CIR

CONTINUITY INSURANCE & RISK

Beware the White Swans

The supply chain and business value

In association with

FM Global

In association with FM Global

Supply Chain Risks Roundtable

Beware the White Swans

This roundtable was held to discuss the current and future threats to supply chain, and in particular the relationship between supply chain and business value and share price

Chairman
What do you see as the consequences of poor supply chain on value? Directly through lost business and indirectly through reputation? Can it be priced accurately? And what has most 'drag'?

PJ: I am very conscious that losses from the Thai floods really caught out many manufacturers of components, and that did bring home to companies who were reliant on supply chain the consequences of loss.

PS: A perfect example of that would be Seagate, which fortunately had decided to put its facility in Thailand on higher ground, so it was in a better position to get back into the market than Western Digital, and profit from its competitor's disruptions and seize market leadership as a result.

AB: I wonder if it was a conscious decision to use higher ground? It is really incumbent on the risk manager to be plugged in to a level of the business where you can have a strategic influence on this type of decision before they are finalised. The decision is then easily influenced if you have the hard risk information on hand to give to the right people.

ES: Supply chain risk and reputation are intrinsically linked to share price. For example, many companies got caught out a couple of years ago where a ship's anchor dragged through some of the subsea communication cables, which in turn disrupted operations in India. This also affected off-shoring operations for many organisations. It is clear reputation affects share price. And my view is that your

In association with FM Global

Supply Chain Risks Roundtable

Attendees:

(AB) Andy Bryson	Group Insurance and Risk Manager	**Cobham**
(RH) Rob Halstead	Head of Risk Management	**Crossrail**
(PJ) Paul Johnson	Director - Insurance and Non Financial Institutions	**Barclays**
(AK) Anand Kumar	Deputy Chief Executive & Executive Director	**Union Bank of India**
(NL) Nico Lategan	Risk & Value Manager	**Network Rail**
(CL) Cedric Lenoire	Manager, Business Risk Consulting EMEA AP	**FM Global**
(ES) Edward Sherley Price	Head of Business Continuity	**Experian**
(PS) Peter Solloway	VP, Regional Development Manager for Northern Europe Operations, Central Europe Operations, and Chemical Operations EMEA	**FM Global**
(LW) Lorraine Winterbone	Business Continuity Specialist	**Experian**

share price is managed best by your reaction to the instrument of crisis. The way you handle your communications, media, staff communications and the actual incident management, will have a positive effect on your share price.

RH: We have got quite a different perspective on life. First of all Crossrail is a wholly-owned subsidiary of Transport for London, so we have no share price, but reputation and public confidence is very important to us. Transportation is very politicised and the London media is very active. They watch what we do, and they watch it closely.

C: I was quite taken by the story of Toyota; due to the disasters in Japan, it lost market share significantly to Nissan, which must have been galling. But it would appear the three major factors of that were: it was very weak in supply chain, it was highly JIT (just in time) and there was an over-reliance on too few suppliers without diversity of geographical location.

CL: Large exposures within complex supply chains are only starting to be well assessed and managed by most international organisations, however the risk profile associated to suppliers are considered as less critical are not well understood, yet can have a significant financial impact in the event of a disruption. The main issue here is that businesses select and assess suppliers purely on cost, which only makes sense for short-term profitability. Assessing risk at the start of the relationship with a new supplier should be seen as a priority if the business objective is long-term stable growth.

RH: We recognised very early on that many of our most critical risks are actually managed primarily by the supply chain and so we have been quite proactive in the way that we engage with our supply chain in our risk management approach. We have been proactive in terms of requiring our supply chain to manage risk and also work with the supply chain to actually bring up their level of maturity and ability in this area.

LW: With the work I have been doing quite recently, especially with supply chain due diligence, I think the start of it all is in the contract process, so how strict your words in it are, and how strict your obligations are in that should be mirrored all the way down. I think if you get it right at the top, then all your subcontractors, and sub-suppliers should.

C: I might say there is a split here between what I see as a rule based approach and a collaborative approach.

PJ: I would say through contracts you can do an awful lot to manage potential risks but at the end of the day if you have outsourced that risk, the reputational impact comes straight back at you irrespective of the contract in place.

ES: A contract gives you a very strong right, and you know if something happens you can always have restitution on a reactive basis, but during 'peace time', it also gives you a very good way to push the effort onto the supplier.

NL: I think there is evolution of the risk management function. Twenty five years ago, risk management was very much rule-based, and today we are actually trying to be much more strategic about what we do and we try to have a better impact on the strategy orientations of the organisations that we work for.

