

INTRODUCTION TO RISK MANAGEMENT--How to Establish a Risk Management Program (54-1)

*[Within the context of risk management, **risk** is uncertainty about outcomes that can be positive or negative. In a larger insurance context, **risk** can also refer to the subject matter of an insurance policy, the insurance applicant, the possibility of loss or injury, cause of loss, or the variability associated with a future outcome. **Risk management (RM)** makes and implements decisions that minimize the adverse effects of accidental losses on a business.*

The risk management process

1. identifies loss exposures,
2. analyzes loss exposures,
3. examines the feasibility of risk management techniques,
4. selects the appropriate risk management technique(s),
5. implements the selected technique(s), **and**
6. monitors the results and revises the risk management program as needed.

*A **loss exposure** is any condition that brings with it the possibility of loss, whether or not actual loss occurs. **RM is an ongoing process** because changes in resources, loss exposures, legal requirements, and the economic environment make it necessary to revise the RM program from time to time.]*

EO 1. **THE SCOPE OF RISK MANAGEMENT: Risk management encompasses**

1. **business risk--aka speculative risk**--risk inherent in an organization's operations (chance of loss, no loss, or gain) **and**
2. **hazard risk--aka pure risk**--risk of accidental loss (chance of loss or no loss).

Enterprise risk management manages all of an organization's key business risks and opportunities to maximize shareholder value.

Enterprise RM typically uses four categories of risk:

1. **Strategic risks** are uncertainties associated with an organization's long-term goals and management, such as valuable partnerships and organizational expansion.
2. **Operational risks** are uncertainties associated with an organization's operations, such as adequacy of utilities and reliability of suppliers.
3. **Financial risks** are uncertainties associated with an organization's financial activities, such as the fluctuating values of securities held by the organization.
4. **Hazard risks** are uncertainties associated with accidental losses, such as the destruction of a factory by fire.

Enterprise RM differs from traditional RM in four ways: Enterprise risk management

1. includes **both** hazard **and** business risk, while traditional RM includes **only** hazard risk;
2. helps an organization achieve its maximum productive potential, while traditional RM restores an organization to its pre-loss condition;
3. focuses on the value of the organization, while traditional RM focuses on the value of accidental losses; **and**
4. focuses on the whole organization, while traditional RM focuses on specific loss exposures.

EO 2. **COSTS OF RISK MANAGEMENT--Risk exposures generate three costs of risk [Know]:**

1. **the cost of actual accidental losses**--loss of use of equipment, loss of trained staff;
2. **the deterrence effects of potential losses**--avoidance of potentially profitable, but risky, speculation; **and**
3. **the cost of risk management**--administrative costs, insurance premiums, costs of losses not reimbursed by insurance, and preventive measures--the 'lost' resources used to maintain risk management departments and to implement risk management programs, resources which could have otherwise been directly applied toward organizational and economic productivity.

In effect, reduction of #1 (accidental losses) and reduction of #2 (deterrence effects) constitute **the benefits of risk management**.

BENEFITS OF RISK MANAGEMENT--[Know]:

A. **ORGANIZATIONAL BENEFITS:**

1. **Reduced cost of risk of current activities**--Maintaining normal activities, but with fewer and less severe accidental losses. **Cost of risk is the total cost incurred by an organization due to the possibility of accidental loss, including** unreimbursed costs of accidental losses, insurance premiums, expenses incurred for noninsurance indemnity, costs of applying risk control techniques, *and* administration costs for RM activities. *[Know!]*
2. **Reduced deterrence effects**--reduced frequency, severity, and unpredictability (dispersion) of potential losses encourages increased speculation (yielding higher return and investment) *and* makes the organization a safer investment for others.

B. **ECONOMIC BENEFITS--result from widespread organizational benefits:**

1. **Reduced resource waste**--RM conserves resources that would have been consumed by accidents or used to recover from accidents.
2. **Improved allocation of productive resources**--Increased speculation and investment expands economic productivity and improves living standards.

Risk management's goal is to minimize those costs while maximizing those benefits.

EO 3. A **risk management program** plans, leads, and controls resources and activities to protect an organization from the adverse effects of accidental losses.

THE PRE-LOSS OBJECTIVES OF RISK MANAGEMENT, or loss preparation goals:

1. **Economy of operations**--Increase departmental and organizational efficiency. RM efficiency can be measured by comparing risk costs with those of similar firms, especially if they use the same expense allocation system.
2. **Tolerable uncertainty**--Provide an awareness of potential losses and an assurance of their effective management, keeping the worry of accidental loss at a tolerable level.
3. **Legality**--Satisfy imposed regulations, honor contracts, and respond to liability exposures. Illegality is itself a loss exposure. Public entities (government bodies, federal agencies, non-profits) often have special legal status and different liability exposures than private firms.
4. **Social responsibility**--Make society more secure by preparing for community-affecting losses. Fulfill your organization's moral obligations. Maintain a good public image.

