Eye on disaster recovery

Insights on disaster recovery through insurance and federal grants

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A message from Allen Melton, Partner, Americas Practice Leader, Insurance & Federal Claims Services

The United States, along with many other countries around the globe, experienced a proliferation of catastrophic events last year. These included record rainfalls with significant flooding, widespread tornadoes, earthquakes, major hurricanes and typhoons, intensified volcanic eruptions, extreme drought, massive wildfires throughout the western United States and explosions at the Port of Tianjin, China. In addition to these catastrophic events, the frequency and severity of cyber attacks have also increased, along with an alarming number of major product recalls in numerous industries.

The magnitude and financial impact of these and other catastrophic events are constant reminders of the need for disaster preparedness across all facets of an enterprise. They are also a reminder of the important role that insurance and federal disaster grants play in the recovery process.

This issue of Eye on disaster recovery addresses financial preparedness and recovery. While most organizations now have disaster recovery plans in place, these tend to focus largely on life safety and physical recovery. Financial preparedness and recovery planning extends disaster recovery planning into areas crucial to sustaining financial stability and recovery following a catastrophic loss, including generation of revenue, cost mitigation, insurance coverage and federal disaster grants.

EY’s Insurance & Federal Claims Services professionals have expertise in assisting clients with financial preparedness and recovery, both pre- and post-loss. We are pleased to share our experience and knowledge in this area and welcome your feedback and questions.

Sincerely,

Allen Melton
The numerous occurrences of catastrophic events around the world in 2015 are reminders of the constant risk exposures faced by every organization. This new year began with severe flooding on the Mississippi River and predictions of significant flooding in California resulting from El Niño. It was only three years ago that many companies were impacted by Superstorm Sandy, one of the most costly disasters in recent years to occur in the United States. The risk of these and other types of catastrophic events challenges every organization to ask how it would recover from a loss event.

The threat of catastrophic events exists on many levels, extending beyond “natural” disasters, such as hurricanes, tornadoes, windstorms, flooding, earthquakes, volcanoes and wildfires. Businesses are also exposed every day to other risks, such as fire, explosion, product recall, cyber attack, supply chain disruption and more. Most of these exposures create risks not only of physical damage and possible loss of life, but also financial loss that can compromise an organization’s financial stability.

Financial preparedness can be the difference between significant financial losses and substantial recovery. However, even companies with detailed disaster recovery plans often pay inadequate attention to “financial preparedness and recovery,” which addresses the actions necessary for an organization to minimize its overall loss following a catastrophic event and recover financially. This includes mitigation of lost revenues, restoration of operations, insurance coverage and the insurance claims process. Planning ahead in this area can help your organization recover in a timely manner should it incur a significant loss.

This article discusses a number of key components in a financial preparedness and recovery plan, including the following:

- Understanding your landscape of risks
- Incorporating financial recovery into your disaster recovery plan
- Monitoring and testing your plan
- Matching insurance coverage to your risks
- Taking action following a loss
Understanding your landscape of risks

The risks faced by organizations are constantly changing. Accordingly, the identification, assessment and quantification of these risks require ongoing entity-wide efforts. As operations change and/or become more geographically diverse, the risks also change and need to be evaluated on a regular basis. Similarly, exposures previously considered low risk may now be considered high risk. Here are some examples:

- After the 2011 earthquake and tsunami in Japan, many companies realized (often after incurring losses) that they did not have a complete view of their supply chain and didn’t understand just how exposed they were to this type of loss. Some had good visibility into their Tier 1 suppliers but little or no visibility into Tier 2 or lower suppliers. The event in Japan encouraged companies across many industries to take a closer look at their supply chain risks.

- The widespread destruction created by Superstorm Sandy created geographically dispersed multiple occurrences of loss within some organizations. These losses changed the way many organizations view and evaluate their exposure to widespread loss events.