RH: I think you need to visualise the impact, if you don't see the criticality to the overall chain, then perhaps you are not going to be as proactive in managing the risks.

AB: Once you have outsourced elements of your manufacturing operations to third parties, you have reduced the influence you can bring to bear on the risk management of the process. I think if you do effective business impact analysis you will highlight the most significant of these outsourced nodes, but once you get to tier two or three even an effective business impact analysis will struggle to get that granularity.

ES: It also depends on the nature and the structure of the company as well. Some large organisations are still very silo structured, so, in terms of the original engagement of suppliers, have multiple companies, and sometimes

In association with FM Global

divisions in countries that go and get their own suppliers. So you can end up with quite a resilient supply chain, purely because you have almost too many suppliers. Too many on your books and resilience is built in, but it can be difficult to operate.

PJ: And that really can make you unprofitable so there is always going to be management pressure to slim down the supply chain and quite rightly. As a shareholder you expect the best return for your money and some of that is to make sure the products are manufactured efficiently, which is going to drive a company down the route of a core supply chain.

PS: We are seeing a greater exchange of continuity expectation between suppliers and customers in the supply chain. An interesting point is that over the last couple of years we have extended supplier cover to go beyond tier one, right out to the end of the supply chain in terms of a physical instance loss trigger for cover. After Thailand, the indirect pay outs (not the direct ones) totalled over US$100m. It is just interesting to see that there are a lot of financial exposures that we can now start to quantify.

RH: Presumably in order to be able to give that cover you must be able to understand the extent of the supply chain and its risk exposure?

PS: If you are going out to the nth degree of the supply chain, I don't think you can ever know everything, but I think it is important to understand your key supplier exposures to the extent you can and try to quantify those.

C: It is an interesting thing to try and think beyond the immediate and think in terms of the less physical things in business – there is also that much used phrase about Black Swans.

PJ: There is that horrendous scenario of the fault on the Canary Islands which, if it was to come away, it would cause a massive tsunami which goes across the Eastern Seaboard and back across to parts of Europe. I don't think that is fully priced into insurance covers at the moment but how do we convince the market that that really needs to be included?

AB: It boils down to how much individual insurance companies perceive the severity of their insured exposures and the consequent effect on pricing both in terms of their capacity and the reinsurance they choose to place.

PJ: In terms of pricing risk though, you have to draw the line somewhere in the likelihood of an event happening. For the Canary Islands slip, you build that sort of low frequency event into an actuarial model so you are pricing it in. Or if we have three suppliers for every component, then we will never have a supply chain interruption. So it is a case of how much do you spend on that risk management piece or that risk.

CL: But a lot of risk managers do the job without knowing what their objectives are.

PJ: There is a gut feel of reasonableness and comfort in a board's position of what they are prepared to lose, beyond insurance and including reputation and share value.

C: Perhaps there has been an issue of perception versus reality, with too much emphasis on the former? 9/11 or 7/7 were Black Swan events, so risk managers do widen their scope a little bit, but I think the effect on risk management is less about Black Swans, but it is the progression of the risk, the evolution of the current risks and range.

PS: I couldn't agree more, we get this question a lot, what are the emerging risks? And we all scratch our heads and we try and think about something that hasn't happened yet, but I am more interested in the changing risks. Technologies are changing the concentration of risk in no end of industries and I think if we could just do a sound job of understanding how those concentrations of risk are changing across organisations on a consistent basis, you

Date	Company	Event	Value	Reaction
			%	$m
March 11	TEPCO	Japanese earthquake	-89.6	-37,368
August 18	Dexia	Exposure to Greek debt	-87.3	-3,990
September 27	Diamond Foods	Accounting irregularities	-77.8	-1,406
October 14	Olympus	Accounting irregularities	-57.8	-5,062
October 10	Research In Motion	Service disruption	-49.7	-6,095
January 3	Renault	Industrial espionage	-35.9	-6,266
April 16	Sony	Computer hacking	-35.9	-10,679
July 29	Qantas	Industrial dispute	-17.0	-795
September 15	UBS	Rogue trader	-13.2	-6,294
July 4	News Corp	Phone hacking scandal	3.2	1,529

Major reputational events in 2011 and value reaction From a study commissioned by FM Global

would get a lot more in terms of return for your risk management efforts than trying to spend time determining possible emerging of risks – because a lot of business continuity efforts should be entirely independent of the nature of the triggering event in any case.

