BFL MAKES A DIFFERENCE

The Cover Note

SPRING/SUMMER 2011

VOLUME 4, ISSUE 2

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EDITORIAL

Barry F. Lorenzetti

The recent earthquake and tsunami that hit Japan as well as the floods and tornadoes that have been hitting the US and Canada have caught the attention of us all.

The impact on these countries' economies is extensive, and has vast repercussions around the world. Organizations from every corner of the globe that trade with industries from the devastated regions have been or could be affected.

These consequences could be true for any event happening in any geographic area any day, whether it involves physical damage or not. This is why we chose to devote our main article, written by Ted Nicolopoulos and Martine Douce, to insurance protection designed to respond to loss of business and financial losses that do not necessarily arise from physical damage.

The above events also reminded us that we have been enjoying a historic seven years of soft insurance cycle and that the market will eventually turn. I don't pretend to know exactly when this will happen, but what I do believe is that the time to prepare for a hard market is now, while the soft market lasts and insurers and other providers are more amenable to negotiation and Risk Managers have more time to devote to the exercise.

Before the market changes, it would make sense to have performed an audit of your program. Depending on your set up, this audit would require that you include the following and/or other steps. You should have:

- Updated your risk profile
- Improved the quality of your physical assets or their protection and thus your insurability
- Revisited your retentions/ deductibles and wordings to take every advantage available as these will serve as "currency" during the tough negotiations of the next hard market
- Rethought your insurance portfolio and strategy including:
  - Can/should some of your current policies be replaced or redesigned to better respond to your specific risk profile?
  - Can/should your global program be restructured to realize substantial savings?
  - Can/should you replace certain markets in your portfolio to obtain better conditions and/or position for the hard market?
- Examined the cost effectiveness of implementing new Alternative Risk Financing solutions or modifying existing ones
- Examined your service providers' contracts and renegotiated them or gone out to tender

A quick remark regarding the replacement of markets with whom you have been enjoying a long term relationship. As is true with any type of provider, insurers who have held an account for a long time can become complacent. It would be sad to deprive your company of fresh ideas and significant savings only because of the amount of work and time required in arranging such a change, especially on a global program. Your broker too may come to be in a rut so you must remain vigilant and proactive on all fronts.

On the Employee Benefits side, in his article Tom Guay addresses the question of adequate income in retirement. ♦

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SUPPLY CHAIN MANAGEMENT

Ted Nicolopoulos, Vice President and Client Executive, Marine and Cargo
Martine Douce, Client Executive Commercial Insurance
BFL CANADA Risk and Insurance Inc., Montreal

Nowadays, a topic often spoken about is "Supply Chain Management and/or Insurance". With the explosion of outsourcing, it's safe to think that the trend is here to stay.

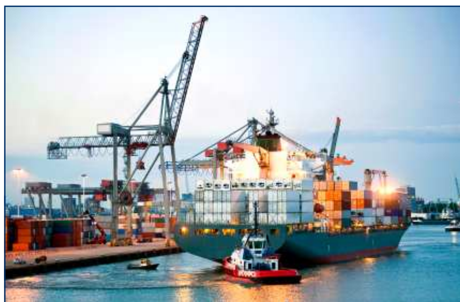
What is it all about? In a nutshell, it concerns potential disruptions to your supply chain which would affect your production and thus your results – how to manage them and, if you choose to, insure the resulting business interruption losses on your organization.

Significant potential disruptions to your supply chain could be identified in a risk mapping exercise directed specifically at your supply chain, but also as part of an ERM process or even through the preparation of a business continuity plan. What would be a significant disruption to your supply chain that would cause your company to lose revenue? For example:

- Inability of key supplier to provide due to a fire, to a strike, to a pandemic, to government ordinance (think of Japan)
- Transportation problem such as a strike in the port of Vancouver, political violence in Egypt, a snow storm or an ash cloud over Europe, etc.

The manufacturing industry is the foremost candidate for supply chain disruptions, as is any organization relying on "just in time". However, almost any other industry is also exposed to business interruption losses arising from non physical damage.

Obviously, the significance of a disruption depends on how reliant your operations are on that one supplier or cargo. If you have only one supplier for certain materials – then, the potential impact on your business is huge.



On the other hand, if your purchases are not "specialized" or your purchasing policies include a mandatory redundancy in the choice of suppliers, then, you may be able to turn somewhere else – unless of course, all your suppliers are located in the same geographical area…

With globalization of trade comes the fact that you need to be aware of what is happening on the other side of the world where your suppliers are located, because the disruption could arise over there instead of in your own back yard.

It does not really matter how the significant potential disruptions are identified but rather how you manage to minimize their impact on your company's ability to carry on its operations. And for those potential problems that cannot be satisfactorily managed, you can consider insurance.