- The ongoing occurrences of cyber attacks at high-profile businesses have raised awareness of the requirements for better cyber insurance coverage. Insurance carriers have increased their coverage offerings in this arena, and organizations continue to increase their focus on these types of risks.

These loss events provide a clear message that the process of identifying and assessing risks never ends. Further, the more your business changes, the more attention needs to be paid to this process.

Incorporating financial preparedness and recovery into your disaster recovery plan

Most disaster recovery plans appropriately place a significant focus on immediate needs following a disaster: maintaining life safety, preserving property and mitigating damage. However, there also needs to be a strong emphasis on financial recovery. The question is: how will your business recover financially following a major loss?

History indicates that not all companies survive a catastrophic loss. For example, a manufacturing company located in the Northeast lost use of a major, custom-built machine due to significant damage from Superstorm Sandy. The company had no plan in place as to how it could quickly repair or replace the machine or how to outsource its unique production. Further, the company lacked adequate insurance for both property damage and business interruption. As a result, the company failed to recover financially in a timely manner and went out of business. Although extreme, this example illustrates the need to consider financial preparedness and recovery in disaster recovery plans.
The question is:
how will your business recover financially following a major loss?

Planning in this area can clearly make a huge difference. Key steps for incorporating financial preparedness and recovery into your disaster recovery plan include the following:

- Plan for the unexpected. Many of the companies that suffered significant losses from Superstorm Sandy thought it unlikely that such an event could occur and did not plan accordingly. Another example would be this question: If one of your Tier 2 suppliers suffered a catastrophic loss, do you (and your Tier 1 suppliers) have a plan regarding how the necessary product would be obtained?

- Understand how, and to what degree, your company could fulfill customer orders and/or deliver services in the event of a major shut-down of operations. This includes fulfilling orders through existing inventory, support from other company locations, and outsourcing production and/or services.

- Develop a plan regarding the retention of key employees and the continuation or non-continuation of other employees.

- Assess required cash reserves and/or access to credit during a major shutdown while awaiting recovery through insurance. While insurers may provide advances following a loss, the complete adjustment and settlement of a loss by the insurer can take longer than expected.

- Understand your structure of fixed and variable costs, which costs are likely to continue following a catastrophic event and how you can mitigate or eliminate some of those costs.

- Identify required management resources and their required roles following a loss event.

- Identify necessary external resources and their roles, including general contractors, attorneys, engineers, accountants and other consultants. Contracting with a team and outlining their respective roles can help expedite the recovery process, increase its overall effectiveness and save costs.

- Outline key areas of insurance coverage and their impacts on the amount potentially recovered. A clear understanding of your insurance policy can influence decisions made during the recovery process involving outsourcing, employee retention and more (some of these are discussed further in the section “Matching insurance coverage to your risks”).

- Determine your organization’s eligibility for federal disaster grants, such as Federal Emergency Management Agency (FEMA) Public Assistance grants, U.S. Department of Housing and Urban Development (HUD) Community Development Block Grant – Disaster Recovery grants and others. These may be available following a qualified widespread catastrophic event and eligible organizations generally include state and local governments, tribal governments and qualified private nonprofits.
Monitoring and testing your plan

To the degree possible, review and test key areas of your disaster recovery plan, including financial preparedness and recovery, on an ongoing basis. This involves reviewing assumptions and factual information initially incorporated in the plan and assessing their ongoing validity. For instance, regularly reviewing a plan to outsource production of a key component in the event of a plant shutdown can help you assess the other company’s ability to deliver the necessary parts on a timely basis, in the quantity required, and with the necessary specifications and quality.

Ongoing testing of the plan can also identify areas of vulnerability. It helps identify weaknesses and deficiencies in the plan before a catastrophic event occurs – the time when you need to quickly implement and rely upon the plan.

Matching insurance coverage to your risks

Many organizations rely on inadequate insurance policies pieced together and, to some degree, “rolled forward” for a number of years. Conduct a fresh review of your coverage at least annually and even more frequently when faced with changes in your operations and landscape of risks. Following a catastrophic loss, companies often discover that their insurance policies provide insufficient coverage for property, business interruption and/or extra expenses. In some cases, the policyholder didn’t understand the policy and/or the policy contained ambiguous language.

