



*Risk Consultants*

# **Business Continuity Planning**

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## Introduction

Businesses of all sizes face increasing pressures to increase profits and rates of return. These pressures have resulted in a greater reliance on techniques such as just-in-time manufacturing and single source suppliers. Increased efficiencies, however, bring increased risk. Serious loss incidents can mean the crippling of an organization's long-term profitability, and even its continued existence.

Financial considerations for recovery begin long before any incident occurs. The Business Continuity Planning (BCP) process, coupled with the financial recovery potential through insurance and other risk transfer means, are some of the strongest tools companies can use to offset the potential impact from incidents.

The main reasons for developing business continuity and crisis management plans are:

- Safety and security of staff and visitors
- Mitigation of financial risk exposures
- Mitigation of physical and operational risk
- Protection of the entity's reputation
- Protection of market share or competitive position

A company's most important asset is its people. A major impact on the staff has a direct organizational impact, and this will have, in turn, a direct financial impact. This has been graphically illustrated in the aftermath of 9/11/01. Long after the physical losses have been addressed, the toll on the staff continues. 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 in their work environment

It does not take a disaster the magnitude of the World Trade Center to produce these impacts. 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 resulting impact to the overall organization.

## Potential Financial Disaster Exposures

Many current issues put a company at a risk of experiencing a major financial impact. These areas need to be factored into the way a company approaches planning and risk mitigation.

### *1. Lack of redundancy of critical operations*

The 1980s and 1990s were a period of operational consolidation and change. This resulted in a move toward sole site operations. The elimination of the inherent abilities to recover critical operations does drive cost out of a business. Unfortunately, it also drives risk into the business. Critical operations, such as information systems/technology and customer call centers, must be backed up to avoid potentially catastrophic risks.

### *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 states roughly that by limiting the amount of goods or services in the pipeline, there is a resulting reduction in defective parts received by the producer of a finished product, or the recipient of a 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 does result in major cost reductions – until something goes wrong in the supply chain. Automobile manufacturers recognized this, and began charging penalties to suppliers who disrupted their operations because of interrupted product flow. A typical penalty within the automotive industry is \$5000 per minute of interrupted production at a vehicle assembly location.

### *3. No safety or buffer stocks*

For most manufacturers, it is now standard procedure to maintain little or no buffer of finished goods or component parts in the production and overall pipelines. The traditional warehouse virtually disappeared in the 1980s and 1990s, and has been replaced with the distribution center concept. In many cases, the distribution center is little more than a staging area adjacent to a shipping deck. This lack of a buffer against production outages has reduced the maximum acceptable downtime for organizations, in many cases, to the 1 to 5 day range.

#### *4. Outsourcing of key components and finished goods production*

Outsourcing is an issue of core competency. Companies are looking very closely at what they do best. In many cases, this results in a decision to have components and/or finished goods produced by outside parties.

Additional risk to the business occurs due to the loss of direct control of production. This is balanced by cost reductions resulting from outsourced entities producing a product at a lower cost. Some companies are addressing this concern through various forms of service level agreements with their production partners.

The exposures discussed above, coupled with the human stress of maintaining tenuous operations, put companies in an exposed position on a daily basis.

Increasingly, companies have:

- Only one place to conduct key operations
- No inherent back-up location or strategy
- No buffer or safety stocks to sustain through even a short-term outage
- 1 to 5 days of finished goods or component parts in the pipeline
- A growing reliance in many companies on outside suppliers to produce key components or finished goods

The leaders of today's companies recognize the need to mitigate risk, but balance this with the need to be more competitive in an increasingly competitive world market. Risk management and risk control professionals need to help bridge the gap between the need and cost of controlling risk, and a company's need to be competitive.

## The Business Continuity Process and Financial Implications

The financial aspects of recovery can be grouped into four 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:

- What is the exposure to loss from various risks that can be identified?
- What is the magnitude of physical and operational risk exposure? How extensive are the risks relative to loss of productivity, revenue, and reputation?
- What can be done to mitigate the risk?
- What are the costs of mitigating the risk?
- What is the cost/benefit of the various mitigation measures that can be implemented?

This process is very similar to the risk management process, with one key difference. The business impact analysis process requires the engagement of virtually the entire organization 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.

### *2. At Time of Disaster Costs*

Virtually all companies will do whatever it takes to recover from a disaster, and do it quickly. They must do it quickly because of market forces, and market share concerns.

