

Crediting Preparedness

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Executive Summary

Businesses operate in an increasingly uncertain global environment with growing operational risks from a diversity of sources ranging from technology failures and supply chain interruptions to natural disasters and pandemics. A business' capacity to manage these risks has become an increasingly important component of its financial condition. In the interest of enabling more informed financial decisions by both investors and creditors, rating agencies should include an assessment of corporate preparedness in the rating process.

Key Points

- Rating Agencies Assess Business Risk: The role of the rating agency is to analyze a company's financial condition, business practices & its risks and to issue ratings and other assessments that enable creditors and investors to make informed decisions.
- Operational Risk is Increasing: Operational risk is an increasingly important element of a company's overall risks as the business environment changes. The growing impact of operational risk (which reflects all risk except market, credit & liquidity risk) has been underscored by a diversity of recent findings and events including:
 - Accelerating globalization with accompanying off-shoring and out-sourcing resulting in a wider corporate footprint and vulnerability.
 - The recent drastic re-evaluation of loss projections by the reinsurance industry reflecting an assessment of increased risk of disaster on a wide scale
- Operational Risk Impacts Creditworthiness: The impact of an operational crisis can affect a firm's overall financial status, including its ability to repay debt and meet other obligations. Fires, hurricanes, workplace violence, major power disruptions and reputational crises are but a few hazards which could dramatically impact the financial capacity of a firm.
- Preparedness Programs Key to Minimizing Impact of Operational Risk: Effective management response and corporate preparedness programs can significantly mitigate the impact of operational risk events and affect corporate recovery.
 - There are significant developments in securities regulation, among insurance industry rating agencies, and among private sector companies that demonstrate the relevance of preparedness to a firm's capacity to repay debt and deliver value to stakeholders.
- Rating Agency Underwriting Should Assess Preparedness Programs with Greater Focus: Current rating agency underwriting practices do not sufficiently assess operational risk and corporate preparedness programs to address it.
- Consensus Standard Exists to Assess Corporate Preparedness: There is an existing consensus-based tool to assess corporate preparedness. It is the Disaster/Emergency Management & Business Continuity Standard (NFPA 1600), a voluntary standard endorsed by the U.S. Department of Homeland Security and the Federal 9/11 Commission and under consideration by ISO (the international standards organization).

The Standard offers a set of criteria that can readily be used to assess corporate preparedness.

- Addressing Corporate Preparedness has Multiple Benefits: Specific and higher profile inclusion of corporate preparedness in rating agency underwriting processes would yield multiple benefits.
 - First, by acknowledging the importance of preparedness for operational risks, it would provide creditors and investors with more comprehensive and accurate assessment of creditworthiness;
 - Second, it would allow investors and creditors to identify those industry-leading firms that have already learned lessons from 9/11, Katrina and other catastrophic events, and proactively undertaken key preparedness measures;
 - And finally, by introducing a competitive dimension to preparedness through specific acknowledgement in the underwriting process, it would provide an incentive for firms to develop more robust preparedness programs and consequently improve the overall resilience of the global marketplace.

The Role of the Rating Agency

In its Code of Conduct, Standard and Poor's (S&P) Rating Services states that the mission of its Rating Services "is to provide high quality, objective, independent, and rigorous analytical information to the marketplace." S&P's furthermore "strives for analytic excellence at all times, evaluated its rating criteria, methodologies and procedures on a regular basis, and modifies or enhances them as necessary to respond to the needs of the global capital markets." In a clarification of its ratings process, Moody's states that "[we] will endeavor to manage our rating process to make it most useful to market participants. We will also strive towards creating greater transparency in our ratings. We will continue to manage our rating system to produce stable long-term ratings, recognizing, however, that in periods of heightened credit stress, ratings have historically been adjusted more frequently."

These statements clearly articulate the function that rating agencies perform for the market. They analyze a company's financial condition, business practices and risks, and they issue ratings that allow creditors and investors to make informed decisions. They update these ratings regularly, keeping pace with change in the business environment. And in principle, by providing these timely updates, the agencies promote the flow of relevant information, a key element of market stability.

A Current Market Shift: Increased Operational Risk

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.¹ 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.ⁱⁱ Furthermore, increasing reliance on technology has resulted in increasing vulnerability; power supply interruptions and cyber threats are but two among many other technology risks.

These heightened risks have not gone unnoticed by the rating agencies of course. As Moody's Credit Policy Committee Chairman Christopher Mahoney wrote in January 2002, "recent events have sharpened the focus of capital market participants on issues of credit quality. These events include the September 2001 terrorist attacks in the United States, global economic contraction, and the highly visible financial setbacks – including some notable bankruptcies – suffered by a number of well-known US, European and Japanese companies."ⁱⁱⁱ

The Impact on Organizations

In addition to a high probability of crisis, the impact of an operational crisis on the corporation is also likely to be high. Research shows that the corporate impact of the five-year crisis discussed earlier will, at minimum, result in a 20% to 30% decline in corporate stock price within the thirty days following the crisis.^{iv} A 20-30% drop in market valuation will certainly have an impact on investors overall and is also likely indicative of a constrained capacity of the corporation to meet its debt and other obligations.

