

## **Insurance Incentives for Corporate Preparedness**

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### **Executive Summary:**

Having an effective corporate emergency preparedness programs can result in relatively lower insurance costs and better policy terms for companies. This can be an important financial consideration in evaluating investment in corporate preparedness and may not be widely known.

Awareness of this common insurance practice should be increased. Also, a reference guideline for what constitutes basic preparedness should be considered by leading insurers. The voluntary Preparedness Standard (NFPA 1600) is a good candidate.

### **Key Points:**

- Emergency preparedness efforts by corporations generally result in the avoidance of emergencies or mitigation of their effects.
- Avoidance or mitigation generally results in lower financial losses to both to the insurance policy holder and the insurance company which insures it.
- Emergency preparedness efforts are evaluated, at least to some degree, in the current underwriting processes of leading insurance companies. The existence of these preparedness efforts is considered in determining insurance policy terms.
- Therefore, if a corporation undertakes emergency preparedness activities, it will most likely receive relatively better policy terms (including better premium pricing and deductible levels) than it would if it did not prepare. And in some high risk situations, the presence of an effective corporate preparedness program determines whether or not the company will be offered insurance at all.
- However, the criteria used to evaluate corporate preparedness are often dispersed among a variety of criteria used to assess overall insurability of the corporation or facility. Thus, there is not necessarily a focused assessment of corporate preparedness as a cohesive program.

- Furthermore, insurance companies generally do not provide comprehensive guidance as to what from their perspective constitutes the basic elements an appropriate preparedness program and thus what they will assess.
- Nonetheless, it was confirmed with leading insurance companies that all key elements of the consensus-based preparedness standard, ANSI-NFPA 1600 (also know as the National Preparedness Standard) are generally reflected in the underwriting processes of the leading insurance companies. These elements may however be dispersed throughout the underwriting process.
- Thus, the ANSI-NFPA 1600 criteria may offer a helpful reference for companies in the development of their emergency preparedness programs as well as for underwriters in assessing the level of preparedness of prospective policy holders.
- In addition, given a potentially significant lack of awareness of the acknowledgement of preparedness in insurance underwriting, efforts should be undertaken by the insurance industry and other stakeholders to highlight this fact so as to encourage greater preparedness efforts.

## History

From June 2003 to March 2004, in support of the Federal 9-11 Commission and with Commission staff involvement, multiple roundtable forums and individual interviews of private and public sector organizations were held to investigate private sector preparedness. These events were held by the Greater New York Safety Council in conjunction with the Working Group on Private Sector Preparedness which consisted of primarily corporate representatives committed to researching the lessons of the 9/11 attacks and their aftermath with regard to business preparedness. A particular focus of these efforts was on incentives for private sector preparedness including the acknowledgement of preparedness in determining insurance terms (e.g., pricing, deductibles, etc.).

The findings of this effort were reflected in recommendations of the Working Group on Private Sector Preparedness made to the 9-11 Commission which served as input into the Commission's final recommendations to Congress and the President.

One of the 9-11 Commission's recommendations stated:

We endorse the American National Standards Institute's recommended standard for private preparedness [NFPA 1600]. We were encouraged by Secretary Tom Ridge's praise of the standard, and urge the Department of Homeland Security to promote its adoption. We also encourage the insurance

and credit-rating industries to look closely at a company's compliance with the ANSI standard in assessing its insurability and creditworthiness. We believe that compliance with the standard should define the standard of care owed by a company to its employees and the public for legal purposes. Private-sector preparedness is not a luxury; it is a cost of doing business in the post-9/11 world. It is ignored at a tremendous potential cost in lives, money, and national security.

The National Preparedness Standard (The Standard on Disaster/Emergency Management and Business Continuity Programs – ANSI/NFPA 1600) represents a cross-industry consensus-based guideline on the key criteria of a corporate preparedness program. It has been endorsed by the U.S. Department of Homeland Security, the Federal 9-11 Commission and the American National Standards Institute after vetting with its 2,000 corporate members.

