

Financial Considerations for Recovery

A Business Continuity Planning Whitepaper

I. INTRODUCTION

Financial considerations for recovery begin long before any incident occurs. The premise of this paper and talk are that the Business Continuity Planning (BCP) process, coupled with the financial recovery potential offered through Insurance and Risk Transfer will prove to be some of the strongest tools companies can use to offset the potential and actual impacts from incidents.

On a broad level the primary reasons for developing a BCP and Crisis Management Plan (CMP) are:

- Safety and Security of staff and visitors
- Mitigation of Financial Risk Exposures
- Mitigation of Physical and Operational Risk
- Protection of a Companies or Entities Reputation
- Protection of Market Share or Competitive Position

Most companies and organizations recognize that their people are their most important asset. An inescapable fact related to this is that impact upon staff translates into organizational impact, and will eventually translate into financial impact upon the organization.

This has been graphically illustrated in the aftermath of the Terrorist attacks of 9/11/2001. Long after companies have come to grips with the physical losses the toll on staff at the affected companies continue.

Some of these tolls include:

- Employees who cannot face the proposition of working following the immense loss of friends and associates
- Employees who exhibit the symptoms of Post Traumatic Stress Syndrome, and are unable to perform at their pre-incident levels
- Employees who do not feel safe or secure in their work environment

All of these impacts are related to the incident, and are expected human responses to the immense personal and professional losses that many have experienced. It doesn't take a disaster of the magnitude of the World Trade Center to produce these Human Resource impacts.

When all of these factors are considered it is feasible to make a case that all of these Human Element related impacts result in financial loss to the organization. Following 9/11, companies expended massive human and financial resources to heal their shattered organizations. A major lesson learned from 9/11 was that most organizations were not totally prepared to deal with the massive loss of life and the follow on impact to families and the organization overall.

Most of the major and well-capitalized organizations were able to relocate, and eventually resume operations within what was viewed as a reasonable timeframe. Reasonable is a relative term here.

Due to the massive nature of the loss many companies were given longer to recover than would have normally been acceptable to their customers and other stakeholders in the business.

Most of those same companies will concede that the human toll continues, and that the recovery process continues as well. Companies with lesser financial and operational resources, or those tied directly to the WTC location on an exclusive basis, may have failed or continue struggle.

This illustrates that, like planning before an incident, the financial impact of an incident can extend to periods well after the apparent physical recovery from an incident.

II. UNDERPINNINGS OF FINANCIAL DISASTER POTENTIAL

The potential for human toll in disasters cannot be refuted. At the same time there are many contemporary issues that put companies at a structural risk of experiencing a major financial impact. Many who read this paper would note that the following features of operations exist within their companies and organizations. We view these factors as a current reality that need to factor into the way we approach planning and risk mitigation.

1) Lack of Redundancy of Critical Operations

The 1980's and 1990's were a period of operational consolidation and change. This exhibits itself through the emergence of Single or Sole Site orientation in operations. Elimination of organizational resilience and inherent abilities to recover critical operations does drive cost out of operations. The problem is that it also drives risk into the business.

It is recognized that many companies do back-up their most critical operations - IS/IT, Customer Call Centers, etc. It is also noted that immense risk remains for critical operations where no recognized back up exists.

2) Just in Time Manufacturing and Service Provision

This theory of operations has its origins, at least in part, in the well-known Demming Method and other aspects of the Total Quality Management processes. The theory is roughly this. By limiting the amount of produced goods or services in the "pipeline" there is a coincident limitation on defective components that are received by a producer of a finished product, or by the recipient of finished product.

For the final "assembler" of a product this removes the cost of carrying large amounts of "safety stocks" of components. Over time this will result in major cost reductions- until something goes wrong in the supply chain. Automobile manufacturers recognize this and were at the vanguard of charging penalties to suppliers who disrupt their operations because of interrupted component flow. A typical penalty within the automotive industry is \$5000 per minute of interrupted production at a vehicle assembly location.

