

AN OVERVIEW OF RISK MANAGEMENT--
THE UNITED STATES PERSPECTIVE

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This presentation (1) defines risk management, (2) explains the essential steps in the risk management decision process as it is coming to be practiced in the United States, and (3) describes the status of the risk management function within many United States organizations.

1. Definition of Risk Management

The most straightforward definition of risk management is that it is structured common sense applied to loss exposures--identifying accidents or other untoward events which may result in losses, and then deciding how to cope with those potential or actual accidental losses.

A more complex definition describes risk management as a speciality within the general field of management, a speciality concerned with protecting an organization or other entity against losses which are accidental from that entity's point of view. By this definition, risk management is the planning, organizing, leading, and controlling of an organization's assets and activities in ways which minimize the adverse operational and financial effects of accidental losses upon that organization.

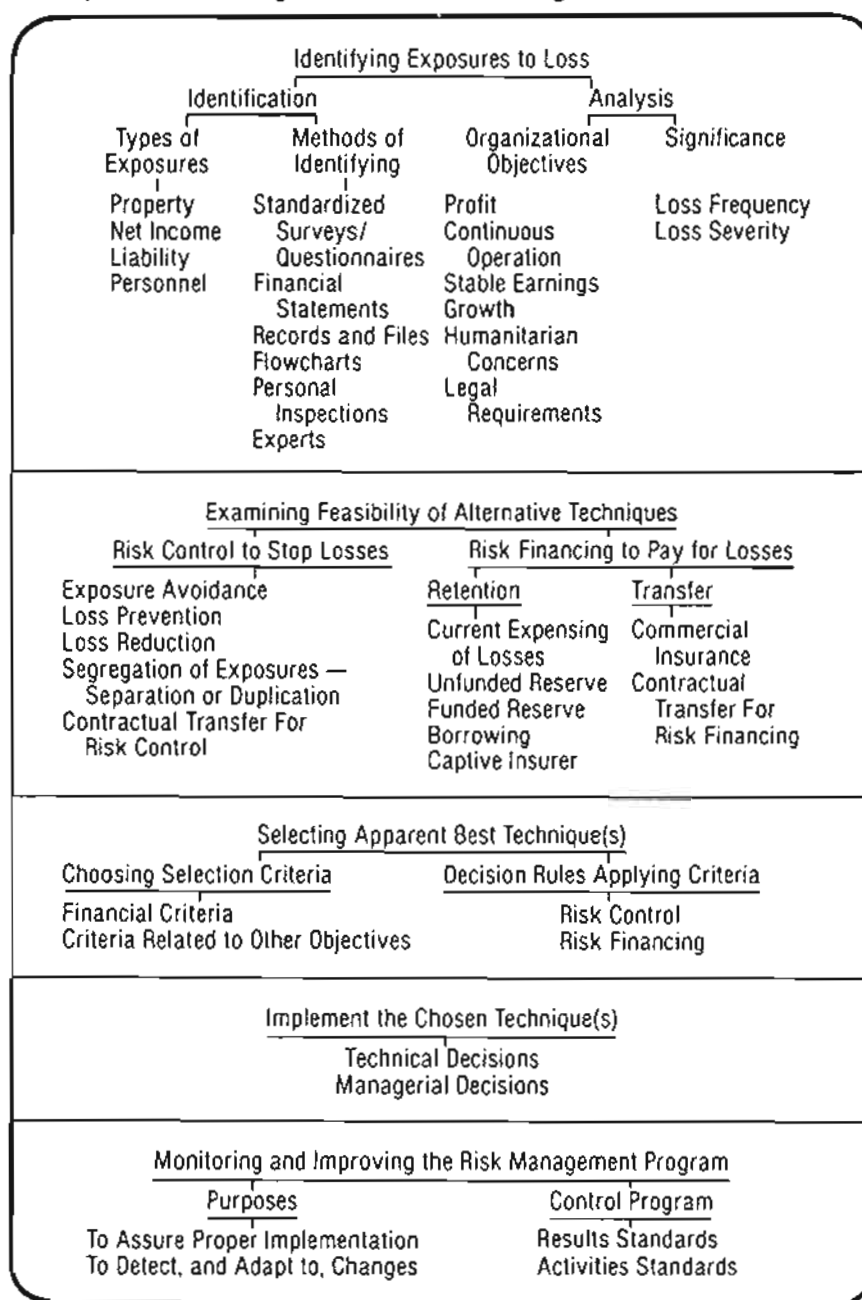
Risk management also can be defined as a decision process for selecting and putting into practice those risk management techniques which are most cost-effective for a particular organization. Under this definition, the risk management decision process typically involves the following (or equivalent) managerial steps:

- identifying and analyzing loss exposures
- examining the feasibility of alternative risk management techniques
- selecting the apparently best technique(s)
- implementing the chosen technique(s)
- monitoring and improving the risk management program

2. Steps in the Risk Management Decision Process

The chart on the following page elaborates the definition of risk management as a decision process by listing each of the decision steps and, for each, indicating the essential elements in performing that step. As indicated in the following paragraphs, performing each step requires an organization's risk manager to be responsible for--but not necessarily to personally perform--the planning, directing, leading, and controlling of each of these steps in the risk management decision process. In fact, in many well-managed United States organizations, risk management of the activities of each department is a basic responsibility of the line manager of that department, with the risk manager providing staff support and technical assistance and working with senior management to coordinate the risk management activities of each department manager.

Steps in Risk Management Decision Making



Source: George L. Head and Stephen Horn, II, Essentials of the Risk Management Process (Malvern, PA: Insurance Institute of America, 1985), p. 9.

Identifying and Analyzing Loss Exposures

Identifying loss exposures is the first, and arguably most essential, step in risk management, because no loss exposure can be rationally managed unless it is first identified and analyzed. Identification focuses on the accidental losses that potentially can happen; analysis deals with how frequent and how severe these accidents are likely to be and how they may interfere with the organization's success in obtaining its basic objectives.

Identifying loss exposures typically begins with a study of the specific items of value which an organization may lose: the property it owns or uses; the net income (revenues minus expenses) it earns from its operations, its freedom from liability to others, and the services of its key personnel whose talents cannot be readily replaced. All the accidental events with which a United States risk manager typically deals involve a loss of one or more of these four basic types of values. In order to have a logical procedure for identifying the types of accidents which may impair these values, many risk managers rely upon a series of standard methods of identifying loss exposures: standardized surveys/questionnaires, analysis of the organization's financial statements, study of its other records and files, analysis of flowcharts which depict the organization's operations and the points at which an accident may disrupt those operations, personal inspections of the organization's facilities, and consultations with experts both inside and outside the organization.

Once the ways in which accidents can happen have been identified, the risk manager needs to analyze these loss exposures for their likely, and also their worst possible, frequency and severity. This is frequently done through the organization's, its insurers', and its trade association's records or through expert judgment as to how frequent and how severe these accidental losses may be. By perhaps a rule of nature, severe losses are relatively infrequent, and frequent losses tend to be relatively less severe.

Historically, risk managers have tended to focus particular attention on large, infrequent, severe catastrophes--the "big bangs" against which the organization clearly needs protection. More recently, however, risk managers and the senior executives to whom they report have come to recognize that an accumulation of frequent, individually small losses--such as back strains or vehicle accidents--can collectively impose greater cumulative costs upon an organization than most sudden "bangs." Therefore, more United States risk managers are giving greater attention to preventing or efficiently paying for these more routine losses, thus alleviating the persistent financial "ache" they have for so long caused.

By protecting the organization against both the "bangs" and the "aches," the risk manager contributes to the organization's fulfilling its basic objectives--whether they be profit, uninterrupted operations, stable earnings, growth of sales or product lines--while, at the same time, meeting senior management's humanitarian concerns for others' well-being and the legal requirements (such as for work safety or pollution control) which governments impose upon every organization.