During 2004 and 2005, the International Center for Enterprise Preparedness (InterCEP) at New York University created an insurance incentives advisory committee and held roundtable forums and key stakeholder discussions to validate the 9/11 Commission's recommendation that the National Preparedness Standard could be used in assessing insurability and motivating corporate preparedness efforts. These discussions also addressed more general incentives to encourage private sector preparedness and defined an implementation strategy to advance further effort on these incentives.

### **Findings To Date**

Targeted roundtable discussions with representatives from leading insurance companies confirmed that the status of corporate emergency preparedness is generally assessed in current insurance underwriting practices when evaluating the insurability of a company.

This assessment may be very fundamental in nature but it is considered in determining whether or not the insurance company will issue a policy and if so, what will be the insurance premium pricing and other policy terms (including deductible level). All other factors being equal, a firm with an effective emergency preparedness program will receive better terms (e.g., relatively lower premiums and deductibles) than would the same firm without a program.

There is a dual benefit to corporate preparedness in this regard. In general, both insurance companies and insured businesses experience losses in the aftermath of any disaster or major emergency. Business policy holders are responsible for the cost of any losses up to their deductible as well as beyond the limits of the coverage, while insurance companies are responsible for any losses between the deductible and the limits of the policy. Businesses are also responsible for the

wider losses that extend well beyond that which can be insured or easily quantified (e.g., loss of market share, reputational loss, etc.). Therefore, both policy holders and insurance companies benefit when preparedness measures are undertaken and these measures ultimately limit the size of the loss due to an emergency.

Because the underwriting process includes a diversity of considerations beyond preparedness in determining premium price and terms, insurance companies are reluctant to provide an “across the board” reduction in premium pricing based upon preparedness programs alone.

Nonetheless, leading companies have indicated a willingness to heighten the awareness of the existing acknowledgement of preparedness in the underwriting process.

Insurance company advocacy in this regard is critical. Without a clear communication of the relationship between preparedness efforts and insurance premium pricing and terms, little compelling rationale in insurance exists to encourage businesses to prepare

In addition, greater clarity as to what constitutes effective preparedness would likely result in more effective corporate preparedness efforts. This need was clarified by general corporate participants in discussions.

There is no standardized method for assessing preparedness across the industry or for insured companies to communicate the nature of their preparedness program to the insurance underwriter.

The Preparedness Standard (NFPA 1600) was discussed as a potential baseline guideline for corporate preparedness. Formally titled the “Standard on Disaster/Emergency Management and Business Continuity Programs,” the standard reflects over 15 years of consensus-based input involving businesses, professional associations, the insurance industry and government. The Preparedness Standard has been endorsed by the U.S. Department of Homeland Security, the 9-11 Commission and the American National Standards Institute (ANSI). The standard is a listing of basic program elements common to effective organizational preparedness programs. The standard has a high-level approach which is scalable to firms of any size or industry and provides a significant amount of flexibility in application..

Furthermore, a diffused approach to assessing preparedness can make it difficult for underwriters to systematically assess preparedness and track its impact on reducing losses both to the insured and the insurance company.

In discussions with leading insurance firms, the elements of the Preparedness Standard (NFPA 1600) were found to be already present in insurance company underwriting guidelines, although often dispersed throughout a number of areas. The concentration of preparedness elements in a single voluntary advisory reference could better inform corporate efforts in this regard and support a programmatic approach to preparedness.

The Preparedness Standard could potentially be referenced by insurance companies as a resource for developing an overall corporate preparedness program and each insurance company could choose to add specific guidance on particular risks or occupancies, if they deem appropriate.

Therefore, the identification by leading insurance companies of the Preparedness Standard (NFPA 1600) as a common starting point for the assessment of existing corporate preparedness programs or the development of new programs could serve to add some clarity as to what efforts should be undertaken by corporations in establishing and maintaining preparedness programs.