3) No Safety Stocks or Buffer Stocks

As eluded to above in the discussion on Just in Time production, it is now standard practice to maintain little to no buffer of finished goods or components parts in the production and overall pipeline. You will be hard pressed to find organizations that run Warehouses. The Warehouse

virtually disappeared in the 1980's and 1990's, and has been replaced with the Distribution Center or DC concept. In many cases, the DC is little more than a staging area adjacent to a shipping dock. This lack of finished goods or component parts as a buffer against production outages has reduced the Maximum Acceptable Downtime for organizations to the 1 to 5 day ranges in many, many cases.

4) Outsourcing of Key Components and Finished Goods Production

This is an issue of Core Competency. As companies drill down on internal competency they are looking very hard at what they do best. In many cases this results in a decision to have components and/or finished goods produced by outside parties.

Again, there is additional risk to the business due to the loss of direct control of production. Again, this is balanced by cost reductions produced by having others produce the product at lower unitized costs than you can produce yourself.

Many may have heard from their purchasing departments on this issue. The typical response from this group is "we have put many restrictions and requirements on our outside partners and to add contingency and continuity to this will only add costs to the situation". This is true but the proposition of not having any potential for recovery of a key aspect of the business is going to be an untenable position in the coming Corporate Governance environment. To be fair and balanced with regard to this some companies have begun to address this, or are at least attempting to do so through various forms of Service Level Agreements with their production partners.

We believe that this is a key issue and one that will need to be addressed in all companies pursuing an outsource strategy at any level.

These fundamental effects, coupled with the human stress of maintaining tenuous operations, put us in a very exposed position on a daily basis. So this is where we find ourselves.

Increasingly we have only one place that we can conduct key operations, no inherent back-up location or strategy, no buffer or safety stocks to sustain us through even short term outages, 1 to 5 days of finished goods or component parts in the pipeline, and a growing reliance in many companies upon outside suppliers to produce key components or finished goods.

Sounds bleak at best, and you may ask yourselves "how in the world could we put ourselves in this position?" The answer is actually very simple and it is related to - you guessed it - dollars.

In order to experience negative impacts an incident has to occur. While any incident *could* occur the probability it will occur and impact the business is virtually never 100%. Because we are Risk Management and Risk Control professionals we see things in a particular way. In our world we would like to mitigate or attempt to mitigate risk to its lowest potential chance of occurrence.

We know that we cannot reduce the chance of occurrence to zero. Decision-makers and leadership in companies have the same goals but consider a wholly different view of risk. This view recognizes the need to mitigate risk but expands the risk picture outside of the boundaries that we normally consider. The expanded view recognizes mitigation in our classic sense but balances this view with the mandatory need to be competitive in an increasingly competitive world market. On this basis decisions get made that we might not all agree with. Remember the probability of occurrence of a

Hurricane is not 100%, while the probability of a business failing is 100% if that business cannot be competitive in the marketplace.

As Risk Management professionals, it is our job to understand both sides of the equation, and if we don't we will only be marginally effective in doing our job and making progress in risk reduction. Our ultimate job is to bridge the gap between the risk landscape and the businesses need to be competitive in order to provide a balanced view of priorities for risk reduction and therefore reduction of the potential for financial impact.

III. THE BCP PROCESS AND FINANCIAL IMPLICATIONS

For the purposes of the remainder of this paper we will examine the financial aspects of Recovery in four primary segments.

Earlier discussions detailed some of the underlying factors that influence the exposures that a company faces. This portion of the paper will address the assessment of financial risk and exposure mitigation in the following areas:

- 1) Pre-Incident Assessment and Business Impact Analysis
- 2) At Time of Disaster (ATOD) costs
- 3) Post-Incident Recovery Costs
- 4) Insurance Implications

These four segments, three of which relate directly to Operations Exposure Analysis and Cost/Benefit analysis, are a logical way to evaluate the full financial risk spectrum related to how a company evaluates and mitigates exposures.