Beyond market price impact, property and business losses are increasing. Even after adjusting for current dollar values, economic losses from natural catastrophes have increased nearly seven-fold since the 1960's.^v

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 skyrocketing 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."^{vi} 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.

Another significant strategic concern for many global firms is the disruption of its supply chain. A study of more than 800 companies from 1989 to 2000 indicates that supply chain disruptions led to stock returns 33 to 40% less than industry peers.^{vii} Preparation for supply chain interruption is a core activity in corporate preparedness programs.

What Management Can Do

Effective management response and corporate preparedness can significantly mitigate the impact of these crises and affect corporate recovery.

Recent research has found that the way management addresses these crises is 'destiny-determining' for the firm and determines when or whether or not the decline in market valuation is every recouped. Oxford Metrica has written that "the ability of management, particularly the chief executive officer (CEO), to deal with the unexpected and turn the situation around, is shown to be

more important in driving recovery than, for example, the direct financial consequences of the loss.”^{viii}

The capability to prepare for, respond to and recover from crises clearly exists in the well-established disciplines of emergency management and business continuity. Corporate preparedness is practiced at least on an elemental basis in most major corporations. Increasingly the support for and scope of these efforts are being re-examined in light of increasing risks.

Emergency planning can be done efficiently and cost effectively through the widely accepted “all-hazards strategy.” This strategy focuses on two basic factors: common impacts and common responses. Rather than develop one set of plans for hurricanes, another for black-outs, and yet another for fire, the “all hazards strategy” looks for common impacts of crises on your critical business operations (for example, loss of power or critical records). Responses are developed then for these common impacts. This “all-hazards strategy” is the foundation for effective emergency management and business continuity programs.

Key elements of an effective emergency management and business continuity programs are outlined in the voluntary Preparedness Standard (NFPA 1600) which will be discussed later.

A compelling illustration of the impact of organizational preparedness can be found in recent research by FM Global, the major property and casualty insurance firm. The firm acknowledges that business interruption insurance is the last line of defense against business interruption, and that the first and most important step is a holistic risk management program that includes all aspects of the organization.^{ix} FM Global provides site-specific, scientifically-based loss prevention recommendations as part of its coverage. In the aftermath of last year’s hurricanes, FM Global compared the loss history of those of its policyholders which implemented its loss prevention recommendations versus those that still had recommendations to complete. They found that those policyholders that fully implemented the preparedness recommendations had on average 75% to 85% lower dollar losses than those policyholders which did not implement such measures. As to the cost of physical improvements and preparedness, the research indicated a remarkable return on investment. In the case of Hurricane Katrina, across 476 locations with a total of \$42 billion in insured property exposed to the hurricane’s impact, FM Global clients collectively spent \$2.3 million to prevent a projected \$480 million in loss, with cost of those improvements averaging only \$7,400 per facility. That equals a 208 to 1 payback – or in other words, for every \$1 spent on targeted preparedness measures, \$208 in resources were saved in one single event.^x

Rating Agencies: Assessing Management Response to Risk

From a rating agency perspective, preparedness activities such as enterprise risk management and business continuity planning appear highly relevant to a company's ability to repay debt and deliver consistent value to stakeholders.

And while the practice of specifically acknowledging preparedness in credit rating analysis is not yet widespread, there are a number of significant developments suggesting that it should be.

Growing Trend of Acknowledging Corporate Preparedness

Increasingly, reporting and assessment of corporate preparedness programs is being incorporated in operational processes. InterCEP research has identified five distinct areas of relevant activity: insurance industry rating, securities regulation, corporate finance, supply chain requirements and competitive positioning.