### **Increased Operational Risk**

Corporate preparedness is especially important as the business environment reflects increasing operational risk from a diversity of sources. The probability of a crisis of one form or another striking the average corporation is high. Recent research of a broad range of Global 1000 firms indicates that, over any five year period, there is an 80% likelihood of a major crisis occurring that will significantly impact any publicly traded business.<sup>i</sup> Crises can range from facility fires to natural catastrophes to disasters of a strategic or reputational nature. Irrespective of the type of crisis, an eight out of ten likelihood underscores the rising importance of operational risk.

Arguably, businesses operate in a substantially riskier world today than decades past. Globalization has expanded the footprint and the vulnerability of most firms. Corporate exposure to risk has dramatically increased as efficiencies are sought from internal and external supply chains that can span the globe.

While terrorism remains a threat as international tensions continue to heighten, more significantly natural catastrophes are on the rise. Insurance statistics indicate a steady increase in the both number of natural catastrophes and overall losses since 1950. There was over twice as many natural catastrophes during the past ten years as there were during the 1960's.<sup>ii</sup> Even after adjusting for current dollar values, economic losses from natural catastrophes have increased nearly seven-fold since the 1960's.<sup>iii</sup>

Furthermore, increasing reliance on technology has resulted in increasing vulnerability; power supply interruptions and cyber threats are but two among many other technology risks.

The increased operational risks posed by catastrophic events such as natural disasters, pandemics and terrorist attacks present serious strategic challenges to organizations. One direct impact is the current trend toward dramatically increasing insurance premiums.

A recent Wall Street Journal article states that "[d]isaster-insurance rates have risen so sharply that businesses with exposure to hurricanes are canceling projects, paying more for whatever coverage they can get, and in some cases, going without insurance altogether."<sup>iv</sup>

This contraction in the insurance market and the consequent necessity for many companies to go forward either with less insurance coverage or in some cases “without insurance altogether” makes effective corporate preparedness programs all the more critical.

### **Conclusions for Corporations**

- **Consider Insurance Benefits as well as Reduction of Overall Losses in Allocating Resources to Preparedness:** The fact that emergency preparedness is a factor in determining insurance terms (e.g., coverage, cost and deductible level) should be considered by corporations in their setting of operational priorities and allocation of financial and staff resources to preparedness activities. The insurance benefit is of course in addition to other benefits which may accrue from preparedness, the most significant of which is the substantial reduction in overall losses to the corporation after any crisis.
- **Identify Corporate Preparedness Efforts to Insurance Companies:** To assure acknowledgement of their efforts, firms should proactively identify their preparedness programs to insurers during the underwriting process.
- **Use the Preparedness Standard (NFPA 1600) To Develop & Assess Corporate Programs:** Since leading insurance companies have confirmed that the elements of NFPA 1600 are reflected in their underwriting analysis and since the standard reflects a consensus of industry experts on state-of-the-art preparedness, this standard is an appropriate reference for both the development of new programs as well as the assessment of existing corporate preparedness programs.

## Conclusions for Insurance Companies

- **Motivate: Increase Awareness of Current Underwriting Policies that Acknowledge Corporate Preparedness so as to Motivate Increased Efforts:** A wider awareness of insurance company practices which effectively reward corporate preparedness would likely motivate greater emergency preparedness efforts on the part of business. Resulting lower losses would benefit both businesses and insurance companies.
- **Guide: Provide Guidance as to Basic Elements of Preparedness by Identifying the Preparedness Standard (NFPA 1600) as a Voluntary Guideline for Corporate Preparedness.** Greater clarity as to what the basic elements of preparedness are would better inform corporate preparedness efforts and likely result in more effective programs to the benefit of both the insured and the insurance company. This widely acknowledged preparedness standard could provide a good baseline reference for overall corporate preparedness programs. Insurance companies could continue to provide more specific recommendations as appropriate.
- **Communicate:** Two potential initial strategies were identified in industry discussions and roundtable forums to further both the efforts to motivate preparedness and provide guidance as referenced above :
  1. **Stress in Internal Communications to Policyholders:** Undertake high profile communication to policyholders on both
    - a. the role of preparedness in determining policy terms during the underwriting process
    - b. and availability of the Preparedness Standard (ANSI-NFPA 1600) as a foundation for developing or assessing a corporate preparedness program
  2. **Join Leading Insurance Companies in Joint Corporate Preparedness Declaration:** A formal joint declaration by leading insurance companies which
    - a. identifies the role of corporate preparedness in the underwriting process and further
    - b. identifies the Preparedness Standard (NFPA 1600) as a key reference for developing or assessing a corporate preparedness program.