RH: I would echo that, and when I think about risk in Crossrail, there are lots of far-fetched ideas of what the risks might be, but the ones that have actually had an impact on us are the ones that we thought we had nailed down. For all the discussion about Black Swans, I am keen that we don't miss the White Swans. And even risks we think we understand, we realise we understand less and less as they become more complex.

CL: I agree. BP is a good example. Once the public perception was that BP knew about the risk of oil spill in the Gulf of Mexico the impact on them was only going to become greater. Damage to reputation is probably the worst thing that can happen to any business. This is even more relevant today with the increasing usage of social media.

PJ: Our executives have to grab the nettle in getting the message out: This has happened, we will contain it, and there are measures to take this forward. In a retail bank it is quite difficult to manage all the shareholders/investors and stakeholders simultaneously. For Barclays I would like to think that we are starting to turn the corner very publicly.

> For all the discussion about Black Swans, I am keen that we don't miss the White Swans

C: Another part of this changing landscape is technology use – that one can tweet around the world in a few seconds, and a board that doesn't seem to be doing its job properly destroys value very rapidly, even if actually they are doing all the right things.

What Antony Jenkins, our CEO, is promoting, is values, which we are trying to embed within the staff culture, and it is about how we do business rather than looking at straight financial targets. It is not a quick win, it is a long-term process.

NL: Within the rail industry we have a laser focus on managing safety, performance and financial risks. In regards to costing risks, when your risk exposure is lower than the cost of mitigation, it makes sense for you to accept the risk. In all other cases you would prioritise the risks to mitigate based on total risk exposure.

PJ: I would say that investors have a combination of ethical involvement, return on capital and dividend capability which is going to drive their decisions. If we are not moving towards the objective of protecting the bottom line which is key to dividend distribution, there is potential to lose that particular investor.

AB: Just to build on the point, are investors only interested in share price, or are they also going to be interested in how you manage your reputation?

RH: That is an interesting point. We sat down and talked about our supply chain and thinking about our supply chain downwards there is actually a chain of events that goes upwards — the contagion can go upwards as well, and people will withdraw their support from an ailing organisation quite quickly.

AB: You talked about shareholders and stakeholders as well. There is definitely a role for insurers to play as stakeholders in the risk, not only in terms of providing insurance capacity. Where an insurer has a particular expertise that a company lacks then the insurer should be actively partnering with that company (its client) to leverage that expertise for the benefit of both the company and insurer by filling the knowledge gap.

In association with FM Global

Supply Chain Risks Roundtable

PS: As an insurer, I am seeing a growing trend from private equity companies showing an interest in the resilience of their investments' supply chains. They are showing a more systematic interest in how companies are managing their downside risks.

CL: Cash flow volatility, as well as dividend returns are two key parameters used by investors to assess the quality of equity investments. We need to better demonstrate that good risk management practices support shareholder value enhancement.

PJ: When investors invest, 10 per cent of their decisions are based on the strength of governance of that company. And I think that has probably doubled in the last 20 years.

AB: Non-executives and the board in general are far more proactive and aware of risk management performance and see it as something to be challenged in terms of its effectiveness.

C: I don't want to be pedantic but does private equity act differently, as opposed to an institutional investor?

PS: I think many private equity partnerships have a certain life span for the investment they are making and they want to be certain that they will be able to deliver value in terms of returns – and part of that now includes issues around continuity and risk management. If you think about a growing awareness of the impact on share price of major disruption, I think that private equity companies are starting to focus on this as much as on other business factors relevant to their decision.

CL: Some of our clients are actually putting resilience at the centre of their commercial offering. We are very close to an organisation that manufactures microchips for credit card and mobile phone providers where the commercial agreement with its clients depend on the level of business continuity that it wants to be able to guarantee in the event of a disruption. In this case, business continuity is very much something sold as a competitive advantage.

PS: There are cases where the share price has been raised as a result of the markets witnessing how that company has responded, putting to the test its business continuity plan and management. There can be a positive outcome to this, and I am quite sure that a big component of reputation is reliability, so the more that these risk management practices are recognised by the markets to be sound and robust, the more that must become a factor in improving share price performance.