POST-LOSS OBJECTIVES OF RISK MANAGEMENT, or loss recovery goals (in order):

1. **Survival**--Resume operations eventually. **The four survival essentials** are producing, marketing, financing, *and* managing. A major loss (property, net income, liability, or personnel) can harm an essential to survival and can destroy a business.
2. **Continuity of operations**--Resume operations quickly. This is an important goal for most public entities, because interrupting operations creates a gap in essential community services such as police and fire protection and provision of clean water.
The four-step plan for meeting the continuity of operations objective:
 - a. Identify activities that can *not* be interrupted,
 - b. identify accidents which can interrupt those activities,
 - c. determine resources needed to counter loss effects, *and*
 - d. provide those resources.
3. **Profitability**--Maintain at least a minimum profit level no matter what accident occurs. Such a program stresses insurance and non-insurance transfers, raising total risk management and financing costs.

4. **Earnings stability**--Maintain a specified earnings level from year to year. Such a program stresses loss reserves and predictable RM costs.
5. **Social responsibility**--Minimize the effects of loss on society through RM programs, for moral reasons *and* for good public relations. This is often a major goal of public entities.
6. **Growth**--Maintain the pre-loss growth pattern. Firms may either reduce RM costs to increase growth, accepting inadequate loss preparation (**unprotected growth**) or increase RM costs to protect expanding resources (**protected growth**).

Post-loss objectives are arranged along two continua.

1. **The first continuum of post-loss objectives: by degree of necessity** (from most to least essential--survival to growth).
2. **The second continuum: by commitment of resources** (from smallest to largest).

Survival is the most essential and uses the fewest resources. Growth is the least essential and uses the most resources. In between are continuity of operations, profitability, stability of earnings, and social responsibility, in order of decreasing essentiality and increasing resource commitment.

OBJECTIVES CONFLICT mainly when the goal of economy of operations is related to the costs of the other objectives. More ambitious post-loss objectives are costlier.

Among pre-loss objectives, all legalities must be met regardless of cost, but uncertainty and social responsibility must be compromised with economy.

Any other conflicts among objectives must be reconciled by the RM professional.

EO 4. **THE STRUCTURE OF A RISK MANAGEMENT DEPARTMENT:** The RM department grows with the organization, starting as a one-person department and adding specialized personnel as needed [*See text Exhibits 1-4, 5, and 6.*]:

1. **The small RM department** usually adds a safety and loss prevention manager and a claims manager under the RM director.
2. **The mid-sized RM department** adds an insurance manager; insurance and claims administrators to handle increasing workloads; and may add a safety engineer and industrial hygienist to assist the safety and loss prevention manager.
3. **The large RM department** makes the RM director a managerial position, with an RM analyst to perform non-managerial tasks. The large RM department may add a security manager and health responsibilities to assist the safety and loss prevention manager. Each manager receives more supervisors and administrators to meet increasing workloads and to fill special needs.

COOPERATION WITH OTHER DEPARTMENTS stresses joint management of each department's loss exposures to coordinate each department's overall RM program contribution to the organization.

1. **The accounting department** can help the risk management professional (**RMP**) establish values for insurance purposes, determine and allocate insurance premiums, and predict possible property and net income losses. Accounting may also handle the finances of loss recovery, such as processing claims and maintaining reserves.
2. **Information systems** can help compile and analyze data on organizational operations and loss exposures, run loss scenarios, project loss trends, analyze alternate risk management techniques, and gather loss experience data used to monitor the RM program.
3. **The legal department** can draft contracts and help provide liability exposure expertise; legal representation; property transfer management; and loss exposure data on real estate purchases, sales, and leases.
4. **The human resources department** can help provide records to identify key personnel loss exposures and potential replacements *and* can help run employee benefit plans.

5. **The production department** can help assume responsibility for recognizing and responding to its own loss exposures *and* can help finance related losses.
6. **The marketing department can help** review sales procedures for false information, provide consumer complaint information to help identify production hazards, *and* work with production to provide a safe product.

[Information flows among departments are categorized by

1. **scope**--within or beyond the organization,
2. **direction**--leaving or entering the RM department, *and*
3. **step (of the RM decision process promoted by the information)**--identify and analyze exposures, examine techniques, select techniques, implement techniques, or monitor the RM program].

[Exposure identification information inside the organization includes departmental loss exposure reports to the RM department and RM reports to other departments about new or intensified loss exposures.

Outside the organization, the RM department receives information from trade associations, government agencies, seminars, newsletters, The Institutes, and The Burnham System to aid in exposure identification and may share its own information with those same sources.]

[Program monitoring information inside the organization includes departmental accident reports, accident rates, and risk management reports to the RM department and RM advice to other departments on reporting procedures and cost compilations.