Both of these initiatives essentially communicate both the “why” to prepare (i.e., for relatively better insurance policy terms –among other reasons) and the “what” to do (i.e, the criteria of the National Preparedness Standard as an indicator of key elements of a preparedness program).

- **If Not Already Done, Consider Modifying Underwriting Processes to Address Corporate Preparedness Programmatically:** Modification of the individual insurance company underwriting processes to provide a more distinct connection between the state of corporate preparedness and impact on ultimate policy terms would serve as a mutually beneficial incentive for greater corporate preparedness. Such modifications could focus on a more concentrated, less diffused, assessment of the corporate preparedness program.

### **Continuing & Future Activity**

To jointly develop a compelling rationale for business preparedness in the area of insurance, InterCEP will continue to work with insurance industry stakeholders and the larger business community to develop supporting policies and strategic communication plans that clarify the linkage between preparedness and insurance benefits, thereby encouraging preparedness by policyholders and minimizing losses for both them and insurance companies.

The initiative's focus on insurance incentives is especially important given the impending expiration of the Terrorism Risk Insurance Act, which has provided a government backstop in the insurance market against catastrophic loss due to terrorism since September 11<sup>th</sup>. Without additional policy solutions or consensus action within the private sector, deductibles for companies that reside in high-risk areas could substantially increase. Furthermore, with the recent contraction of re-insurance coverage in the aftermath of the 2005 disasters, individual corporate preparedness is even more critical as a factor in lowering loss exposure for insurance companies or in some cases bolstering a default "self-insurance" strategy which many companies have undertaken in light of the lack of affordable insurance coverage.

This initiative will continue to facilitate multi-stakeholder forums and begin a separate focus on each of the potentially impacted lines of insurance (e.g., property/casualty, business interruption, directors and officers, etc.).

Extra:

## Appendix A: Comments from Advisory Group Members

This appendix includes verbatim comments on this white paper from members of InterCEP's Insurance Incentives Advisory Group. These comments will be considered during the Roundtable discussion on October 19, and together with the roundtable proceedings, integrated into a subsequent draft of this white paper.

- There are some things that the private sector can do to prevent terrorism, but it cannot prevent hurricanes, floods, etc.
- What can the private sector do to mitigate against loss when these bad things happen?
- My concern is that there is insufficient partition between the concepts of prevention and mitigation
- Underwriters are restricting the capacity by agreeing to insure those who take the most rigorous steps, and for those who don't, there's no price they can pay to get insurance
- Capacity is being rationed, and when demand exceeds supply we can get picky about what we want to write
- Prepared firms are attractive to underwriters
- You can get people to sign an industry statement if you don't define preparedness, because if you do, then you're risking antitrust
- The wording should be something like NFPA is not the only thing, but it has value
- For me, the issue is how do you prepare for disaster, whatever it may be, to mitigate its impact to you, your business and your people
- And, to the extent that you do it, what does it mean to me as an underwriter for capacity and terms
- My resistance is that too often, with GAO and Congress, people want to hear a soundbyte formula like 'a floodwall will get you a 20% insurance break'
- Instead, there are cost effective things you can do to protect the business from harm
- The motivation should be, protect your people, your business
- WalMart was ready for Katrina in their crisis control room, they just went through their checklist and maintained their position and got their stores back up quickly
- Verizon also did well, though they were frustrated in Katrina because the enormity and security that inhibited their response
- But other enterprises need this information
- You should pitch your message so that it doesn't offend companies like Home Depot that have already got it right, but still educates and gets a response from organizations that need more robust concepts and practices
- What you're doing is great, but you have to be perceived as able to discriminate between those that have it already and those that don't
- You can't use me as your representative of the industry however, because we're doing some different things
- We can all agree on motherhood, that if we are impacted by a major event, we make sure our people are protected, and that we have done things that we can do to mitigate the impact
- Preparedness means knowing in advance what can be done to mitigate
- But what about best practices? How does preparedness translate into salary continuation during long-term outages, into HR practices? Communication practices?
- The types of insurance we're talking about are about 1-2% of the total revenue, so it's peanuts
- That means companies won't necessarily get motivated to do the things we want them to do by shaving a percentage point or two off their premiums
- Instead, they'll do it because they won't be able to hire people unless they can prove that they'll be safe