A bit of insurance background would help: Traditionally, in the Insurance world, you could only insure business interruption losses resulting from direct damage to your property. Over the years, coverages evolved and exceptions to this general rule arose where you could insure against risks which did not involve physical damage to your property, for instance:

CONTINGENT BUSINESS INTERRUPTION – covering your business interruption arising as a result of direct damage losses to the property of key suppliers or clients of yours
CONTAMINATION – covering your business interruption as a result of real or suspected contamination/recall of your products
CYBER RISK – covering your business interruption as a result of an "attack" on your website
PANDEMIC – covering your business interruption as a result of a pandemic
TRADE CREDIT – covering your business losses resulting from insolvency of suppliers and political risks

The latest products available are:

SUPPLY CHAIN INSURANCE (SCI) – which is designed specifically for the purpose of addressing possible problems in the supply chain
TRADE DISRUPTION INSURANCE (TDI) – which is designed specifically to address risks associated with trade routes from suppliers and/or to clients

Where the first list of coverages above targets specific risks potentially affecting the supply chain, the two more recent products are much broader by nature and are (or should be) complementary to your existing coverages.

Insurance has never been the perfect solution, consequently, risk control /prevention should always come first; spreading the risk between as many suppliers, geographic regions and transportation arrangements as possible.

You need to understand the specific risks which are material to your own operations and quantify them in order to decide their importance and how to control/prevent/manage them. Depending on your appreciation of the residual risk, then you can look into insurance as required, since, notwithstanding all your efforts, your organization could still be at risk of suffering real and serious consequences due to non physical damage losses.

It could be well worth your while to look into insuring a specific supply/supplier or client contract even if only temporarily, while measures can be implemented that would mitigate your company's exposure in that respect. In any event, it is important to choose the coverage that best suits your needs and to ensure whatever coverage you purchase to protect against non physical damage losses does not overlap your existing policies but rather is properly synchronized with other insurance in place.

Needless to say, in order to achieve the cost effective tailoring of your insurance, you must be able to rely on a broker intimately familiar with all these products and with a solid understanding of your operational logistics.

In order to illustrate how Trade Disruption Insurance and Supply Chain Insurance can contribute to protect your organization compared with Cargo Insurance, let's look at an example:

SCENARIO

A Chinese manufacturer of equipment parts has a supply contract with a Canadian manufacturer of industrial machinery who delivers to Europe. The Canadian manufacturer has no stock and favours just-in-time inventory. Delivery deadlines to clients must be respected as penalties are charged for each day of delay. A combination of events leads to significant losses for the Canadian manufacturer:

1. a fire breaks out at the Chinese manufacturer on the day the parts must be shipped and the shipment is delayed for a few days;
2. the parts finally leave the warehouse, but a landslide delays the goods from reaching the port;
3. a raging storm at sea causes some containers to be thrown into the sea;
4. part of the goods are damaged by strikers at the Port of Montreal;
5. the Canadian manufacturer finally supplies his customer 15 days late;
6. the penalty for late delivery is $500,000 and the contract is cancelled – a loss of 50 million sales volume per year.

HOW THREE DIFFERENT POLICIES WOULD RESPOND:

POLICIES	CARGO	TRADE DISRUPTION INSURANCE	SUPPLY CHAIN INSURANCE
Type of indemnity	DIRECT DAMAGE	DIRECT DAMAGE AND FINANCIAL LOSS	FINANCIAL LOSS
General description of coverage	Direct damage to cargo caused by external & fortuitous events happening during the ordinary course of transit. Cargo insurance will not cover loss of market, financial loss caused by delay & inherent vice of the goods.	Direct damage, contract penalties, cancellation of contract, business interruption and extra expense following disruption occurred on the trade route of the goods – either from supplier to Insured or Insured to Buyer.	Business interruption and extra expense resulting from a difference between the supplies actually received and the supplies purchased by the Insured from a supplier, following a disruption which occurred at the supplier's facility or during delivery to Insured.

EVENT	DOES IT TRIGGER COVERAGE?		
	CARGO	TDI	SCI
A fire breaks out at the Chinese supplier's plant and causes a delay	no	no	yes
A landslide delays the goods from reaching the port	no	yes	yes
Some containers are thrown into the sea	yes	yes	yes
Damage to goods at the Port of Montreal	yes	yes	yes
The bill for late penalties totals $500,000	no	yes	no
The client cancels the contract; lost sales volume of 50 million per year	no	yes	no

As is the case with all insurance products, underwriting is crucial and the scope of coverage may be affected. **Exceptions and special coverages can be negotiated on a case by case basis.** The above tables are based on specific wordings and are given as examples only.

While there are many insurers underwriting cargo coverage, there are only a few for SCI and TDI.

In the end, it would be prudent to look into TDI or SCI if:

- your organization has an extensive or complex supply chain
- you deal with unique or dedicated/hard to replace suppliers
- some of your clients impose late delivery penalties or a cancellation clause in case of delivery problems
- you deliver/export or receive/import goods to and from remote areas
- you are importing key materials or components
- you import from areas prone to disruption to trade route
- you operate "just in time" or you produce "build to order"

As always in risk management, it is essential to anticipate risks and not wait until the risk becomes reality to implement preventive measures or to purchase insurance. The above example will help you to assess your coverage and identify areas that require change or adjustment. ♦

WILL CANADIANS HAVE ENOUGH TO RETIRE ON?

