A Unique Balance

The Essence of Risk Management

by Michael R. Levin and Michael L. Rubenstein

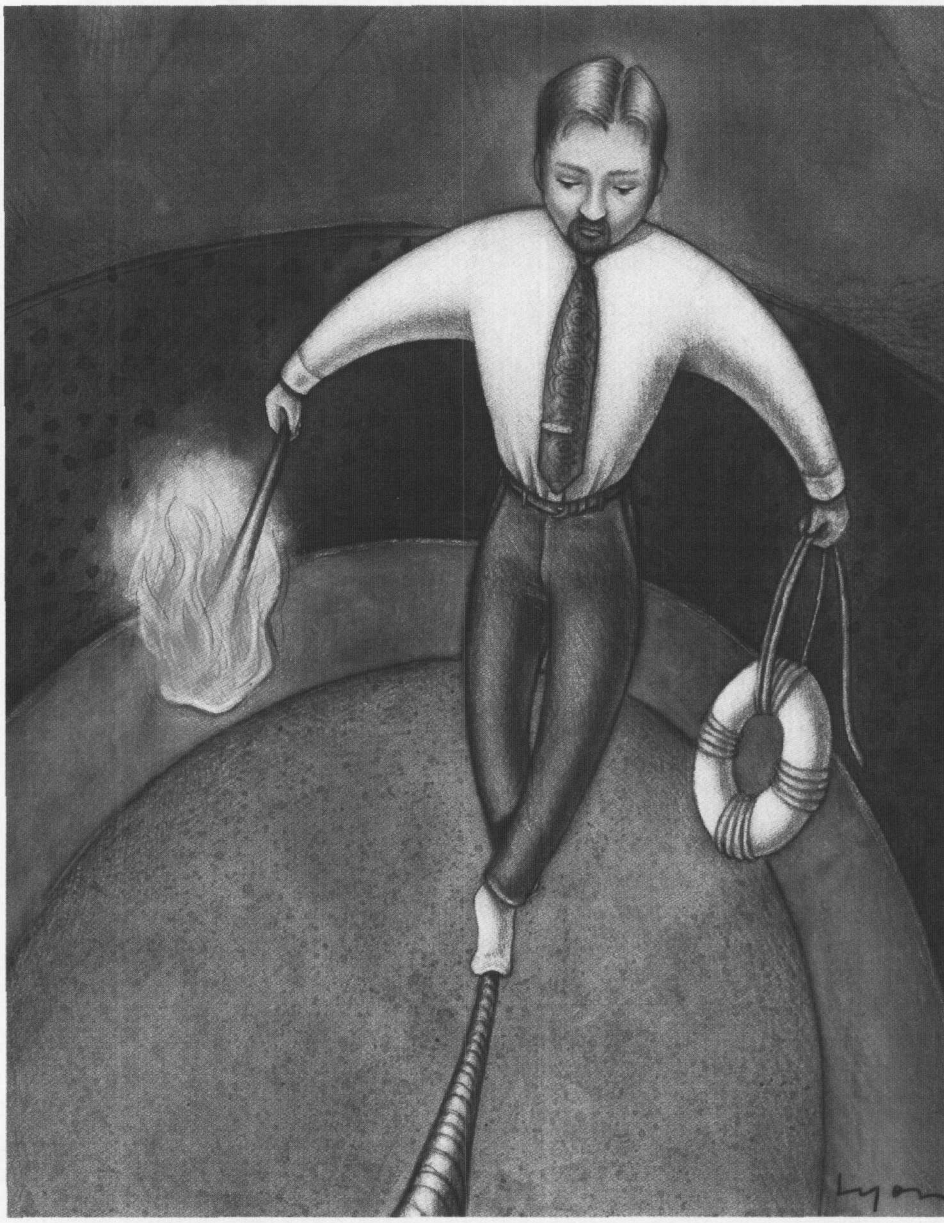
The term "risk management" means different things to different people. Wall Street investment bankers apply it to hedging transactions used for foreign exchange, interest rate, liquidity and commodity price exposures, while internal auditors use the term to refer to the operational and financial controls they create and monitor.

The term also applies to property/casualty exposures, but in many instances, "risk management" has become a euphemism for "insurance coordination." This situation can often frustrate the people with principal responsibility for these exposures. These "risk managers" find that the euphemism can sometimes imply a lack of stature and a narrow focus in their organizations, when they like to think they add considerable value.

