural hazards.”

When dealing with known risks, the industry relies on well-defined standards or best practices as a requirement of coverage for physical assets. These would include minimum fire safety standards, building safety codes and a variety of other standards designed to reduce the chances of accident or injury. Companies that meet or exceed these requirements may receive benefits in the form of reduced premiums. By contrast, however, there are no defined standards or best practices that insureds can meet to reduce the risks of unexpected disruptions.

The insurance industry has been in the forefront of exhorting businesses to develop a business continuity plan — arguing that insurance does not represent a viable alternative to an internally developed risk management capability. There are step by step Internet-based guides to assist small business owners in developing business continuity plans. [See Appendix 1] Yet, these efforts are largely educational — the pricing and availability of business interruption coverage is not determined by any objective measure of a company’s ability to manage disruptions.

**Business Interruption Insurance Basics:** Business interruption (BI) coverage is the primary way that businesses can protect themselves against disruptions. BI insurance covers the business expenses while it is closed, including payroll, rent, taxes, lost revenue, lost inventory etc. The problem is that BI coverage can be limited in both scope and value. There are three critical elements to BI Insurance.

**1. It is triggered in three limited circumstances.**

- There is physical damage to the premises of such magnitude that the business must suspend its operations. The requirement for physical damage may exclude business closures that resulted from some other cause, such as a blackout, IT or supply chain disruption.
- There is physical damage to other property caused by a loss that would be covered under the company's insurance policy and such damage totally or partially prevents customers or employees from gaining access to the business. BI insurance generally mirrors what is covered in the company's main business policy. If a company didn't include flood coverage in its general policy, it won't have interruption coverage for flooding either. Loss of utilities is also sometimes excluded from standard interruption policies. Additional coverage is available for purchase to cover other contingencies.
- The government shuts down an area due to property damage caused by a peril covered by the company's insurance policy that prevents customers or employees from gaining access to the premises.

**2. Coverage is limited.** The coverage is not retroactive to the day of the event. After the waiting period, coverage is provided for lost net income, temporary relocation expenses (designed to reduce overall costs) and ongoing expenses such as payroll that enables businesses to continue paying employees rather than laying them off. In addition, the business is required to prove all business interruption losses to the insurance. Business Owner Policy (BOP) coverage typically puts a dollar limit on the interruption insurance, which may or may not cover the loss. For small businesses, that dollar value is often capped at between \$10-25,000.

**3. Coverage is not open-ended.** Business interruption coverage ends when the damaged property is repaired or replaced. It is possible that the organization may still suffer a decrease in sales and lower profitability even when it is once again able to function at 100 percent.

**Bottom line:** Business interruption insurance was never intended to cover all business interruptions. Its original objective was to provide a backstop in areas where companies were already required to mitigate risk under their insurance policies. The dearth of standards for resilience — risk management or business continuity systems to reduce the impact of unanticipated risks — makes it virtually impossible for insurers to drive investment in resilience best practices through economic incentives or requirements.

## Section 2: Small Business Perspectives on Insurance and Risk Management

Interview with Aaron Levine, Professional Insurance Agent and owner of LG Insurance Group, Long Branch, New Jersey, December 29, 2014

In an interview with Debra van Opstal, Executive Director of the U.S. Resilience Project, Mr. Levine addressed the challenge of increasing risk awareness and risk management among his small business customers.

### 1. How do your business clients deal with risk management?

First and foremost, it is essential to distinguish between large and small companies — two completely different worlds — and they need to be assessed separately. Big businesses have more resources and geographic diversity to mitigate losses. And they tend to have risk management assessments in place.

By and large, small businesses do not do risk assessment. Their risk management strategy is often buying insurance. Many buy it because their landlords require it to lease the space. They're using insurance as an alternative to business continuity plans.

Often, small business owners want business interruption insurance coverage, but they do not want to pay for it. They try to buy as little insurance as possible, leaving themselves exposed. They may kick themselves later when something happens for choosing to save \$50 or \$100 per month because, often, they do not have a nest egg to pay for recovery.

Individual businesses, especially small businesses, are not doing their own risk assessments, and they often get angry when the insurance companies put requirements on them that reduce the possibility of accidents or incidents. Uneducated tenants and business owners are often unsure why the insurance companies put such requirements on them for risk management. Many small business owners feel that insurance is adequate and do not need to do additional risk management.

### 2. How do you deal with your clients in terms of assessing their potential exposure? Do you discuss with them what their potential loss could be?