Insurance provides a financial vehicle for the transfer of those risks that cannot be eliminated or fully mitigated. Companies transfer these risks to insurance with the expectation that any related losses will be partially or fully covered. Some of the key actions to take regarding your insurance coverage include the following:

- Review your existing policy to understand types of coverage, limits, sublimits, deductibles, waiting periods and co-insurance requirements.
- Discuss with your broker all areas of risk exposure identified in your risk assessment to determine available coverage and the potential cost for each coverage. Many companies, for example, have yet to secure the newer cyber coverages now being offered by carriers, opting to retain their older, more limited coverage.
- Confirm that the policy lists or otherwise covers all existing locations, especially newly added locations. For example, a retail chain experienced flooding at a new store due to a burst pipe. The company’s policy covered the cause of loss but failed to list the new location, thereby placing coverage of the loss at risk.
• Assess your statement of property values to determine if they’re current and, if necessary, update the values. As companies upgrade or sell equipment, add new equipment and change physical structures, property values may need to be updated.

• Assess your business interruption values. This means, at a minimum, looking at each location/operation to determine your potential loss of net income plus expenses that would likely continue in a worst-case scenario, such as a total shut-down of operations. As your business grows or declines and margins change, these values will likely change. For example, if your business anticipates a 20% increase in sales next year, you might need to report your business interruption values to the carrier at an increased amount. Failure to do so could result in a lack of coverage due to policy limits or trigger a co-insurance penalty if designated by your policy.

• Pay attention to limits, sublimits, waiting periods and deductibles. An entertainment facility experienced a significant loss from the cancellation of a show on a busy weekend due to a loss of electric service. Management was surprised to learn that the loss was not covered due to a 48-hour waiting period for “service interruption.” Waiting periods, as well as deductibles, limits and sublimits, are policy provisions used by underwriters to manage coverage versus policy cost. They can all significantly impact your ability to financially recover following a catastrophic loss.

• Determine the parameters of your period of indemnity. Insurance policies typically define the period of indemnity as beginning on the date of loss and extending through the period during which the property can be repaired, rebuilt or replaced, with reasonable speed, to the condition that existed prior to the loss (or, alternatively, the date when business is resumed at a new location). Many policies provide an “extended period of indemnity” of 30 days or longer in order to provide additional time for the business to restore normal operations. In some losses, this extended period of indemnity provides a critical means of financial recovery during the period immediately following completion of physical repairs.

• Consider your need to maintain employees on payroll following a catastrophic loss. Business interruption insurance policies may provide full, limited or no coverage for “ordinary payroll” following a catastrophic loss. Ordinary payroll refers to payroll expenses of employees other than executives, department managers, employees under contract and other employees deemed critical to continuing operations. Companies with the desire or critical need to maintain such employees on payroll following a loss event typically require this type of coverage in their policy.

• Determine your need for coverage of extra expenses following a loss in order to discern the proper limits of coverage. This coverage generally covers expenses incurred during the period of restoration to avoid or minimize the suspension of operations at either the current location or temporary location(s) without the need for these expenses to mitigate any business interruption losses.
• Understand your need for the inclusion of special coverages, such as contingent business interruption (to cover losses incurred by your organization as a result of damages/losses incurred by suppliers and/or customers), supply chain, cyber losses and other areas of exposure.

• Pay attention to coverage endorsements and exclusions. For example, a cable company experienced a significant loss from a hurricane that caused extensive damage to cable lines. The policy listed exclusions related to losses caused by damage to “transmission lines” that resulted in the insurance carrier denying coverage. Similarly, a consumer products company’s facility maintained massive amounts of underground storage for certain raw materials. The insurance carrier denied the company’s claim for a loss of those materials following a fire because the insurance policy excluded coverage for everything below ground.

