

General BI Subjects

The Insurance of Wages

No other expense receives as much attention in Business Interruption (“BI”) insurance and claims, as does Wages. Following a damage event, when turnover is down, there are many competing demands on a business’s cash resources. The landlord (rent), the bank (interest and loan repayments), media companies (future advertising commitments), and shareholders’ dividend expectations are examples. Why, therefore, are unique policy Items only designed for Wages?

The Loss in Respect of Wages

Wages are not lost. What is lost in a business interruption is the ability to recover Wages in full when there is a reduction in turnover. If, say, 35 percent of every sales dollar is required to cover Wages then for every \$100,000 of sales lost, \$35,000 of Wages will not be recovered. This is what the BI policy must address and it does so by reimbursing the loss of sales (minus saved expenses) from which the insured can pay expenses that are not saved, including the ongoing Wages.

Of course the same can be said for any other expense. If say, 15 cents in every sales dollar is required to recover the Interest or Rent or Repairs & Maintenance then the BI claim must reimburse \$15,000 for every \$100,000 of sales lost, to cover normal Interest, Rent or R & M. Why do so many policies insure Wages in a special Item? I have never seen a BI policy with a separate Item insuring Interest Payable and I have never seen a “Dual Rents” or a “Dual R & M” Item.

Wages are often a very significant cost item and they nearly always have both fixed and variable elements, but no two companies have these in the same proportions.

If Wages were totally variable they would not need to be insured at all because like Cost of Goods Sold, or Packaging, if there were a reduction in turnover there would be a directly proportional saving in Wages. On the other hand, if they were totally fixed they would simply be insured in full for the total Indemnity Period, like Rent and Insurance. That is, they would be an insured expense in the Gross Profit Item.

Wages are usually fixed in short term interruptions (i.e. There are no savings in Wages). Therefore they do need to be fully insured in the short term.

They are also likely to be fixed (i.e. no savings) during extended partial interruptions for which they need to be insured, even for the maximum Indemnity Period.

However, there will almost certainly be substantial savings in Wages in the event of a major long-term business interruption but even in this extreme situation the saving will not be in proportion to the reduction in turnover.

Recently a retail store in a rural town was destroyed and it was immediately apparent that trading would not resume within the maximum 12 month Indemnity Period. Wages

were insured in full; i.e. 100% for 12 months. Key staff were found jobs in shops in neighbouring towns and others were given notice after a reasonable notice period. (There were no redundancy provisions in the employment contracts). Nearly 80% of the annual Wage bill was saved.

Following fire damage at an export meat works all “seasonal meat workers” were “seasonally laid off” after a week on the daily minimum Wages, until killing resumed when they were re-hired progressively as needed.

In both cases, although damage was severe and a total interruption followed, cover for Wages was only required for the notice periods.

On the other hand, I had a claim for the Business Interruption following total destruction of a warehouse, in which there were no savings in Wages in spite of a substantial loss of turnover. And there are countless examples of damage followed by interruptions of varying durations and severities, in which the savings in Wages do not reflect the degree of damage or the interruption to the business.

What I can infer is that, however we insure Wages, it must be flexible enough to respond to brief or extended interruptions and total or partial losses. And in all these situations it has to cater for both the Wages of key staff who must be retained and the notice period Wages for those who can be made redundant.

I will now describe the more common methods of insuring Salaries, Wages and Payroll.

The Insurance of Salaries

Like Wages, the loss in respect of Salaries arises directly from a reduction in turnover for which there is not a corresponding reduction in Salaries. Only in an interruption of great severity and duration, is there likely to be any reduction in Salary costs and even then it will not be in proportion to the reduction in turnover.¹

Quite simply, Salaries should be insured fully for the entire indemnity Period. They are usually included within the Gross Profit Item as an insured expense (i.e. When using the Difference Method to define Gross Profit, they are **not** listed as “uninsured”).

The Insurance of Wages

Wages can also be insured fully within the Gross Profit Item and this certainly gives maximum coverage and maximum flexibility. Whatever the circumstances of business interruption, however severe or extended the period of loss, all Wage-paid staff can be kept on the payroll if necessary.

¹ A 50% reduction in turnover will not result in a 50% saving in Salaries and an 85% reduction in turnover will not result in an 85% saving in Salaries. The saving in Salaries will be less than 50% or 85%, respectively.

This provides total cover for Wages in both the short term and the long term. However, if the damage is substantial and there is a major interruption to business operations for most of the Indemnity Period, there will probably be significant savings in Wages. The export meat works and the supermarket illustrate the probability.

