Low-Cost Preparedness Efforts Significantly Mitigate Loss

An InterCEP Mini-Case Study

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Overview

InterCEP is currently investigating the value of preparedness for private-sector organizations. One significant research focus area is the connection between preparedness and insurance benefits (including capacity, policy terms, pricing, etc.). The data presented here has been provided to InterCEP by FM Global, a leading commercial and industrial property insurance company. This mini-case story indicates that relatively inexpensive investments in preparedness can pay huge dividends by mitigating the risk of property loss due to extreme events such as hurricanes.

Mini-Case Study

Commercial and industrial property insurance company FM Global takes a proactive stance regarding the property risks and associated business threats faced by its corporate policyholders. The insurer and its clients share a philosophy that it is better to prevent a loss than try to recover from one.

For nearly two centuries, FM Global has believed that the majority of all loss is preventable. As such, the firm does not just accept the statistical risks associated with its policyholders based upon their general characteristics such as industry and location. Rather the firm works with each policyholder to identify the specific threats and physical vulnerabilities of each facility and then makes tailored engineering recommendations based on scientific research and loss experience to prevent or minimize the potential for loss and business interruption. The firm's loss history certainly underscores the value of loss prevention.

The firm compared the loss history of those of its policyholders which implemented its loss prevention recommendations versus those which had recommendations yet to complete following several major hurricanes. They found that those policyholders that implemented the preparedness recommendations had on average 75% to 85% lower dollar losses than those policyholders which did not implement such measures.

After Hurricane Georges in 1998, the policyholders that had taken FM Global's advice and made recommended physical improvements to their facilities experienced 75% less loss than those policyholders that had not. Hurricane Rita losses were mitigated by similar improvements at the same 75% rate. During Hurricane Katrina, the differential between prepared versus unprepared increased to 85%.

As to 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's 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.

Overall, across all its policyholders experiencing a diversity of unplanned events, FM Global has found that their proactive stance towards preparedness translates into an actual gross insured loss of 60% less than what would be otherwise predicted on a pure actuarial basis.

Case Analysis

The data set for this mini-case includes organizations that were all FM Global clients, and as such were all subjected to similar investigations and all received similar recommendations for how to prevent loss. Therefore the difference between those firms that took FM Global's recommendations and those that did not appears starkly relevant for all firms with facilities in coastal areas potentially subject to hurricane-force winds.

The primary lesson of this mini-case is that relatively inexpensive measures can significantly mitigate or prevent property loss due to extreme events such as hurricanes. In this sense, preparedness can have a direct, beneficial impact on the bottom line.

Moreover, the mini-case illustrates the value of a proactive approach to dealing with operational risk. It suggests that this proactive stance should include risk assessments based on empirical investigations of physical business operations, and policy terms that are based not only on actuarial data, but also on the concrete preparedness steps that firms take to mitigate loss potential.

This mini-case focuses only on measurable differences in the area of physical property damage and loss. Yet it seems reasonable to assume that these preparedness measures also helped to mitigate impact on the continuity of business operations. If these impacts were identified through additional analysis, they would only increase the return on investment for preparedness.