Companies generally believe it is more efficient, on a cost basis, to respond to a disaster, rather than to prepare and expend funds in advance of an incident that may never happen. Pre-incident mitigation costs real dollars that are in strong competition with actual operations.

Following an incident, companies generally expect to collect insurance for the loss incurred. The primary flaw with this theory is that insurance will not directly protect market share or retain customers for the long-term. Also, due to the “hard” insurance market, coverage is not always available in the type and amount need to totally reduce the impact of losses. Pre-incident costs, therefore, become more cost efficient as the reliability and thoroughness of insurance is reduced.

### *3. Post Incident Recovery Costs*

Costs incurred shortly after an incident obviously overlap with those incurred at the time of the incident. Some of the costs that are important to consider in advance of an incident are:

- Support for the evaluation of damage and any required outside professional assistance
- Costs for the immediate restoration of damage
- Computer hot sites and alternative location costs
- Travel costs for staff deployment to alternative operation locations
- Staff efforts diverted away from operation/production towards recovery
- Employee crisis counseling for staff directly or indirectly impacted by the incident
- Employee costs for getting new equipment and supplies in place quickly

Many of the above costs will be covered by a broad property insurance program. The largest cost not covered by insurance is lost market share. Some aspects of this risk, however, can be covered over a short period, and will be discussed in the next section.

To help facilitate a possible loss adjustment, the following steps can be taken by a company prior to any loss:

- Discuss with the property insurer their expectations for the documentation of a loss
- Discuss with the insurer and broker the names of possible restoration contractors
- Establish a strong finance and accounting component to the Business Continuity Plan so that disaster cost accounting procedures are in place before a loss occurs

The ultimate goal is to activate the damage and assessment plan, document the damage, and institute restoration procedures as soon as possible.

### *4. Risk Transfer and Insurance*

A Business Continuity Plan (BCP) provides many advantages to an organization. A BCP is certainly a positive addition to a property insurance submission. The presence of a BCP, however, does not insulate a company from the current hard insurance market, nor does it

even mean an explicit premium credit. Some of the factors influencing the situation include the following:

- Insurance market pricing is affected heavily by overall industry results and investment returns
- Insurers tend to group the good with the bad. The presence of a BCP along with a good spread of risk, a strong mitigation culture, and a good loss history can all improve a company's standing with underwriters.
- There is no standard evaluation tool to judge the quality of a BCP.

The primary reason to develop a BCP is not to reduce insurance costs, but to reduce the real time exposures that a company faces every day. From an insurance standpoint, a BCP focuses on the "time element" risk and impact potential. Insurance coverages that relate to this risk include:

- Business Interruption (BI) – Covers lost profits and continuing expenses
- Contingent Business Interruption (CBI) – Insures a business interruption caused by a covered loss at a supplier or customer location
- Extended Period of Indemnity – Extends the business interruption coverage past 12 months to assist in recovering market share
- Extra Expense – Covers expenses incurred above the ordinary in the recovery of a business
- Demolition and Increased Cost of Construction – Provides coverage when a facility's reconstruction cost according to current building codes exceeds the reconstruction costs on an "as is" basis. This would, for example, cover the extra costs to rebuild a formerly non-sprinklered building with sprinklers, if required by current building code
- Off Premises Power – Insures against property damage and resultant business interruption due to the stoppage of operation caused by the interruption of power from an off-site facility resulting from a covered loss
- Civil Authority – Covers losses caused by the inability to access a facility due to limitations on access by public officials

Business interruption provides essential coverage for the loss of profits and continuing expenses. Extra expense coverage, however, is actually more important from a business continuity standpoint. Extra expense provides real time funding for costs being incurred to produce recovery and maintain the customer base.

## Conclusion

The Business Continuity Planning (BCP) process is one of the strongest tools a company can use to offset the potential impact from significant loss incidents. Each company's actual plan will be unique to address its own exposures and situations. Each plan, however, should address the following key issues:

- 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 Business Continuity Planning process offers the best chance to bridge the gap between risk management and operations concerns related to financial impact reduction from large loss incidents. Once this bridge is built, the organization will have an excellent platform for the ongoing evaluation of the financial impact potential and the ways to reduce it.

For more information, contact:

Win Chaiyabhat

Chicago

+1.312.381.3908