- Rating Insurance Companies
The first set of developments is occurring within a niche area of the rating agency environment. In April 2006, A.M. Best – an agency that rates insurance companies – introduced a series of 'stress tests' designed to determine whether insurers have enough capital to survive the recently-revised, worst-case loss projections. Although these stress tests were designed to apply to insurance companies and include a strong focus on capital adequacy, they may provide a clear example of how a rating agency has focused on specific risks and mitigation strategies.
- Securities Regulation
The second set of developments is occurring at the level of securities regulation, where the principle of serving the investor's interests through reporting requirements has increasingly been applied to business continuity. In April, 2005, the SEC approved business continuity rules for every NASD and NYSE member and also required each member "to disclose to its customers a summary of its business continuity plan that addresses how the member intends to respond to potential disruption of varying scope." This pattern of strategic action continued on June 9, 2006, when the SEC cited "recent global developments," as the reason for adopting amendments to certain of its own business operations rules that operate in the event of emergency conditions. The SEC has also expanded its definition of emergency in this regard to reflect the "all-hazards approach" that includes the imminent threat of or occurrence of any "natural or man-made disturbance...that results in, or threatens imminently to result in, a substantial disruption of the organization or operations of the Commission." These actions indicate clearly that securities regulators are recognizing the strategic importance of enterprise preparedness, and taking strong steps toward requiring firms to report on their preparedness-related activities.
- Corporate Lending
According to researchers at the Nagaoka University of Technology, the Japanese development bank has executed at least one lending in which the credit worthiness of a corporation was based in part on its business continuity plan.
- Supply Chain "Push-Down" Requirements
InterCEP research has found that many global firms are already introducing corporate preparedness reporting as a push-down supply chain requirement on product and service vendors to hedge the risks associated with the firm's reliance on external production and distribution capacities which may be distributed widely across the globe.
- Internal Corporate Focus on Preparedness as a Competitive Advantage
InterCEP has additionally gathered anecdotal data suggesting that within this competitive environment, some industry-leading firms are already embracing 'all-hazards preparedness' as a point of strategic differentiation and advantage. Preparedness programs in some cases are seen as adding agility to respond to changes in the business environment. Additionally, other firms have found that their customers value the perception of safety and security that results from effective corporate preparedness, especially in the commercial office space and retail environments.

These various areas of development – insurance industry rating, securities regulation, corporate lending, supply chain requirements and competitive practices – indicate how the market is already responding to the need to deal with increasing operational risk.

A Consensus-based Set of Preparedness Criteria: NFPA 1600

While rating agencies could choose to assess corporate preparedness by requesting a general review of a firm's plans and activities, a valuable tool exists which could greatly facilitate the review process and support standardization. There is an existing standard for business

continuity and emergency preparedness, the Preparedness Standard: NFPA 1600. This criteria-level standard has been developed as a consensus-based standard with wide public and private sector input since 1991. Additionally, it has been endorsed by the US Department of Homeland Security (DHS) and the American National Standards Institute as well as the Federal 9/11 Commission. The Standard's elements were also recently acknowledged as common to international emergency preparedness and business continuity activities at a summit meeting organized by the International Organization for Standardization (ISO).

The Standard is high-level and performance-based, and it does not provide significant detail prescribing how it should be implemented. It allows management to tailor a firm's preparedness program to the unique aspects of its line of business, geographical location, and management culture. It focuses on common functional elements of effective preparedness programs and is scalable to large, medium and small organizations.

NFPA 1600 is already being used by several major corporations for self-assessment ranging from retail leaders such as Target to manufacturers including Raytheon.

Conclusion: The Implications of Crediting Preparedness

It is not the purpose of this paper to identify specifically how preparedness should be included in rating agency evaluations –that task necessarily falls to the agencies themselves, likely in conjunction with key stakeholders. InterCEP stands ready to assist in this regard as and if appropriate.

Instead, the goal has been simply to articulate why preparedness should be included in rating processes, while providing preliminary indications of how it might be done.

Irrespective of how rating agencies develop and apply rating processes in specific contexts, it appears clear that the inclusion of preparedness in rating agency underwriting would yield three significant benefits.

- 1) Better information: By acknowledging the importance of preparedness for operational risks, it would provide creditors and investors with more comprehensive and accurate assessment of creditworthiness;
- 2) Identify market leaders: It would allow investors and creditors to identify those industry-leading firms that have already learned lessons from 9/11, Katrina and other catastrophic events, and proactively undertaken key preparedness measures;
- 3) Promote market resilience: By introducing a competitive dimension to preparedness, it would provide an incentive for firms to develop resilience in the global marketplace.

It is with these clear benefits in mind combined with the underlying responsibility of the rating industry to provide accurate and actionable information to investors and creditors that the inclusion of corporate preparedness in agency underwriting is strongly recommended.

Endnotes

ⁱ “Risks that Matter.” Oxford Metrica, 2002.

ⁱⁱ “Hurricanes – More intense, more frequent, more expensive: Insurance in a time of changing risks.” Munich Re Group, 2006

ⁱⁱⁱ “The Bond Rating Process in a Changing Environment.” Moody’s Investors Service, January 2002.

^{iv} “Risks that Matter.” Oxford Metrica, 2002.

^v “Topics Geo: Annual Review: Natural Catastrophes 2005.” Munich Re Group, 2006

^{vi} “As Hurricane Season Begins, Disaster Insurance Runs Short.” *Wall Street Journal*, July 9, 2006.

^{vii} “The effect of supply chain glitches on shareholder value.” Hendricks, K.B. and Singhal, V.R. *Journal of Operations Management*, 2003.

^{viii} “Risks that Matter.” Oxford Metrica, 2002.

^{ix} “The New Supply Chain Challenge: Risk Management in a Global Economy.” FM Global, 2006.

^x Data provided to InterCEP by FM Global.