Examining the Feasibility of Alternative Risk Management Techniques

There are basically two things to do with any loss exposure, any possibility of accidental loss: (1) stop the loss from happening (or reduce its size) and (2) finance recovery from the loss. Therefore, all the techniques of risk management--all the options for dealing with any loss exposure--can be divided into two large categories: (1) risk control techniques to stop losses from happening or to reduce their size and (2) risk financing techniques to provide funds to finance recovery from any loss.

Risk control techniques include:

- Exposure Avoidance--not taking on (or discontinuing or disposing of) an asset or activity, ridding the organization of all possibility of loss (such as by abandoning a building to avoid the fire exposure or deciding not to manufacture a product to avoid the products liability exposure)
- Loss Prevention--taking any measure which reduces the frequency or likelihood of loss (such as controlling ignition sources to prevent fires or carefully designing and testing a product to make liability claims about it less likely)
- Loss Reduction--taking any measure, either before or after a loss occurs, to reduce the size or severity of that loss (such as installing fire-fighting sprinklers before, or salvaging damaged property after, a fire; or recalling from the market products thought to be potentially defective in order to reduce the extent of products liability claims)
- Segregation of Exposures--increasing the number of independent exposure units either (1) by relying on more than one independent facility in daily operations (such as using three widely separated warehouses, rather than one, so that no more than one is likely to be ruined by a single fire) or (2) by having duplicate facilities on standby so that, if the normal facility is shut down by an accident, the duplicate can be called into action (such as by having spare parts for an important machine or maintaining duplicate accounting records at a separate location)

- Contractual Transfer for Risk Control--contracting with another entity (not an insurer) so that the entity to which the exposure is transferred bears the entire exposure (such as by leasing, rather than owning, a building to transfer to the landlord the exposures arising out of building ownership or by subcontracting a particularly hazardous manufacturing operation so that the subcontractor bears the related work injury exposure)

Risk financing options fall into two categories: (1) retention (where an organization relies upon funds which originate within its own operations or corporate family) and (2) transfer (where an organization looks to outside sources for funds to restore its losses).

Risk retention options can be categorized in order of their increasing formality or complexity:

- Current Expensing of Losses--relying upon currently generated revenues to pay relatively small, budgetable losses (such as the costs of minor, "wastebasket" fires or of settling "nuisance" products liability claims by sending claimants a new supply of wholesome products)
- Loss Reserving (Either Funded or Unfunded)--establishing an accounting reserve in anticipation of accidental losses in order to smooth the accounting recognition of irregular losses or, if the reserve is funded, to provide cash with which to pay such losses
- Borrowing Funds for Losses--relying on credit, arranged either before or after a loss occurs, to pay for substantial losses (considered retention, rather than transfer, because the borrower suffering the loss transfers no real uncertainty to the lender, and the borrower must repay a fixed amount of debt for any given loss)
- Insuring Through a Captive--establishing a captive "insurance" subsidiary to finance specified types of losses of the parent organization (considered--for managerial, if not tax, purposes--retention because the parent organization usually controls the terms of the captive arrangement, and because the captive is within the parent's own corporate family)

Under risk transfer, an organization looks to outside, unrelated organizations for funds with which to restore its losses. The two broad risk transfer techniques are:

- Commercial Insurance--the typical insurance arrangement, distinguished by transfer to the insurer of an unknown financial burden for future losses in exchange for the insured's payment of a determinable premium

- Contractual Transfer For Risk Financing--transfer (under contract provisions often called "hold harmless" or "indemnity" clauses) to an entity not an insurance company, of the financial burden for a loss--the legal responsibility for the loss still remaining with the transferring organization if the one to which the financial burden is transferred fails to provide the promised funds

In practice, sound risk management usually calls for the combined use of risk control and risk financing techniques, such as both loss prevention and insurance for either fire or products liability losses. Risk control techniques hold down the cost of risk financing; risk financing also is essential when--as is inevitable--risk control techniques fail, and some major accidental loss eventually occurs.

