Making the distinction: Risk management or exposure management
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Making the RISK MANAGEMENT

The practice of risk management has come a long way. Many risk managers recall a time when they focused virtually all of their energies on building an insurance portfolio and negotiating and reviewing the cost and terms of insurance contracts. Since then "insurance buying" has become "risk management," and risk management has expanded to include various financial, engineering, legal and other corporate functions. What risk managers do has become more interesting and important.

BY **Michael R. Levin and Mark G. Schneider**

Distinction

Why, then, do risk managers still have problems with their role? For instance, some risk managers claim that they have little influence over strategy or business decisions. Or they think they lack the stature of other staff, such as finance or human resources executives. In fact, there is still a group in the profession who consider the title "risk manager" just a fancy euphemism for "insurance buyer." ➢

EXPOSURE MANAGEMENT

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Any entity's operations give rise to potential events that represent sources of cost and can be classified by exposure.

Several seminars at the 35th RIMS Annual Conference & Exhibition confirm this trend. An increasing number focus on how to communicate with senior management or how to improve career prospects.

We think this situation occurs because when we refer to risk management, we are really talking about two different processes—exposure management and risk management. Most of what risk managers do actually falls within exposure management.

Basic Definitions

Risk management has a variety of definitions:

•"... the identification, measurement and treatment of property, liability and personnel pure-risk exposures" (Williams and Heins, *Risk Management and Insurance*, 1985, p.16)

•"...dealing with the risks that (various) events might occur, and with their consequences when they occur..." (Mehr and Hedges, *Risk Management: Concepts and Applications*, 1974, p.2)

•"...the process of making and carrying out decisions that will minimize the effects of accidental losses on the organization" (Head and Horn, *Essentials of Risk Management*, 1991, p.6)

•"...a multidiscipline approach to dealing with the uncertainties of modern living" (Kloman, *Risk Management Reports*, January 1994, p.1)

We suggest that for purposes of understanding why risk managers' roles vary so greatly, we need to use more literal definitions:

Management is the art and science of running a business or its components. According to the classic formulation in business literature, it entails planning, organizing, directing and controlling. "To manage is to forecast and to plan, to organize, to command, to coordinate and to control" (Henri Fayol, quoted in Williamson (ed.), *Field Guide to Business Terms*, 1993, p.181).

Risk is the chance that events and their consequences will diverge from predicted or anticipated outcomes. Hence, managing a company's risk entails planning, organizing, directing and controlling risk to respond to that chance. At its most extreme, risk undermines a business' management process.

More practically, we submit that risk pertains to the variability inherent in large-scale events. For our purposes, an entity's risks are events that, if they occur, represent a material threat to an entity's fortunes. Examples of risks in this context include large-scale natural disasters or massive product recalls.

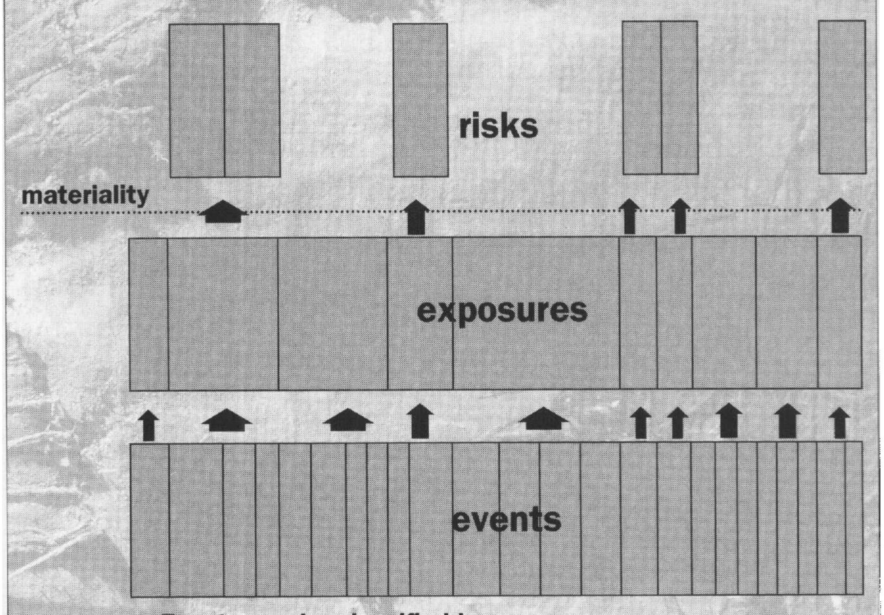
The term *exposure* involves the same events as risk, but at a different level. A degree of uncertainty surrounds these events, in that the exact amount of cost for a given exposure is not known before an event occurs. But the potential variability in the costs for these events does not represent a *material* threat to the organization's finances. Exposures can be analyzed using a variety of actuarial, statistical or financial techniques. Example of exposures include workers' compensation claims and auto liability incidents. (For a discussion of materiality in risk financing programs, see Levin and DiCenso, "A Stakeholder Approach to Risk Financing Programs," in *Alternative Markets/Self Insurance*, May 1996.)