Outside the organization, the RM department receives government bulletins on safety, fire, and hygiene standards and sends proof of its compliance to regulatory authorities.]

[Many communications have more than one scope, direction, or step.]

[The value of information depends on ten factors. Information should be

1. **accessible**--be easily available,
2. **comprehensive**--stand independent of other information,
3. **accurate**--have a low degree of error,
4. **appropriate**--suit the request or the need,
5. **timely**--be quickly available,
6. **clear**--be unambiguous,
7. **flexible**--apply to more than one user and situation,
8. **verifiable**--be easily proven or confirmed,
9. **unbiased**--be unaltered and unmodified, *and*
10. **quantifiable**--be able to be mathematically manipulated.]

EO 5. **THE NON-DELEGABLE RESPONSIBILITIES OF THE RM PROFESSIONAL fall into four categories:**

A. **Program duties--**

1. Help senior management set risk management policy.
2. Organize and manage the risk management department.
3. Help senior management set RM responsibilities and establish communication channels throughout the organization.
4. Define RM duties for personnel and motivate those people.
5. Allocate program costs among departments.
6. Adapt the RM program when necessary.

B. **Risk assessment duties--**involve identifying and analyzing loss exposures and judging the feasibility of risk management treatment alternatives.

- C. **Risk control duties**--are usually dispersed among several departments.
The RM professional has staff rather than line authority over most loss control decisions.

Four essential risk control responsibilities:

1. Help senior management implement company-wide safety measures.
2. Promote company-wide recognition and control of hazards.
3. Help line managers in accident prevention.
4. Seek more efficient (less costly) risk control techniques.

- D. **Risk financing duties**--focus on retention and transfer techniques.

Typically, the RM professional arranges for funds from inside (retention) and from outside (transfer) the organization to cover potential losses.

Five essential risk financing responsibilities:

1. Help senior executives determine the retention/transfer dividing line for each loss exposure.
2. Choose among risk retention and risk transfer techniques.
3. Implement techniques, negotiating with others as needed.
4. Activate techniques when loss occurs.
5. Seek more efficient risk financing techniques.

The RMP is responsible for delegating tasks both within the RM department and among other departments.

REPORTING RELATIONSHIPS depend on

1. **the organization's basic mission**--In product or market-oriented organizations, risk management often falls under finance, with the RMP reporting to the treasurer, controller, finance director, or financial VP.

In service-oriented organizations (schools, hospitals, cities), the RMP may report to a senior administrator, senior executive, chief executive, or finance director.

2. **the emphasized loss exposures**--The essence of particular risks may dictate the reporting relationships.

An organization with many net income loss exposures should have the RMP report to a finance specialist.

One with many liability exposures and claims should have him report to the chief legal counsel.

The amount of reporting depends on senior management's concern with loss exposures and the RM department's past performance.

Efficient RM departments reduce senior management's concerns and receive more autonomy.

EO 6. **THE RISK MANAGEMENT POLICY STATEMENT outlines the RM program, its purposes, and its related activities throughout the organization.**

1. **PURPOSE**--The RM policy statement has several advantages:

a. **For the organization, the risk management policy statement**

- 1) establishes the organization's general RM objectives,
- 2) defines the duties and authority of the RM department,
- 3) standardizes loss exposure treatments throughout organization,
- 4) establishes and improves communications, *and*
- 5) aids transition during RM personnel changes.

b. **For the RM department, the risk management policy statement**

- 1) acts as a continual departmental guide,
- 2) educates new employees,
- 3) dictates responsibilities for loss exposures,
- 4) emphasizes the importance of the RM function, *and*
- 5) positions the RM department within the overall organization.

2. **CONTENT--**
 - a. **All RM policy statements**
 - 1) describe risk management and its importance to the organization;
 - 2) position the RM department within the organization, including communication and authority relationships; *and*
 - 3) state senior management's RM objectives.
 - b. **More detailed RM policy statements also include**
 - 1) the internal structure of the RM department *and*
 - 2) a discussion of RM techniques and their decision rules (which define when each risk treatment technique will be implemented).

EO 7. **MONITORING THE RM PROGRAM** is a three-step process:

1. **Set performance standards--in measurable terms.**
 - a. **Results standards** focus on achievements, measured in dollars, percentages, ratios, and/or numbers of losses and claims.
 - b. **Activities standards** focus on efforts toward results, measured in types and amounts of activity (eg, the number of annual inspections).
2. **Compare actual performances against those standards**--Actual performances may fall below, meet, or exceed standards.
Performances that meet or exceed standards may indicate the need to raise those standards.
3. **Correct the standards or the substandard performances--to improve future performances.**
Consider the type and the importance of the unmet standard, the people involved, and the possible options for meeting the standard.
Some standards should be reset before accepting or correcting performance.