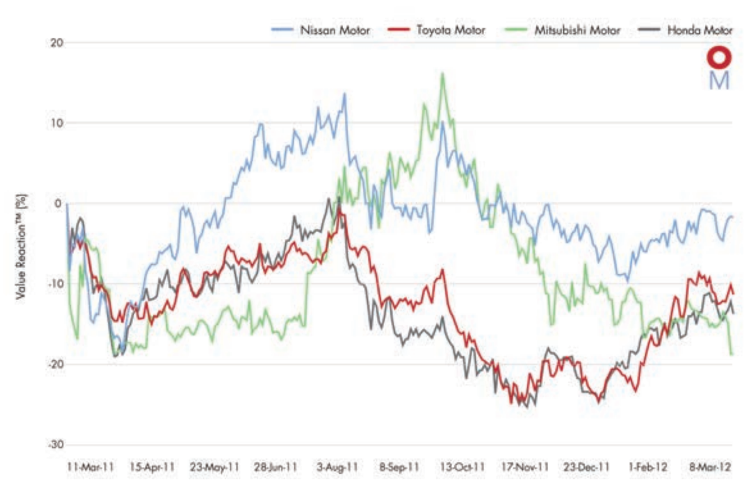
CL: Intel is a good example. If you look at what happened to its share price before and after the 2011 Japanese tsunami it demonstrates the value of risk management. The share price was going down before the event and up after. The only reason for this is that Intel managed to deal with the crisis really well, being able to maintain a normal level of activity. On the other hand, Texas Instruments went through the exact same event but the trend of its share price was reversed – going up before and down after. They were simply lacking good risk management solutions.

AB: On a more basic level, we are discussing the question of whether good supply chain risk management practices create value? Absolutely they do but you don't have to think in terms of disasters happening and their adverse effects being avoided. Effective supply chain risk management should be embedded in a well run business and I believe overall this will feedback positively into the share price.

RH: At Crossrail, it is definitely part of our approach to our supply chain to help them develop their risk management capabilities. We are actually looking after our own interests and getting what we want when we want it, in a safe way, but we are also helping our supply chain to

There are cases where the share price has been raised as a result of the markets witnessing how that company has responded

In association with FM Global



From a study commissioned by FM Global

An Interconnected World: Impact on motor manufacturers of great east Japan earthquake
Although Toyota's plants were not badly hit, its supply chain suffered, and caused shortages. Nissan held more stock and has a more diverse set of suppliers. Both companies were affected but Nissan endured a far lower downgrade in value, gained share and its reputation was enhanced.

deliver efficiently and improve their profitability. That is something some of our suppliers understand and are implementing, others have yet to learn, but I am sure they will.

NL: Traditionally risk management was about threat minimisation, but if you go back to the principles of risk and uncertainty management you will find that identifying and exploiting opportunities may be an untapped area for adding value in many organisations. This is an area we are increasingly focussing on, and working in collaboration with partners to develop an opportunity identification toolkit called Future Focus Framework.

The takeaways

NL: Key themes for me are to understand your risk appetite, focussing on opportunities and working in collaboration with your supply chain to manage risks, which most industries are now moving towards.

RH: I think we now have more innovative ways of partnering, contracting and working and collaborating. The understanding of who has got the risk, and what happens if the risk eventuates, gets awfully messy and we have to think about it.

AK: The risk is constantly evolving, so in my view you have to go around with the contract to suppliers and see that they are on the same page as you, and this is important because if anything goes wrong then it's your share price. So manage your supply chain as if it is your own.

PJ: I was interested in the point you made Peter about how FM Global will cover exposures through the lines of supply chain.

PS: We have been talking about the disasters and how to mitigate their effects, which is actually the interesting thing to me about this discussion – the success stories and upsides, and how well some companies are actually implementing and benefiting from the practices they are putting into place.

AB: For me the discussions around the new Black Swans have underlined my view that you must focus and understand the processes that have to go right within a business to deliver the product on time and in specification, rather than try and plan for what could go wrong. If you achieve this you will begin to understand where risks are concentrated and what needs to be done to mitigate them on an event neutral basis rather than trying to spot the next Black Swan.

LW: For me the point on the cultural change of using cost as a main driver for selecting the supplier and then in turn how you turn that into an upsell, and perhaps Rob's point about partnering with your supplier and not just getting a contractual obligation right, but also working with them going forward.

ES: I like Rob's point in being a lot more collaborative with the supplier, and again with Cedric's points about how we can think about putting this good news to use and selling it – offering it as sort of a service, the on-goingness of the management, of the products, that we have is very important, let's shout out more about it and market ourselves.

CL: We all come from slightly different industries, but we all seem to be going in the same direction. I think we went through an approach which was very much about 'let's identify what the risk is and make sure that we have a solution for that', to a focus on what is really a holistic strategic approach.