Let me show several scenarios in Table 1:

Table 1

Maximum Indemnity Period	12 months						
Standard Turnover	\$1,200,000						
Standard Wages	\$480,000	i.e. 40%					
Scenario 1: Total loss of turnover for 1.5 months ; i.e. 12.5% of Indemnity Period							
	Reduction in Turnover	x	Rate of Wages	=	less Savings in Wages	=	Loss
	\$150,000	x	40%	=	\$60,000	=	\$60,000
Scenario 2: 12.5% loss of turnover throughout the Indemnity Period							
	Reduction in Turnover	x	Rate of Wages	=	less Savings in Wages	=	Loss
	\$150,000	x	40%	=	\$60,000	=	\$60,000
Scenario 3: Total loss of Turnover throughout the entire Indemnity Period							
	Reduction in Turnover	x	Rate of Wages	=	less Savings in Wages	=	Claim
	\$1,200,000	x	40%	=	\$480,000	=	\$80,000

In Scenario 1 there is a 12.5% loss of sales but it is all 'front-end loaded'. It is a brief but total interruption and there were no savings in Wages. In Scenario 2 the same 12.5% loss of sales resulted from a much longer but partial interruption and again there were no savings in Wages. The loss in respect of Wages is the same for both.

In Scenario 3 there is a massive loss of sales; in fact a total loss for the Indemnity Period. But the loss in respect of Wages is not much greater than the first 2 scenarios because significant redundancies were possible and these Wages were saved.

The insured does not appear to need full Wages cover in either a partial interruption loss or a total interruption loss.

This does not imply that the insurance of 100% of Wages is always unnecessary and therefore a waste of premium (but it might be so in some industries). It only illustrates that the more severe a business interruption, the more likely it is that there will be major savings in Wages to reduce the loss.

It must be said, however, that there will be only negligible savings in Wages, even in a major interruption if the employees cannot be dismissed easily and rehired as soon as required. Such a situation arises when the staff are skilled, replacements are not readily available, there is an exposure to redundancy payments, or owners/managers have a paternalistic attitude to maintaining employment (e.g. a major employer in a small community). The insurance of 100% of Wages in the Gross Profit Item does provide total, flexible cover for Wages and if that is what is required then the premium is not wasted.

In my work as an adjuster I do not deal with premiums but I have heard that sometimes the Wages component of Gross Profit is rated at a discount because during major interruptions there is a greater probability of savings in Wages than of savings in other expenses insured in the Gross Profit Item.

Alternatively, instead of including Wages with Salaries, in the Gross Profit Item they are both separated into a "Payroll" Item. The only benefit would appear to be that this clearly identifies Payroll, which would otherwise be indistinguishable from the other elements of Gross Profit and allows the differential premium to be applied accurately to the sum of Salaries and Wages.

There is good news and bad news about the insurance of Wages. The good news is that BI insurance offers numerous ways of sacrificing some degree of flexibility for cheaper premiums. The bad news is that some of the most flexible methods are quite complex and Dual Wages is an example of both flexibility and complexity. Before dealing with Dual Wages, I will comment on other methods of partial Wages insurance.

(Remember that the only method of achieving total Wages cover is by insuring it 100% for the entire Indemnity Period, either as a separate Item or included in the Gross Profit Item.)

Wages in Lieu of Notice

This is the title often given to a short term insurance of Wages such as for 4 or 8 weeks. It is used less frequently in recent years as full cover under a Gross Profit Item has become cheaper and short-term redundancies have become more difficult to achieve. Current employment law requires a consultative process before any position is made redundant (It is the position, not the employee who is made redundant) and the period of cover and sum insured should be adequate for Wages during the time for consultative staff meetings plus the required notice period.

This Item also responds to partial interruptions during the period specified, by covering the loss resulting from the inability, in consequence of the insured damage, to utilise staff fully. "Utilisation" is usually related to turnover and the implication is that it is the recovery of Wages costs from turnover that is actually insured.

Staff might be idle but if turnover is maintained in full (such as from undamaged stock) there can be no claim if turnover is the sole measure. Alternatively, they might be kept busy (e.g. doing additional cleaning and maintenance) but their Wages can be claimed if there was a reduction in turnover.

An example of the Item is:

“Wages in Lieu of Notice

The insurance under this Item is limited to the loss incurred by the payment of Wages for a period beginning with the occurrence of the Damage and ending not later than the number of weeks thereafter shown in the Schedule. The amount payable as indemnity will be the actual amount paid as Wages for such period to employees whose services cannot, in consequence of the Damage, be utilised at all and an equitable part (based upon reduction in turnover) of the Wages paid for such period to employees whose services cannot, in consequence of the Damage, be utilised to the full.”

Because this Item’s cover is so brief it is usually limited to staff who can be readily dismissed and it is paired with insurance of other staff for a longer period. The key issue here is how the categories of staff are identified and how the cover for their Wages is defined.

