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Supply Chain Risk

Managing your piece of a global problem

As we enter 2022, supply chains are like the weather. Everybody's talking about it, but what can you do about it?

"2021 was the year that supply chain finally tipped over into the public consciousness and became headline news all over the world," writes Jim Yarbrough, director of the global intelligence program for the British Standards Institution (BSI), an organization that promulgates technical and market standards for the United Kingdom.[1] Supply chain concerns extend to the highest levels of government, with U.S. President Joe Biden taking several high-profile steps to address shortages, bottlenecks, and security threats impeding the flow of products.

Observers have used the well-worn phrase "perfect storm" to describe the factors leading to supply shortages in numerous sectors of the economy in 2021. These include:

- Shortages of terminal capacity at major ports, resulting in backlogs of vessels idling offshore waiting to be unloaded;
- Shortages of shipping containers, partly as a result of the terminal backlogs;
- Shortages of qualified drivers to transport shipments over land;
- Regional lockdowns due to outbreaks of COVID-19 and its variants; and
- Disruptions in transit due to trade disputes and political unrest.

In light of these and other far-reaching causes of supply chain disruption, Everstream Analytics, which specializes in supply chain analytics, predicts that enterprises will shift to shorter, more localized supply chains with increased reliance on multimodal means for transporting products.

Even with such adjustments, Everstream anticipates supply chains will continue to be disrupted by constraints in air cargo capacity, cyber-attacks on production sites and logistics operators, and insolvencies among small and specialized producers.[2]

Okay, now what?

If there's one thing that's not in short supply in 2021, it's advice about how to manage supply chain risk. Type those words into a search engine, and you'll trigger a tsunami of advice about enhancing your "visibility" into the various "tiers" of your supply chain (the suppliers of the suppliers of your suppliers, so to speak).

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Supply Chain Risk
Continued

There's a common phrase among supply chain managers, according to Paul Raw, BSI's senior consultant for supply chain security: "You inherit the risks of your business partners." He adds that "if you don't understand your business partners, and you don't understand their risk, you don't understand your own exposure to it."[3]

But, given the number and range of factors disrupting supply chains, how much time and effort can an enterprise really devote to monitoring its business partners and their operating environments?

To illustrate, consider the advice provided by consultants from McKinsey & Company, who propose a four-step approach to supply chain risk management: (1) identify and document risks; (2) build a supply-chain risk-management framework; (3) monitor risk; and (4) institute governance and regular review. Sound simple? It's not.

The McKinsey authors themselves cite three major impediments to implementation of effective supply chain risk management[4]:

- "Supply-base transparency is hard (or impossible) to achieve." There are so many parties involved in the creation and distribution of a product that simply identifying them requires significant investment.
- "The scope and scale of risks is intimidating." The number and range of hazards and operational shortcomings is so great that it is extremely difficult to quantify probabilities and severities.
- "Proprietary data restrictions impede progress." Not all participants in a chain are willing to share critical information, especially with parties they do not have direct relationships with.

Most organizations must therefore rely on a "risk-aware culture," which the McKinsey authors describe as one where employees are free to acknowledge mistakes and share bad news, issue warnings about internal and external risks, and respond rapidly to changing circumstances. At the same time, a risk-aware culture ensures that risks to the organization and the individuals within it are aligned. No one should benefit individually from taking or avoiding risks that affect the larger organization.

Where insurance comes in
Insurance is available to transfer some, but not all, risks of disruption in supply chains. Coverage is likely to be more costly and harder to come by in 2022, so enterprises are well-advised to understand the extent and limitations of coverage.

Standard commercial property insurance almost always includes an option to add business income, or business interruption, (BI) coverage for lost revenue and extra expenses incurred when an insured business is forced to suspend operations because of damage by a peril (fire, wind, vandalism, etc.) covered by the policy.

Supply Chain Risk
Continued

The damage does not necessarily have to occur at the insured location to trigger coverage. Business income coverage can be triggered by damage that occurs at a nearby location resulting in an order by civil authorities closing off access to an insured location (as when police might close off an area following a riot or natural disaster). BI coverage typically commences 72 hours after a suspension begins and continues for three consecutive weeks unless a longer period of coverage has been purchased.