- Business continuity has enormous value that has little or nothing to do with insurance
- The proposition is totally different for a building that was built 20 years ago and needs to be retrofitted vs. a building that will be built tomorrow and needs to be built in accordance with a revised code
- Look at WTC 7, built beyond code, with a state-of-the-art system for terror
- Doing this didn't cost that much, but it was a business decision
- There's a big debate about retrofitting to meet new codes, which can have tremendous costs, vs. 3-4-8% the cost of a new construction
- As underwriters, we know that if you build to code, we'll be happy to pay for a few new shingles after the storm blows through
- We can't discount the policy enough to pay for retrofitting, and yet, we are willing to discount price to structures built to code
- It's clearly evident in the way the insurance industry is addressing the coastal market
- We created an electronic, self-guided assessment of preparedness for terrorist attacks
- Risk managers self-score and it becomes evident that these are areas that you need to address
- The current InterCEP white paper "Insurance Incentives for Corporate Preparedness" is compelling, but firms are not likely to implement such incentives because it remains difficult to quantify the ROI
- Typically, insurers are concerned about the worst case, the maximum foreseeable loss (MFL)
- With an event like a fire, we can quantify the MFL, and we can quantify the impact of sprinklers on the MFL, but it's harder to quantify the impact of the business continuity or emergency preparedness planning process on that MFL
- The impact of the planning process on business interruption will be even harder to quantify
- For example, if a firm has business interruption insurance for loss of income for one year due to a catastrophic event, and claims that because it has a new, improved plan, it would only need 1 month to recover, and that therefore the premium should be reduced, it's not likely that the insurer will pay much attention
- What is the ROI for preparedness? There's very little data history, and no significant actuarial data that could correlate:
  - Preparedness activities undertaken
  - Type and severity of event
  - Resulting insured loss
- Insurance companies may be willing to agree publicly that
  - Preparedness is good
  - Preparedness is factored into our underwriting strategies
  - Prepared firms get better terms
- Of course, the pricing of specific terms offered will always depend more on market conditions than on preparedness
- The challenge is that the value impact of preparedness activities depends on the type of industry
  - For example, pharmaceutical companies making one product in one place will have difficulty arguing that their business continuity plan significantly reduces their risk of business interruption
- InterCEP should look for a database of business interruption insurance payouts
- The financial industry should have data on
  - Companies that have a BC plan
  - Companies that have obtained business interruption payouts
- Alternatively, what if corporations confident about their preparedness plans would retain the risk themselves by accepting a higher deductible in exchange for lower premiums?