Partial Insurance (Core Staff) under the Gross Profit Item

When the Wages of staff who can be dismissed in the short term are insured for that period (i.e. the consultative and notice period) the other employees need to be insured for the long-term. Whether this is achieved by a separate Wages Item or as part of the Gross Profit Item, it is necessary to define which categories of employees are covered by “Wages in Lieu of Notice” and which are insured elsewhere.

Imprecise terms like “skilled staff” are potentially subject to different interpretations and to avoid dispute at the time of a claim, the distinction should be based on objective criteria such as adopted in the financial accounts, or in employment contracts. Many Statements of Financial Performance show “Direct Wages” separately and the meat exporter mentioned above could use “Seasonal Meat Workers” as a category (i.e. all others being insured for the long-term).

In these cases the Wages insured only for the notice period would be “Direct Wages” or “Seasonal Meat Workers” and the insured Gross Profit Item would specify these as Uninsured Expenses (i.e. all other Wages are insured under the Gross Profit Item.)

I also think that the use of a percentage of payroll is too imprecise (i.e. 40% Wages insured as Wages in Lieu of Notice and 60% insured under the Gross Profit Item). Even worse is the specification of a dollar value (i.e. Gross Profit includes \$600,000 Wages). Although this is objective, it needs constant revision if the incorporation of a fixed sum into the Rate of Gross Profit is not to distort the percentage as turnover fluctuates.

Redundancy Pay

I see some policies that include a special Item for Redundancy Pay, with its own sum insured and, presumably, attracting an additional premium. Why is this necessary? If

Wages are defined to include wages in lieu of notice and redundancy pay, the latter is already covered in other policy items to the extent that they insure Wages.

You will recall that I said above, that the loss in respect of Wages is calculated by the formula:

Table 2:

$\text{Reduction in Turnover} \times \text{Rate of Wages}$ $\text{Less Savings in Wages}$

The greatest possible claim would arise if there were a total loss of sales but no savings in Wages. The following is a variation on Scenario 3 in Table 1. There was a total loss of turnover but on this occasion there were no savings in Wages. The claim would reimburse total Wages.

Table 3

Maximum Indemnity Period	12 months	
Standard Turnover	\$1,200,000	
Wages	\$480,000	
Wages to Turnover Ratio	40%	
Scenario 4	Total loss of Turnover throughout the entire Indemnity Period	
	No savings in Wages	
	Reduction in Turnover	Rate of Wages
	x	=
	\$1,200,000	40%
	x	=
	\$480,000	less Savings in Wages
	=	=
	\$480,000	\$0
	=	=
	\$480,000	Loss

But this would not be adequate to indemnify an insured that had a massive redundancy pay liability in the event that the business interruption was very long term; if, for example, the insured was unable to resume business for several years, which is not an impossible scenario today with huge potential delays arising from the Resource Consent process.

If the total redundancy pay exceeds the savings in Wages during the Indemnity Period the loss will exceed the sum produced by the formula quoted in Table 2.

The next table shows a situation in which the insured saved \$400,000 in its normal Wages but at the expense of making most staff redundant, which cost \$540,000 in redundancy pay. The net Wages position was not a saving but an increase of \$140,000 in the Wages bill (Standard Wages \$480,000; Actual Wages including Redundancy \$620,000).

Table 4

Maximum Indemnity Period	12 months	Actual Wages	\$80,000					
Standard Turnover	\$1,200,000	Redundancy Wages	\$540,000					
Standard Wages	\$480,000	Total Wages Paid	\$620,000					
Scenario 5 Total loss of Turnover throughout the entire Indemnity Period No savings in Wages								
	Reduction in Turnover	x	Rate of Wages	=		less Savings in Wages	=	Claim
	\$1,200,000	x	40%	=	\$480,000	\$0	=	\$480,000

This additional Wages cost is not reimbursed by the Wages component of a Gross Profit Item, even if it insures 100% of Wages, nor by a Dual Wages Item. It requires an additional policy Item for the amount by which the redundancy pay exceeds the saving in normal Wages during the Indemnity Period (\$140,000 in Scenario 5, above).

Conclusion

Total (100%) insurance of Wages for the maximum Indemnity Period, either in the Gross Profit Item or as a distinct Wages or Payroll Item provides the greatest flexibility. The only situation in which it might be inadequate is if redundancy pay obligations result in the total actual payroll during the Indemnity Period being in excess of the normal payroll for that period.

The insurance of Wages in Lieu of Notice is only appropriate for employees who can be dismissed in the short term and re-hired progressively as required. All other employees should be insured in full.

My final comment comes from the owner of an apple pack-house, who suggested that, “I don’t need to insure wages because I would use the staff on nightshift at another pack-house”. My question in response was, “Will you maintain all your turnover? If you might lose turnover but without a saving in Wages then they must be insured.”

And that is the essence of the insurance of Wages.

The next module describes the insurance of Wages under a Dual Wages specification.

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