Selecting Apparently Best Technique(s)

Ideally, in selecting among this array of risk control and risk financing techniques, an organization will use either of two types of decision rules, or criteria: financial criteria or criteria related to other objectives.

Financial criteria lead to risk management decisions reached on the same bases by which many well-managed organizations arrive at all of their important decisions: how the choice will affect the organization's profitability or rate of return. In traditional finance, these rate-of-return decisions among alternative assets or activities are made on the basis of the present value of the future net cash flows (inflows less outflows, both discounted for their time in the future and their unpredictability) which that asset or activity will generate.

Similarly, risk management techniques involve cash inflows and outflows from, for example, future losses prevented, future insurance premiums paid, or earnings on funded reserves. Therefore, when an organization makes its risk management decisions on the basis of sound financial criteria, it evaluates not just the present value of net cash flows from an asset or an activity but the present value of those net cash flows from each asset or activity combined with each of various alternative risk management techniques. The organization then chooses the combined asset/activity-with-risk-management-technique(s) which promises the highest present value of net cash flows.

Some organizations, particularly with respect to certain operations, will value growth, humanitarian considerations, or legal requirements more highly than profits alone. Here, the organization will place top priority on fulfilling these nonfinancial objectives through appropriate risk control or risk financing measures (such as complying with an anti-pollution law or purchasing state-required insurance)--and give only secondary consideration to the most profitable selection of assets or activities combined with risk management techniques.

Implementing The Chosen Technique(s)

Once an organization's best feasible combination of risk control and risk financing measures has been selected--usually recommended by its risk manager and approved by higher financial or other senior management--the risk manager becomes responsible for implementing the chosen techniques. This implementation requires two types of decisions: technical and managerial.

The technical decisions usually lie within the personal expertise of the risk manager--for example, the selection of the actual policy form on which to purchase a needed type of insurance or the most efficient type of fire extinguishing system to install in a particular plant. For the most part, these technical decisions can be made by the risk manager alone who can then advise (or even direct) that the technical decision be implemented, either within the risk management department or by the operating management of other departments.

But no risk manager can alone make a risk control or risk financing technique successful--for this, the cooperation of managers (and, indeed, all personnel) throughout the organization is essential. Where others' efforts are required, managerial decisions--made jointly by the risk manager and other operating managers--are necessary. These decisions involve when, how, and by whom particular risk management measures will be put into practice. For example, having made the technical decision to install a particular type of fire-fighting sprinkler system in a given plant, the risk manager must consult with executives in that plant to determine when and how to install that system in a way which will minimize disruption of production. Similarly, having made the technical risk financing decision that specified types of losses up to a given size should be retained and charged against the operating departments generating the losses, the risk manager must explain to the managers of those departments the rationale for these charges, the mechanics of the budgeting process, and how each manager can minimize the losses charged to his or her department. Cooperation is essential in making these managerial decisions.

Monitoring and Improving the Risk Management Program

Monitoring the results produced by implementing the chosen risk management techniques is an essential final step in the decision making process. Checking the results provides the needed control for determining whether the original choice of risk control and risk financing techniques was correct or even if originally proper, whether recently changed conditions (such as in the organization's loss exposures or in the relative costs of insurance and other risk financing and risk control techniques) now call for a change in its mix of risk financing and risk control. Thus, monitoring the results of past decisions not only provides control and coordination of the risk management program but also leads to the strengthening and flexible adjusting of that program.

In essence, through the monitoring step, the risk management decision process renews itself through new information on loss exposures and on the availability and costs of alternative means of treating these exposures. The information from this final "feedback" step back into the first and second steps thus makes the risk management process a self-perpetuating cycle.