Thomas Guay, President
BFL CANADA Consulting Services Inc., Montreal

As the first wave of baby boomers turns 65 this year, the question of adequate income in retirement headlines the news almost every day. Today, a male age 65 can expect to live to age 83. This compares to the life expectancy 40 years ago of age 78.

When applying for Old Age Security (OAS) and the Canada or Quebec Pension Plan (C/QPP), many baby boomers come to the stark realisation that they are drastically underfunded to maintain their current lifestyle. OAS will provide a monthly income of $524. In addition, C/QPP will provide additional revenue up to $960 for a combined maximum of $1,484 per month.

The most recent Quebec provincial budget proposed to enhance the benefit payable to employees who defer their retirement beyond age 65. Effective January 1, 2013, the pension payment will be enhanced by 0.7% instead of 0.5% for each month that pension payments are deferred. If the pension is deferred to age 70, the payments will be enhanced by 42% as compared to the current formula which is only 30%.

However, commencing on January 1, 2014 and phased in over three years, should you elect early retirement, the pension will be reduced by 0.6% for each month of early retirement versus the current 0.5%. This results in a 36% reduction in the Quebec pension benefit for someone who retires at age 60.

The budget also introduced a new pension program for workers who lack private plans. Only one in three Quebecers has access to an employer sponsored retirement savings plan. This Voluntary Retirement Savings Plan (VRSP) will provide a simple, low cost option to Quebecers particularly those in small and medium size businesses to save for retirement through payroll deductions. Businesses would be required to auto-enrol all employees, however an employee would have the option to opt-out of the plan. Other provinces as well as the federal government are considering similar legislation.

The hope is that VRSPs will dramatically improve pension coverage thus relieving pressure to expand the Canada and Quebec Pension Plans. Furthermore, by improving coverage and increasing participation the administration and asset management fees will be lowered thus enhancing the ultimate retirement income.

The tough unanswered question is how much does one have to save so as to provide an adequate income on retirement. Let's take as an example, an individual earning pre-tax $75,000 per annum and retires at age 65. He feels that he can live on 80% of his pre-retirement income or $5,000 per month. OAS and the C/QPP will provide a monthly income of $1,484. The balance of $3,516 (pre-tax) will have to be funded by either a company sponsored plan or his own personal savings.

The present value of a monthly annuity in the amount of $3,516 payable for life based on today's interest rates is $547,216.

In order to accrue this amount at age 65 and furthermore assuming an average rate of return of 5% per annum, it would take monthly contributions of $1,335 over a 20-year period to accrue $547,216. If you only earn 3% over the same 20-year period, the monthly contributions would have to be increased to $1,660.

Added to the equation is the effect of inflation on eroding your buying power in retirement. Assuming an average inflation rate of 3% per annum, the monthly annuity of $3,516 will only be worth $2,437 in 10 years and $1,934 in 20 years, a reduction of 45% in buying power.

If the annuity of $3,516 were indexed at 3% per annum, the present value of the annuity would increase to $724,237.

Baby boomers are faced with the reality of continuing to work beyond age 65 as well as cutting back on their lifestyle over the next 20 years.

In summary, it is never too soon or too late to maximize tax deductible savings for retirement. ♦

1-866-688-9888

BFL CANADA Risk and Insurance Inc.
45 Westwind Drive
Hammonds Plains, NS B3Z 1K6
Tel: (902) 864-4982
Fax: (902) 864-0200

2600 Laurier Blvd, Suite 857
Quebec City, QC G1V 4W2
Tel: (418) 658-6337
Fax: (418) 654-2045

2001 McGill College, Suite 2200
Montreal, QC H3A 1G1
Tel: (514) 843-3632
Fax: (514) 843-3842

BFL CANADA Risk and Insurance Services Inc.
1565 Carling Avenue, Suite 606
Ottawa, ON K1Z 8R1
Tel: (613) 722-7798
Fax: (613) 722-7829

181 University Avenue, Suite 1605
Toronto, ON M5H 3M7
Tel: (416) 599-5530
Fax: (416) 599-5458

BFL CANADA Insurance Services Inc.
877 Henderson Highway
Winnipeg, MB R2K 2L8
Tel: (204) 661-2446
Fax: (204) 663-0344

1167 Kensington Crescent NW, Suite 200
Calgary, AB T2N 1X7
Tel: (403) 451-4132
Fax: (403) 313-3365

1177 West Hastings Street, Suite 200
Vancouver, BC V6E 2K3
Tel: (604) 669-9600
Fax: (604) 683-9316

BFL CANADA Consulting Services Inc.
2001 McGill College, Suite 2200
Montreal, QC H3A 1G1
Tel: (514) 937-4188
Fax: (514) 937-5585

181 University Avenue, Suite 1605
Toronto, ON M5H 3M7
Tel: (416) 599-5530
Fax: (416) 599-5458

1177 West Hastings Street, Suite 200
Vancouver, BC V6E 2K3
Tel: (604) 669-9600
Fax: (604) 683-9316

www.BFLCANADA.ca

Send comments or suggestions to Corporate Solutions, BFL CANADA:
publications@BFLCANADA.ca