The questions thus arise: What value do these property/casualty risk managers really add? What is their contribution to an organization's success? Or, what is the essence of risk management?

Risk Management Contributions

Recent accounts seem to indicate that risk managers have very diverse views about their contribution. Examples, among many others, include: controlling workers' compensation costs; ensuring a safe workplace; protecting corporate assets; managing brokers, insurers and other important vendors; and purchasing efficient insurance programs. ➢



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But these and other contributions often do not appear to satisfy senior management. In some instances, risk managers find that their organizational stature is decreasing and their scope is narrowing further, while others may find that their services are no longer needed.

Part of the problem, it appears, arises out of the nature of these contributions. Risk managers claim responsibility for them, but they must share responsibility with others. Many human resources executives, with their experience in managing medical and disability processes, could control workers' compensation costs at least as well as risk managers. Plant and facility managers have at least as much to do as risk managers with maintaining a safe workplace and protecting corporate assets. Any good executive can manage vendors, and most purchasing executives could procure insurance. (Insurance coverage and brokerage services are becoming increasingly marginal to most large corporations, anyway.)

Risk identification and assessment represent areas in which other individuals or functions can likely add value but in which risk managers appear to have a better perspective and more effective tools than other executives.

Unique Contributions

Many different people contribute to the success of an organization. Individuals and units justify their continued value by exploiting their unique contribution to that success—efforts that no others can contribute or contribute nearly as well. We can think of three unique contributions made by risk managers: exposure management, risk financing and risk management.

Exposure management, in turn, entails three components: identifying and analyzing risk, evaluating new risks and studying the relationship among different risks.

Risk identification and assessment represent areas in which other individuals or functions can likely add value but in which risk managers appear to have a better perspective and more effective tools than others. Although most executives worry about what can go wrong, few concern themselves with studying that issue rigorously, thoroughly and continually. Some do study a narrow aspect of these threats: Attorneys, for instance, examine legal liability, while engineers evaluate potential threats to physical assets. But unlike most others, risk managers seem to have the resources and the mandate to monitor and measure all sorts of organizational threats. They do so with a fairly broad perspective, including a variety of sources of cost, such as legal liability, damage to physical and intellectual assets and employee-related harm of many types.

Risk managers also evaluate new sources of risk; keeping up with new types of claims can be a job in itself. Effective risk managers concern themselves, for instance, with remaining current on new types of employment costs and new varieties of economic damages asserted in lawsuits.

Finally, risk managers also study the relationship among risks. A given event rarely affects only one exposure. A weather catastrophe can damage property, interrupt continuing income and harm employees and their families. Risk managers seek to understand these relationships in depth and analyze the contingencies and costs that arise from a complicated business environment.

Increasingly, risk managers are relying heavily on advanced information technology to facilitate exposure assessment. A few advanced risk managers sit at the center of a web of risk information and work closely with other similar functional areas (such as internal audit) to create and operate processes that accumulate, compile and analyze risk information continually and rigorously.

A Matter of Balance

A risk manager's other contributions, risk financing and risk management, represent areas in which no one else really adds value. They represent the truly unique contribution of risk managers and constitute the essence of risk management. Both involve the key concept of balance.

Risk financing entails the traditional concepts found in risk management literature: insurance and retention. Balancing these ideas requires a unique knowledge of insurance economics and finance, and of the actuarial characteristics of property/casualty claims and losses. Insurance has a role in most organizations, even though its importance has diminished considerably in recent years. Risk managers, alone among corporate staff, have the experience and expertise to balance insurance and retention properly in the organization.

Some may argue that other financial executives have the same ability. The finance function makes important contributions to balancing insurance and retention by providing the economic context for decisions about how much risk to retain. But risk managers have a more detailed knowledge of the exposures being retained and thus understand all the components in these decisions.

Risk management represents the most advanced application of the concept of balance. It also entails the traditional concepts of risk control and risk financing. Risk control represents the operational efforts needed to prevent property/casualty losses or to mitigate their effect on the organization. As noted earlier, risk financing represents the combination of insurance and retention that pays for the financial consequences of events that do occur.