- In such cases, it would be up to the corporations themselves to assess the risk of taking the initial hit.
- In that regard, it would be interesting to track companies who self-insure through catastrophe bonds and correlate that to NFPA 1600 compliance
- Companies that are proactively compliant could pool their business interruption risk, and municipalities are doing this already
  - Their combined histories build lower collective loss projections
- But the challenge remains: how do you focus on and quantify the value of all-hazards preparedness?
- If you look at Protect America, supported by Allstate, and what the AIA American Ins Association is advocating, you'll see that they both want regulatory relief, but that the industry is not together on this issue at all
- Most if not all would agree that preparedness is important, but there's little agreement on how the industry should position itself
- Sarbanes Oxley can be read as a requirement to engage in operational preparedness exercises, and in some cases it is driving a review of the operational capacity for preparedness
- But the carriers do not publish their underwriting guidelines
- Their point of pain is: am I putting my reinsurance in the right place?
- AIA is looking for a catastrophe savings account, like a deductible, but that would provide tax free savings and allow firms to buy less reinsurance
- Catastrophe reserving may be the easiest thing to do from a public policy standpoint
- Like TRIA, but instead putting 15-20% of expected loss into a catastrophe reserve
- This could have a real effect on the treasury, but it's just a tax policy problem, not an insurance problem
- Many companies are creating captives
- The tax benefit here is that if they send \$2m to a captive it's a legitimate risk transfer
- It allows them to reinsure their own policy through the captive
- But overall, I'd say the industry has a moral obligation to explain why they aren't together pushing a preparedness agenda
- A joint statement could start the public process if people could leave partisanship to the side
- But how? How does preparedness manifest? Right now there is no difference in pricing between firms that are compliant and those that are not.
- What are the elements of NFPA 1600 and how do they quantitatively impact the underwriting process?
- Should carriers have rate freedom to surcharge those people who are a bigger risk? i.e., those who do not follow NFPA 1600?
- It would be very interesting to model 1600 on an actuarial basis
- Do loss runs of those who do and do not have plans, do claims reviews and analyses
- The National Association of Insurance Commissioners could do this together with NYU and the federal government to come out with a statement that says "we think the value of NFPA 1600 preparedness is X"
- If preparedness has a value, X, then companies that do not practice preparedness would face an insurance surcharge
- It would be a great way to start getting people to think about 1600
- Risk managers are already starting to try to quantify their activities by factoring in various elements
- That leads to a risk-based capital formula for operational risk management: "here's the impact on the cost of capital for our operational risk activities"
- So far the CFO's have only quantified 1 element of risk management, the cost of insurance

- But this shift would put the conversation about risk strategy more centrally in the conversation about corporate strategy
- Firms could start branding around their core risk strategy
- It would also help to codify crisis management processes, make the war room where strategy is made all the time
- This is important to create the 3-D environment, the operational atmosphere where you use it everyday to make decisions
- This operational risk atmosphere makes the link between the reactive and the proactive
- RIMS doesn't get it, and there's a self-imposed glass ceiling for many BC and EM professionals
- You have to start by convincing the board to engage in preparedness from the top down
- Or create a risk committee that includes the CFO, general counsel, the COO, government affairs, and internal audit, that reports directly to the CEO and the board audit committee
- These have to be 3-D reporting relationships
- A joint statement about the importance of preparedness would have to involve the trade associations and affirm that
  - We have different approaches to underwriting
  - We agree that preparedness is important and that NFPA provides a good starting point
  - We want to move forward with a preparedness working group to dig deeper into this issue
- The problem is how to characterize the threat environment from a holistic all-hazards perspective in an industry that is set up to parse and differentiate one risk from another
- There's been progress on the homeowner's side, but there's a long way to go yet on the corporate side
- We need to identify risk metrics that relate specific preparedness actions to loss prevention

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<sup>i</sup> "Risks that Matter." Oxford Metrica, 2002.

<sup>ii</sup> "Hurricanes – More intense, more frequent, more expensive: Insurance in a time of changing risks." Munich Re Group, 2006

<sup>iii</sup> "Topics Geo: Annual Review: Natural Catastrophes 2005." Munich Re Group, 2006

<sup>iv</sup> "As Hurricane Season Begins, Disaster Insurance Runs Short." *Wall Street Journal*, July 9, 2006.