The industry must make the case for supply chain insurance

By Mark Wing, Clyde & Co

Businesses can suffer huge losses as result of supply chain disruption – the insurance industry should do more to improve resilience

Source: © 2018 Matt Dunham/AP KFC: THE FAST FOOD CHAIN'S RECENT SUPPLY CHAIN WOES HIGHLIGHT THE RISKS FACING BUSINESSES THAT RELY ON A STRING OF OTHER FIRMS

For years now, manufacturers and retailers have been outsourcing to cut costs and improve efficiency. A whole industry has grown up to help them drive production, hone their supply chains, minimise lead times and ensure deliveries are just what they need, just in time.

The result is many manufacturers and retailers are no longer competing on their own merits. Their reputation and their ability to do business are almost entirely dependent on the competence of a small number of key suppliers and, in turn, the businesses that supply them, all of which are operating on wafer-thin margins.

Although this state of affairs has created a substantial out-sourced risk, it appears not to be one companies believe they can, or should, insure. In part this may be because the industry has been slow to step up to the mark.

Cover for supply chain risks is a form of business interruption insurance, which historically has been limited to interruption flowing from damage to the insured's own property. This means an event that does not have a physical effect on the insured's property (such as DHL's failure to distribute chicken to KFC's restaurants) would not give rise to an insured business interruption loss under a standard policy, no matter how significant the impact on the insured's business.

Insurers' attempts to increase the relevance of the cover, via contingent business interruption policies or, more recently, bespoke multinational supply chain programmes, appear also to be failing to gain traction.

The 2017 BCI supply chain resilience survey found 51% of businesses said their supply chain-related losses were uninsured. Recent surveys by CNA Hardy have repeatedly shown supply chain is never a risk that rises to the top of the boardroom agenda, irrespective of horror stories in the news.

Why is cover not being bought? There may be a number of reasons for this. Supply chain complexity is a fact of life. It is relatively easy to perform deep vetting on a company's known main suppliers, all of which will be required to meet the appropriate regulatory standards – ISO, employment, health and safety and so on – and all of which are subject to external audit.

Secondary suppliers

The challenge is more for companies to get their arms around the broad network of smaller businesses supporting these main contractors, for which there may be no central procurement process and therefore less data available. Knowledge of the chain is essential if risk is to be managed and cover to be made effective and affordable.

An even more fundamental issue is that businesses are either unaware of the existence of supply chain cover or that nothing is available that fits their needs. Supply chains are bespoke, so there is no “one size fits all”, standard product, even at the more developed multinational programme level. With so little traction in the risk-managed corporate market, there is little data available to build insight into losses, making it impossible for more standard covers to trickle down into the mid-market.

With specialist cover hard to access, standard practice appears to be for most businesses to manage their risks through contractual arrangements with their suppliers and, when discounts cannot be negotiated, to litigate. But while a combination of commercial leverage and legal recourse can deal with the everyday failures, it is unlikely to be sufficient to resolve catastrophic failures.

The business interruption cases we have seen in recent weeks are likely to be just the first of many as supply chains become ever more stretched and it takes less to disrupt them. The combination of fewer main suppliers forced to compete largely on price, sourcing more aggressively across a wide range of sub-contractors in a broad range of geographic markets represents both a unique concentration of risk among a few businesses, but also exposure to a much wider range of perils including natural catastrophes power failures, cyber risk, strikes, political unrest as so on.

Paradigm change

So is it time to change the paradigm? As businesses struggle to respond to the increasingly complex and interconnected environment in which they operate, this would seem to be a good time for the insurance industry to respond to the evolving supply chain threat and help improve resilience. But how?

For risk to be managed it has to be understood. Could supply chain be yet another example of where technology may provide the answer? If more supply chains could be run on blockchain, we would generate transparency and insight – paving the way for better risk management and more tailored covers at competitive prices.

As every sector reaches the point of maximum efficiency, so a new paradigm opens up. Maybe we have reached that point with supply chain insurance. Or maybe we just need to head down to Burger King.

Mark Wing is a partner at Clyde & Co