Exposure assessment is based on the clients' needs and our experience in assessing those needs. Salaries can be used along with rent and taxes to help with determining proper coverage. At the end of the day, the insured has the option of choosing which level of insurance to take.

### **3. What is the process for assessing risk of companies applying for insurance coverage?**

We [independent brokers] assess the risk through the initial application. For larger clients, I often go out and do a risk assessment. For smaller clients, the assessment tends to be verbal, since there's not enough revenue to justify a site visit. The underwriters are responsible for verifying the assessment of risk. If there are issues that need to be addressed, they do it during their audit and inspections.

There is a financial penalty for my company in not getting the risk assessment right. If there are too many claims, the insurance companies won't want to continue to do business with me. On the other hand, there is no financial incentive for me to spend time helping businesses develop better risk management or business continuity planning. The only benefit for me assisting clients in risk assessment and management is maintaining relationships and the business year after year. If there were additional financial rewards for me, I would be able to set up a risk management department to better help all clients.

### **4. Are insurance purchasers aware of what their insurance covers?**

Many of them are not. In the digital age, where people are buying on line, they tend to choose low price without looking carefully at the coverage. They often do not know what they're buying. This is something I deal with on a daily basis because I compete for those clients. I ask them: What kind of coverage do you have? And they do not actually know. There's a tremendous amount of business owners who are uneducated about their insurance.

### **5. When you see a market gap like that, is there a feedback loop for communicating with the underwriters?**

There isn't one. It's my job to sell insurance. If I have an issue with the way an insurance company is writing the policy, I go to a different insurance company. I have 30 companies that I work with to find the right coverage for the client?

### **6. Do you ask clients if they have a business continuity plan?**

It seems like a no-brainer, but I've never asked. And it's not on the application or risk assessment forms provided by the insurance companies. But, I believe the percentage of my small business clients with a tested business continuity plan is likely to be very low.

### **7. Is there any kind of help from underwriters to help clients develop business continuity plans?**

Insurance companies do educational outreach and risk management assessments — but that's the extent to which I've seen it taken.

There is a company ServPro — a national loss mitigation franchise business — that has created a readiness checklist. That tool helps you gather critical recovery information and contacts — your emergency contacts, your utility shutoff information, your landlord, insurance, property information and all building access all in one file — and access the information on a mobile app.

**8. Are there underwriting criteria that carry standards on how to be more resilient or how to test the quality of business continuity plans.**

No.

**9. What percentage of your clients have business interruption insurance?**

Ninety-five percent of my clients have this coverage. They maintain the coverage in various degrees, but there are very few clients without any interruption coverage.

**10. What does basic business interruption insurance cover?**

Business interruption (BI) covers your gross business profit which covers payroll, rent, taxes, other utilities if the business is forced to shut down by an event that is covered under the policy. BI is an add-on to your basic business insurance. If you have the fire protection in place you're eligible for BI.

Take as an example, a transformer blows and a local restaurant is without power for five days. During that period, no meals can be served. Inventory is ruined. It takes an additional two days to reopen. The lost seven days of business revenues must be quantified. With the right coverage, that income as well as the lost inventory can be quantified and recovered. The business, however, needs to be able to document payroll, gross revenues and inventory that needs to be replaced. Cash businesses lose on this every time. Businesses that are hiding money from the government are also unable to accurately document losses on an insurance claim.

A business interruption sublimit is part of standard Business Owner's Policy (BOP). So, business interruption coverage is often tied to physical damage and that damage must be covered under the basic insurance policy. There are exclusions for certain types of triggers. For example, earthquake and flood damage are typically excluded on a standard BOP insurance policy. The flood exclusion can be problematic, given that this is a big risk in this region (i.e. coastal New Jersey). Under the sublimit, water damage from a pipe that broke inside the building would likely be covered. But, flooding from a broken water main in the street would be excluded, unless the company had a separate flood insurance.

Some policies also include losses from utility disruptions in the business interruption coverage, including gas, phone, electric and water. However, this is limited in terms of dollars and coverage. Depending on the policy, coverage would typically be capped at between \$10-25,000 regardless of the actual loss.

Additional business interruption insurance can be purchased separately, increasing the amount and scope of business interruption coverage. The Hartford has introduced a new Extreme Weather Endorsement. The coverage reflects the interdependencies that can cause cascading failures; for example Hurricane Sandy caused flooding which resulted in power failures which in turn created business losses. While a traditional sublimit might have excluded coverage because the damage was triggered by flooding, the Extreme Weather Endorsement creates business interruption coverage no matter what triggered the disruption. But, it must be purchased for an additional premium.