It is surprising how often exclusions such as the above find their way into insurance policies only to be later discovered, at the time of a loss, by the policyholder. This emphasizes the importance of understanding your policy and, if necessary, retaining qualified professional guidance.

Taking action following a loss
Following a catastrophic loss, an organization must initiate actions to repair or replace property and, at the same time, focus on actions to maintain or restore operations. The organization must execute all of these initiatives in tandem and manage them in a manner that supports and maximizes recovery from insurance. Areas to consider in this process include the following:

• Notify the insurer(s): policyholders need to contact their insurer(s) immediately following a loss so the insurer(s) can assign an adjuster and inspect the damaged facilities as soon as possible. The policy also typically defines the timeline for filing a proof-of-loss, and policyholders need to closely monitor any such timelines.

• Assemble a claim team: as discussed earlier, designating a team before a loss event, as part of the disaster recovery planning process, represents a best practice in this area. The claim team should include internal representation from a number of disciplines within the company, including risk management, legal, production, operations, engineering, accounting and finance, sales and marketing, and other areas as appropriate.

• The company should designate one individual as project leader who will also function as primary liaison with the insurance carrier and its representatives. The claim team may also include a number of external advisors, including forensic accountants specializing in claims preparation, other experts, such as engineers, and if appropriate, coverage counsel. The team will oversee the entire claim process and should develop a project plan early in the process.
- Protect key assets: insurers require that, following a loss, the policyholder take all actions necessary to prevent further damage to key assets. Retain all assets, including those damaged and ready for salvage, for inspection by the insurer prior to disposal or repair unless immediate action is necessary to insure life safety and/or mitigate further damage.

- React quickly and gather information: reacting too slowly in collecting information pertinent to insurance recovery could negatively impact both the timing and the amount of financial recovery, including the ability to request advance payments from the insurer.

- Track and properly classify all costs: policyholders need to establish, early in the process, procedures and protocols to capture and properly classify all costs in order to compile and support the insurance claim. Companies also need to implement a process for the capture, retention and retrieval of documentation.

- Document all substantive meetings and discussions with the claim team, the insurer and its representatives.

- Develop estimates early in the process to assist the insurer in setting reserves and to manage internal expectations.

- Request advances from the insurer early and often throughout the claim process.

- Take actions, where feasible, to mitigate the loss, including the use of a temporary location(s), outsourcing, make-up of lost production and other initiatives, including mitigating continuing costs, where possible.

- Manage extra expenses: opportunities can exist to treat some costs as either extra expenses or property-related costs. This a point to consider should there be potential policy sublimit issues for either type of expense.

- Manage payroll costs: subject to the provisions of your policy, opportunities may exist to claim payroll costs that may not otherwise be covered. An example includes utilizing employees for clean-up or other recovery work and, in so doing, covering their cost under the property coverage. Also, if policyholders lay off employees, associated severance payments can often be claimed.

**Summary**

Every organization today faces exposures to catastrophic events now deemed the “new normal” due to the increased frequency and severity of natural disasters, major product recalls, continuing incidences of cyber breaches, expansive supply chain disruptions and other risks. Preparedness sets the framework for successful financial recovery from such loss events, and insurance coverage plays a primary role in this process. Optimum and timely recovery through insurance requires diligent planning and closely managed execution of that plan in tandem with other disaster recovery efforts. Taking the time and effort to integrate financial preparedness and recovery into your disaster recovery plan can help ensure the continuity of your business and be the difference between significant loss and significant recovery.
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The EY Insurance & Federal Claims Services practice assists clients with financial recovery from catastrophic disasters through insurance and federal grants. We help clients measure, document and prepare complex property damage and business interruption insurance claims. We also assist state, local and tribal governments, as well as qualified nonprofits to develop and manage disaster grants from federal agencies such as FEMA and HUD. The end result is expedited recovery via strategic management and planning of the process from start to finish.

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