Both Are Important

Stated another way, any entity's operations give rise to potential events that represent sources of cost. These events can be classified by exposure. These exposures create some potential cost to the entity, but the precise amount remains uncertain until the event (or events) actually occur. Moreover, for some exposures, the events that can occur represent material risk to the entity's fortunes. As Exhibit 1 illustrates: Events can be classified by exposure; all risks arise from exposures; but not all exposures

EXHIBIT 1

EVENTS, EXPOSURES AND RISKS



• **Events can be classified by exposure**
• **All risks arise from exposures**
• **Not all exposures lead to material risks**

lead to material risks.

Now, there is honor in both risk management and exposure management. Both are important to an entity and help to reduce an organization's costs and improve its effectiveness and efficiency. However, exposure management is not risk management, and confusing the two can lead to the problems noted earlier. Exposure management is not a strategic function because even though the costs that arise out of exposures are uncertain, they do not likely represent material risks. While the costs themselves are material, their variability is not. Workers' compensation, again, is a good example. The absolute costs of

EXHIBIT 2

COMPARISON OF RISK AND EXPOSURE MANAGEMENT

	Risk Management	*Exposure Management*
General aspects		
subject matter	catastrophic events long-term impact less predictable events	routine events short-term impact more predictable events
operational mode	planning crisis response	budgeting administration
orientation	external public relations impact	internal employee communications
functions involved	strategic planning public relations facilities management board of directors senior management	legal human resources finance fleet management
Components of management process		
planning	understanding extent of potential harm from risk	identifying and analyzing potential costs
organizing	coordinating resources within organization	creating efficient and effective administrative processes
directing	raising awareness across organization	initiating and monitoring administrative processes
controlling	benchmarking against other entities' catastrophes reviewing and analyzing causes and consequences of events	measuring costs with respect to projections
Components of traditional "risk management process"		
assessment	scenario testing fault-tree analysis	actuarial projections
control	avoidance	prevention
financing	insurance contingency financing	budgeting cost containment
administration	contingency planning process	vendor management MIS
Examples		
	products and professional liability earthquake and flood events	workers' compensation auto liability

occupational injury are usually material to an entity, but the variability in these costs usually is not. Over the long run the variability in these costs will probably not have a significant effect on an entity's strategies.

Exposure management also involves processes that are not as central to the entity. Managing exposures usually involves addressing property/casualty safety and claims processes. In most organizations these are not as important to an entity's business strategies as critical production or financial processes.

Finally, exposure managers continue to supervise insurance programs and vendors; managing such efforts generally doesn't require strategic oversight. These processes are easy to outsource, usually as part of an insurance transaction.

Structural Differences

Risk management and exposure management differ in a number of ways. Exhibit 2 presents a side-by-side comparison of the characteristics of management processes and examples of risk and exposure management.

Fundamentally, it seems that most people who carry the title of "risk manager" are actually exposure managers. Their subject matter, operational mode, orientation and relationship with other functions all involve exposure management—the activities on the right-hand side of the chart.

At least one interesting irony emerges from this comparison: Traditional insurance is used in the finance component of risk management but has only a limited role in the finance component of exposure management. Those who seek to be risk managers will need a command of insurance principles and the marketplace, and those in exposure management have less need for this knowledge.

Critical Examination

How is this distinction useful to business executives?

Companies should analyze the distinctive roles of risk and exposure management critically and determine the extent to which they need each. All

All organizations need some form of exposure management for various events, but the extent to which they also need risk management for a particular exposure depends on whether the exposure represents a material threat.

organizations need some form of exposure management for their various events; however, the extent to which they also need risk management for a particular exposure depends on whether the exposure represents a material threat.

Everyone who calls himself or herself a risk manager should examine the characteristics of both risk management and exposure management. Decide whether your skills and interests make you one or the other. There is no right answer, since both roles are important to any organization.

If you are or aspire to be a risk manager, perhaps you should not worry if the human resources department is asked to handle workers' compensation, or if management considers outsourcing some traditional functions of the risk management department, such as tracking certificates of insurance or administering claims. These changes represent recent trends that involve exposures whose variability is not material to the entity.

If you are or aspire to be an exposure manager, you should focus your energies on designing and maintaining efficient processes. You should not worry about access to the company's strategic plans or about creating the optimal insurance program.

So perhaps the evolution of "risk management" has a bit further to go. Many professionals who have progressed from purchasing insurance may focus on managing these exposures efficiently, but not on events whose variability may have a significant effect on the company. Becoming a manager of risk, rather than exposures, and gaining a voice in strategy and a role beyond supervising insurance brokers will require focusing on events that are material. RM