Few risk managers, however, appear to try to balance risk financing and risk control to make sure that an organization applies enough—but not too much—of each, in the appropriate proportions. For example, here's the mission statement for the risk management department at a major corporation:

We will seek to assess the principal exposures of the corporation, and for each exposure assist divisional management with designing and implementing a thorough, appropriate and comprehensive system of safety and protection. We will then create a cost-effective insurance program that protects the assets and resources of the corporation against incidents and accidents that occur.

What's wrong with this statement, which almost any large company could probably claim? It's out of balance.

Like many others, this organization appears to take an approach that suggests it will apply every available control tool, program and technique, and then pay for the residual losses that nonetheless slip through the control structure.

Why might organizations take this approach? We're not sure, but we suspect that the explanation lies in our cultural propensity for zero tolerance for accidents or mistakes. Having a philosophy that controlling some events is just too expensive relative to their cost, or that some incidents are not likely enough to merit serious attention, makes a corporation seem callous and negligent. So, companies seek out and control even the least likely events (such as incursions from computer hackers) or low-cost ones (such as petty crime) and then purchase substantial insurance against these events for good measure.

Now, we don't want to suggest that organizations should begin to ignore all but the most significant exposures. Most companies should probably be aware of the problems related to unauthorized access to their computer systems (exposure assessment, again). Many may take some measures to limit this access and insure against its consequences, and the level of control and insurance most actually use might even be appropriate.

We are merely suggesting that a logical and rational approach to responding to an exposure requires the organization to balance its control and financing tools in degrees appropriate to the risk. Not all exposures require extensive controls and comprehensive financing. Some may benefit from much more control than financing (workers' compensation or crime-related exposures come to mind), while others might benefit from more financing with less control (floods or other difficult-to-prevent natural catastrophes seem to fit this category).

Once again, the business context and environment is critical to determining how to achieve this balance. In some contexts, absolute control over some exposures may be critical. In others, an organization may ignore the exact same exposures safely. Ordinary premises liability exposures (slips and falls) mean much more to a medium-size retailer, for instance, than to a large manufacturer.

This concept of balance leads to a concise, useful definition of risk management: the process of understanding exposures in an organization and balancing the appropriate control and financing tools for a given exposure or portfolio of exposures. Defined in this way, risk management may become the principal subject of the work of a chief risk officer.

The Chief Risk Officer

There has been discussion in the trade press and professional gatherings recently about the chief risk officer concept. Much like the disagreement about the definition of risk management, there appears to be little consensus about what that role entails. At least a few risk managers consider themselves the logical candidate to fill the position.

We are suggesting that risk managers can have as good a perspective as any other executive on achieving the sense of balance the chief risk officer will require. Understanding exposures through the assessment process and showing how to balance the control and financing tools needed to respond appropriately to these exposures requires a unique view of these issues.

Narrow focus and limited perspective, however, will prevent many risk managers from achieving that stature. The chief risk officer will likely oversee many risks, not just property/casualty risks, and will handle many components of these risks, not just insurance. Unfortunately for many risk managers, they focus on exposure management, not risk management (see "What Does it Mean: Risk Management or Exposure Management?", *Risk Management*, August 1997).

Fortunately, the concept of balancing control and financing tools represents the broad perspective that a good chief risk officer will likely bring to an organization. While assessing risks attracts the most attention now, this will likely constitute only a part of their role. It is difficult to envision any organization appointing a specific senior corporate officer with the sole duty of identifying and evaluating potential problems that might arise from the organization's operations and finances. A chief risk officer will likely need to advise management about appropriate responses to risks and design and manage programs for these risks.

Others within a corporation might also aspire to the chief risk officer position. However, they, too, might suffer from a narrow focus and limited perspective. Capital markets specialists within a treasury operation, for instance, tend to focus on a small number of fairly complicated risks, such as interest rate, foreign exchange, equity value and, in some organizations, commodity prices or credit. Most such specialists oversee hedging programs, which in some aspects resemble insurance programs.

Internal audit staffs don't necessarily bring a narrow focus. In fact, they identify risks in a wide variety of areas. However, they tend to focus mostly on financial process controls and bring little knowledge of methods for financing exposures using hedging and insurance transactions.

Risk managers who aspire to fill this role should take the approach that the chief risk officer is a senior executive who seeks to balance control and financing tools in the company. Doing this requires expanding a risk manager's scope beyond property/casualty exposures to encompass various control and financing tools, as well as the analytical skills and judgment needed to create a balanced, effective program. RM