Coverage for 'contingent' locations
For purposes of supply chain risk management, it is important to be aware that BI coverage can be extended to compensate for losses and extra expenses due to damage at "dependent" or "contingent" locations, such suppliers, distributors, buyers, or venues. Typically, the damage must be caused by a peril insured against under one's own property policy, unless a separate policy is purchased.

With income coverage for dependent locations, an insured business is at least partially protected from the effects of physical damage that shuts down a critical business partner. Thus, if a supplier suffers windstorm damage, or a buyer is paralyzed by strikes and civil commotion, the insured would be compensated (subject to a deductible and limit of insurance), presuming those perils are covered under its property policy.

Considerations and options for contingent BI coverage are explored thoroughly in a companion publication from Adjusters International, *Adjusting Today,* titled "Contingent Dependent Properties Insurance: Understanding the Basics." In the report, the author covers:

- The distinction between "manufacturers or contributors" of goods to insureds, "recipients" (buyers) of the insured's products, and "leader locations" that attract customers (such as anchor stores in shopping malls).
- The distinction between primary and secondary contingent locations, and the related distinction between direct and indirect suppliers.

The report also explains that BI coverage does not extend to losses due to interruptions in electricity, water, internet, and other utility services; those exposures are addressed by separate utility interruption endorsements.

Transit insurance
The transportation of products and their components is a central consideration in supply chain risk management, and various forms of insurance are available for covering shipments on land, sea, and air. These include:

- Trip transit insurance — Coverage for individual shipments, commonly purchased by or on behalf of organizations that do not ship property regularly;

Supply Chain Risk
Continued

- Transportation insurance — Commonly refers to coverage for shipments of an organization's property on its own vehicles;
- Motor truck cargo liability insurance — Coverage for shipments by common carriers who provide transportation services to the public;
- Contingent cargo insurance — Coverage for freight brokers in situations where they are liable for loss to cargo they have assigned to a carrier; and
- Air and ocean cargo insurance — Specialized forms of coverage subject to international conventions and admiralty law, respectively.

In recent years, these types of coverage have been incorporated with warehouse property and liability insurance into "logistics" policies that cover property throughout the course of transit. Although transit and logistics coverage is generally placed by specialists in transportation risk, all parties to a shipment — the shipper, the cargo carrier, and the recipient — should know if and how their interests are protected.

Supply chain insurance
Insurance for contingent income and transit exposures are valuable for supply chain risk management, but they are limited in that coverage is provided only for physical damage by an insured peril or loss to physical property due to covered liability.

Even before the Covid-19 pandemic, Swiss Re, a leading international reinsurer, was advising risk professionals to "look beyond the physical" to other factors that disrupt supply chains, including raw material shortages, product recalls, supplier bankruptcies, port closures, and regulatory actions.

In response to this growing range of risks, major insurance companies and brokerages have developed specialized supply-chain insurance packages that cover broader ranges of risk than those addressed in standard property and business income policies, usually on a customized basis for each insured enterprise.

These packages are attractive, but costly. It will be some time before non-physical supply chain risks can be insured, even partially, at a rate small- to mid-sized businesses can afford. In the meantime, organizations like BSI and Everstream Analytics, cited in this article, are developing and deploying software to help organizations understand their position in a supply chain and anticipate disruptions.

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[1] "Delivering Supply Chain Resilience: The five questions we need to answer," 2022 BSI Supply Chain Risk Insights Report, November 2021, p. 3; accessed at https://www.bsigroup.com/en-GB/our-services/consulting/supply-chain-risk/supply-chain-reports/
[2] Everstream Analytics, Annual Risk Report 2021, April 2021, pp. 9-13; accessed at https://www.everstream.ai/wp-content/uploads/2021/04/20210408-Everstream-Analytics-Annual-Risk-Report.pdf
[3] "Delivering Supply Chain Resilience . . .," op. sit., p. 8
[4] Tucker Bailey, Edward Barriball, Arnav Dey, and Ali Sankur, "A practical approach to supply-chain risk management," McKinsey & Company, March 2019; accessed at https://www.mckinsey.com/business-functions/operations/our-insights/a-practical-approach-to-supply-chain-risk-management