3. Status of the Risk Management Function

In the United States, and presumably elsewhere, the importance of risk management as a management function, and the organizational and professional status of the executive responsible for risk management, can be measured in terms of (1) the specific responsibilities and title of that executive, (2) the types of decisions with which that executive deals, especially in conjunction with other managers of the organization, and (3) the authority/reporting relationship of that executive.

In the United States, as presumably elsewhere, risk management tends to have a more exalted status in larger organizations than in smaller ones. While it is often said that risk management is more advanced in the United States than elsewhere, there are undoubtedly many organizations outside the United States which, because of their enlightened management or substantial size, have better risk management programs and give risk management more status than do many smaller or poorly managed organizations within the United States. Thus, the status of risk management varies more from company to company than it does from country to country.

In terms of specific responsibilities and titles, it appears to be generally true that the job-title sequence of "insurance buyer"/"insurance manager"/"risk manager" which has taken place in the United States--and which is still progressing within many American companies--also holds (with appropriate variations for language differences) throughout much of the world. Some organizations have no executive whose primary responsibility or job title relates to insurance or risk management; here, this function is one of many responsibilities held by some more general executive. The title "insurance buyer" implies primarily a clerical function, carrying out rather specific senior management orders with respect to only the purchase of insurance. "Insurance manager" denotes greater authority and discretion in choosing among coverages and insurers, but is still limited only to insurance. "Risk manager" connotes still greater managerial responsibility and discretion--both with respect to other forms of risk financing beyond insurance and for decisions involving loss control measures. In some United States organizations, the executive with the "risk manager" title also is responsible for the organization's employee benefits plans; in others, this responsibility is signified by the title of "risk and employee benefits manager." Yet, in perhaps the majority of the United States organizations, responsibility for employee benefits management rests within the personnel department or some other portion of the organization not directly related to risk management.

The second barometer of a risk manager's status is the types of decisions in which he or she is involved. Traditionally (meaning only the perhaps thirty years "risk management" has been widely identified as a managerial function), risk management has been concerned only with "pure" risks, not "speculative" ones--that is, situations in which the outcomes are either an accidental loss or the absence of such a loss, not situations with potentials for gain. (Hence, the identification of risk management with "accidents.") In a few forward-thinking United States organizations, this split between "pure" and "speculative" risks has been recognized as artificial; the senior management of these advanced companies recognizes that virtually every business decision has both its "pure" and "speculative" components.

For example, such "speculative" decisions as where to locate a new plant, the selection of packaging in which to market a food product, the choice of marketing channels, or the development of a strategy for dealing with labor-management disputes have been seen to involve potentials for accidental loss: the plant may be in a flood plain, a food product may be unsafely packaged, some types of wholesaling operations may not be able to protect the integrity of a product, or unwise labor-management negotiating strategies may lead to excessive absenteeism or even vandalism. In these progressive organizations, the risk manager is given substantial status of being asked to confer with other managers as part of an overall "team" which, together, makes crucial strategic decisions. In other, less progressive firms, these decisions are seen as having no risk management component because, as is sometimes said, "They have nothing to do with insurance."

The third basic indicator of the status of risk management within a particular organization is the reporting and authority relationships which attach to the position of risk manager. In general, the higher in the organizational pyramid the risk manager reports, the more status, the more influence he or she has--formally or informally--over the organization's activities. Moreover, the status of the function to which the risk manager reports also affects the risk manager's prestige. Thus, in an organization which is highly production-oriented, and in which the marketing and financial functions are seen as less significant, the risk manager will have more status if he reports to a senior manufacturing executive rather than to an equally high financial or marketing executive.

Moreover, the risk manager has more status if, in dealing with other departments, the risk manager has line, command authority--such as the right to correct unsafe practices or, if necessary, to actually halt production. By this same logic, the risk manager has less status where his or her authority is limited to only a staff responsibility--for example, the authority only to advise the responsible department manager to either correct an unsafe practice or to halt production.

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