Other types of BI insurance are available to cover supply chain disruptions or cyber disruptions — and these are also priced separately.

## Appendix 1: Travelers Insurance Guidance on Business Continuity Planning

**Demands of the 21st Century:** The importance of business continuity planning has grown significantly over the past few years with the explosion of the Internet, e-commerce and non-stop applications. Just a few years ago, customers were willing to tolerate 24 hours of downtime. Today, most companies need to recover within hours and demand that a full complement of capabilities be maintained during disaster conditions. To be successful, your organization's business continuity plan must be an integral part of your strategic operating plan. It must become a philosophy, a culture, a mindset and a way of life. A predefined continuity plan hastens recovery with solutions that are carefully thought out beforehand, thereby eliminating hasty decisions made under stressful conditions. By providing a more rational, fact-based procedure for decision making, planning allows the opportunity to minimize risk and uncertainty.

To maximize your chances of successful recovery, combine your business continuity plan with proper insurance coverage such as business interruption, extra expense and contingent business interruption coverage. A strategic business continuity plan should provide the guidance needed to minimize downtime and organize the resources needed to plan a prompt recovery.

**Why Do You Need A Business Continuity Plan:** Every organization is at risk. A fire, tornado, earthquake or explosion could seriously damage your building. Floods originating inside or outside your building could affect your operations. A prolonged power outage, sabotaged computer system or damaged equipment can also shut down an organization. Your managers and employees could be killed or badly injured. Your facilities, inventory and essential information could be inaccessible for a prolonged period. Any event, big or small, may cause an interruption in your business operation.

**Competition and the Pace of Today's Business Demands Fast Response:** Long-lasting business relationships are fading in the face of global competition, customer demands and shifting markets. If business interruption occurs, the ability of your business to survive may be threatened. Unless you are prepared to respond immediately, your employees, suppliers, and customers may go elsewhere. Before that happens, arm yourself with the best defense – a well prepared and practiced business continuity plan.

**Pre-Requisites for Successful Business Continuity Planning:** Senior management must be actively involved in the development of the business continuity plan and must do the following:

- Agree that a plan is needed
- Assign the necessary resources for plan development
- Agree in the selection of essential activities and priority for recovery
- Agree to back-up arrangements and the costs involved
- Be prepared to authorize activation of the plan



## Step-By-Step Guide

1. List the major functions or activities of your organization. List the functions of each unit, department or branch.
2. Determine which activities are time-critical business functions. The continued operations of these services or activities are considered critical for the organization.
3. Assign a priority to each of the time-critical activities. Rate each activity from 1 to 5 to show the length of time it can remain disrupted. For example, one day or less is a priority 1, 2-4 days a priority 2, 3-5 days a priority 3, and so on.
4. Develop a planning objective for each activity. A planning objective states your organization's goal for resuming each activity within a specific timeframe [i.e., restore data center operation in four hours].
5. Determine the minimum needs for initial response. Plan for restoring communication methods, and then consider essential information sources, essential equipment and key internal or external personnel who will be crucial for continuity efforts.
6. Obtain senior management approval of the essential functions, priorities and planning objectives. This allows confirmation of key decisions made during the planning process.
7. Delegate planning assignments to the staff who carry out the essential activities on a daily basis. Personnel who carry out tasks on a daily basis are generally the best qualified to perform recovery and continuity functions.
8. Incorporate fine details into the plan. Focus on the impact of the business interruption, not the cause. Review budget and staffing needs to implement the plan requirements.
9. Consolidate all sections of the plan into a comprehensive business continuity plan for your entire organization. Communicate the plan to all employees. Assemble individual department or branch plans into the overall company plan. Train key employees in their response to plan activation. Inform all employees of the plan.
10. Remember, there is a human cost in a crisis or disaster. How will you help employees restore their emotional and physical health following a crisis or disaster? Identify resources, such as employee assistance programs or community-based resources, to help your workforce cope with the event.
11. Test the plan. Update the plan regularly based on test results and organizational changes. Testing is crucial to determining whether your plan will work as intended in a real disaster or crisis situation.

Travelers Insurance: <https://www.travelers.com/business-insurance/risk-control/protecting-your-business/Docs/Business-Continuity-Risk-Management-58668RMG.aspx>