1) Pre-Incident Assessment and Business Impact Analysis (BIA)

The Risk Identification, Quantification, and Mitigation process is ultimately a Cost/Benefit analysis consisting of the following:

- a) What is the exposure to loss from various risks that can be identified? What risks do we face?
- b) What is the magnitude of Physical and Operational risk exposure? How bad are the risks relative to loss of productivity, revenue, reputation, etc.?
- c) What can be done to mitigate the risk?
- d) What are the costs of mitigation of the risk?
- e) What is the Cost/Benefit of the various mitigation measures that can be implemented?

Readers may view this as the Risk Management process, and it is...with one key differentiation.

The BIA process requires the engagement of virtually the entire organization in order to produce a balanced view of the risk and benefits of recovery or mitigation e.g. the impact avoided (benefit) vs. the costs of mitigation.

This process allows Risk Management to frame risk issues across a wide range of organizational perspectives. A key embedded element in the BIA process will be a review of existing levels of planning and preparedness. This final element will become visible when the organization is evaluating real costs of further risk reduction.

2) At Time of Disaster Costs

As one of our clients observed “We will blacken the sky with helicopters to achieve recovery but we have trouble evaluating costs and benefit prior to an incident”. This client will remain anonymous but everyone will have heard of the company, which is in the Fortune 500. Put differently most companies will do whatever it takes to recover, and do it quickly. They need to do it quickly because of market forces, market share concerns and other issues that we detailed earlier in this paper.

In general companies will believe it is efficient, on a cost basis, to respond rather than prepare and expend funds focused upon the recovery process in advance of an incident occurring. A primary reason for this is the fact that pre-incident mitigation costs real dollars. Following an incident there is a potential for collecting insurance dollars to pay for recovery actions. The primary problem with this theory is that insurance dollars will not directly protect your market share or retain customers for you.

Due to space considerations for this paper it is not possible to provide a complete rundown of every potential cost that may be incurred at the time of an incident, and in support of recovery. This will vary from company to company, by type of industry, is influenced strongly on the up side during regional disasters, and will run the gamut of essentially whatever is needed to recover the business.

The issue of post incident costs will be addressed in subsequent sections on Post Incident and Insurance and Risk Transfer.

3) Post Incident Recovery Costs

This segment of time obviously overlaps with the At Time of Disaster cost considerations. Some of the costs that will be important to consider in advance of an incident are:

- Support for evaluation of damage and outside professional service provider costs that are needed to accomplish this. Consider things like the need to have a structural engineer on retainer for evaluation of earthquake damage should you be in an earthquake prone area.
- Costs for immediate restoration of damage. These services would be provided by one of the national or local firms engaged in property restoration. These services should be planned for on a pre-incident basis over the wide range of restoration needs- general building restoration, electronic equipment, haz-mat/environmental, dewatering/humidity control/mold abatement, and rapid reconstruction of the building
- Computer hot sites and alternative location costs. Also consider the technical expertise that will enable the reconfiguration of systems, reestablishment of connectivity and recreation/retrieval of data needed to get your IS/IT operations up and running again
- Travel costs for staff deployment to remote, alternative operations locations
- Staff deployment away from production or operations and towards recovery
- Employee Crisis Counseling for staff directly or indirectly impacted by the incident
- Expediting costs for getting new equipment and supplies in place quickly, with little notice.

We offer these cost components as prime examples of what can be expected. Many of the costs above will be covered by a well-positioned property insurance program. Overall the largest cost that

will not be covered is lost market share. This can be partially offset, over a short period, by certain insurance that will be addressed later in the paper.

A closing point on this topic. For many years insurers and brokers have told clients that they should take actions to recover quickly, without letting insurance drive the process. This is because Business Interruption losses will many times far exceed direct property damage.

While this is true we would caution the following:

- Engage with your insurer for Pre-Incident discussions on their expectations on documentation of a loss. Ensure that these provisions are incorporated into the Damage Assessment portion of your Emergency Response and Crisis Management Plans.
- Also engage with your carrier and broker with regard to your choice of restoration contractors. Insurers maintain lists of acceptable contractors that they trust and have worked with successfully in the past.
- Establish a strong Finance and Accounting component in your BCP so that disaster cost accounting procedures are in place before an incident occurs.

Ultimately your goal should be to put yourself in a position to act and activate your Damage Assessment Plan, document the damage, and institute restoration procedures as quickly as possible. Ideally you should communicate your plans and intentions to act quickly to your insurer, gain their acceptance on the overall approach and be prepared to begin the process of recovery before the insurer's claims representatives are on site at the loss.

4) Risk Transfer and Insurance

One of the most frequently asked questions today is "Will the existence of a BCP reduce my insurance costs?" The answer to this question is a qualified no at this time. It may be a bit strong to say that the answer is no as the current insurance market is one of the toughest of most of our careers, and there are positive effects that can be achieved through the proper communication of an effective BCP.

Some of the factors that influence this situation are worth highlighting:

- a) Insurance markets and the pricing that any individual risk receives are influenced by many factors. These factors are influenced by macro economic issues such as large losses that have been paid by the insurance industry, reinsurance underwriting results and any large loss aggregations that have made their way to the reinsurers, and the investment income results for the carrier's investment portfolio. It is clear why we are currently in a very hard insurance market, and the actions of any individual company will have limited effect on their ability to receive vastly better pricing than the overall insured community.
- b) Insurers operating in a hard market tend to group the good with the bad. This can be overcome by pointing out how your company is out performing the industry. A solid BCP along with a good spread of risk, a strong mitigation culture, and good loss history will move you up the list for consideration by underwriters.
- c) At this point in time there is no insurance industry standard for insurers to use as an evaluation tool. NFPA 1600 exists and offers a very good set of criteria that a plan should contain, however due to the complexity of each individual companies exposures standardized risk evaluation criteria are difficult to apply with consistency.

In the end the real reason to develop a BCP is not to reduce insurance costs but to reduce the real time exposures that a company faces every day. The BCP process can influence many aspects of the exposure. From an insurance standpoint it focuses upon reduction of “Time Element” risk and impact potential. Insurance coverage’s that most closely relate to this are:

- Business Interruption (BI). This covers lost profit and continuing expenses.
- Extra Expense. This covers you for expenses that you incur above the ordinary in the recover of your business.
- Contingent Business Interruption (CBI). This coverage allows you to insure the business interruption that may occur should a supplier experience a loss.
- Extended Period of Indemnity. This extends your Business Interruption coverage past 12 months in order to theoretically allow you to recoup market share.
- Demolition and Increased Cost of Construction. This covers you when your facility reconstruction costs exceed the conditions that your current building is insured for. For example if your currently non sprinklered building required sprinklers under new codes this coverage could be utilized to fund the sprinkler installation.
- Difference in Conditions and Earthquake coverage with BI and CBI extensions.
- Off Premises Power. This insures you against property damage or business interruption loss that results from your curtailment of operations when power is interrupted to your facility.
- Civil Authority. This will cover you from losses that result from your inability to access your facility due to limitations on access by public officials.

The most coveted of these coverages is Extra Expense. Business Interruption will pay you for your lost profits and continuing expenses to maintain your facilities; however most companies must attempt to recover quickly and will do whatever it takes to avoid loss of sales and customers. BI coverage is needed to address large losses and fulfill the fiduciary responsibility of a company. EE would provide real time funding for costs being incurred to produce recovery and maintain your customer base. Both are needed but a strong case can be made for EE being more important, in the context of BCP and post incident funding, than BI.

IV. CONCLUSIONS

It would be convenient to attempt to provide a checklist of the financial aspects related to the recovery process. The complexity of the issue does not allow for this to be done in a singular sense that can be easily applied across industry groups and business types. The key issues to focus upon are:

- Pre-Incident Risk Assessment and Planning
- Business Impact Analysis
- Operational Readiness Review
- Insurance and Risk Transfer
- Assessment of At Time of Disaster Costs
- Post Incident Restoration, and Recovery Costs

The BCP process offers the best chance to bridge the gap between Risk Management and Operations concerns related to financial impact reduction. Once this bridge is built the organization will have an excellent platform for the on-going evaluation of the financial impact potential and ways to reduce it.