AN EMERGING RISK ISSUE FROM

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Enterprise Risk-An Elementary Approach

Enterprise risk management continues to be a major topic of discussion among risk managers. To many, it sounds like a process too complicated to understand or to implement. Some experts talk of the need for specific technology platforms, a holistic[1] view of risk and the need for a chief risk officer in order to embrace enterprise risk management.

- Can the average organization implement what may appear to be a complicated enterprise risk management program, even without designating a "chief risk officer"? In most cases the answer is yes!

Many organizations manage only hazard and operational risk, which can lead to risk management silos - risk is viewed by facility, by product, by service or by department. A major benefit of enterprise risk management is it empowers an organization to make better decisions since all forms of risk exposures and risk treatments are considered. In this newsletter, we examine ways to begin to move your organization from hazard/operational risk management toward enterprise risk management.

Enterprise risk management-defined

While there are multiple definitions of enterprise risk management, for our purposes we will define enterprise risk as "an organization's management of hazard, operational, financial, strategic and reputation risk." These categories of risk are defined as:

- Hazard – loss from fortuitous events, either natural or manmade, such as fires, earthquakes, windstorms, theft, or icy roads.
- Operational - loss from operational failures, such as failure of quality control, the cost of product recall, or failure to comply with regulations or laws.
- Financial - loss from changes in asset quality, risk of dealing in a foreign currency, or the risk of extending credit to customers or vendors.
- Strategic - loss caused by business decisions, such as the development and sale of new products or services or the acquisition or divestiture of assets or operations.
- Reputation – loss due to the decrease in the value of an organization's name, brand, product or service.

The holistic approach

Enterprise risk is holistic because a risk of loss in any one of the five categories may greatly affect the entire organization. Risk information is shared among all appropriate employees and not restricted to individual silos. A poor management decision (strategic) or an unwise or improper extension of credit (operational/financial) may imperil the organization as much or more than a catastrophic fire (hazard/operational). An electrical fire from improper wiring installed by the lowest bidder may be seen as hazard risk (fire), operational (improper wiring) or strategic (low bids win). Any one of the three risk categories is correct. What is important is that all risks are identified and addressed. Since one risk may fall into multiple categories, proper risk treatment may need expertise from many disciplines in order to create an effective strategy for elimination or mitigation of the identified risk.

Enterprise risk management is practiced using the same process followed for years in managing hazard or operational risk. While all of the steps of the process are important, it should be emphasized that a risk cannot be managed unless and until it is identified:

1. Identify the exposures and/or risks of loss,
2. Evaluate and analyze the risks identified,
3. Identify and examine the techniques available for treating the risk,
4. Select the most appropriate techniques,
5. Implement the chosen techniques, and
6. Monitor/improve the risk management program.

Risk treatment will differ by risk by category. Snow removal practices (hazard) by a retail establishment will not have a bearing on the organization's purchase of product from a manufacturing firm (strategic) currently in Chapter 11 bankruptcy (financial).

The philosophy of risk retention may not be exactly the same for all risks within an organization. A manufacturer may set a maximum customer credit exposure at $100,000, but decide it can prudently accept a workers compensation deductible of $250,000 per accident. This variance may be explained by the relative cost of the transfer the risk – the cost of purchasing a $100,000 deductible for workers' compensation may be inordinately high; it may be more cost effective to retain a greater risk for workers' compensation.

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[1] "Holistic" is defined as "relating to or concerned with integrated wholes or complete systems rather than with the analysis or treatment of separate parts. Webster's New Explorer Dictionary, copyright 1999.

Enterprise Risk -AN ELEMENTARY Approach

Organizations in different industries may have diverse risk concerns

- A hospital may be concerned about its reputation as a surgical center and focus on the malpractice incident rate of its physicians.
- A publicly owned bank may be concerned with adherence to its lending practices, which will affect profitability and the value of its stock.
- A bus company may be concerned about existing contracts for future charters because of volatile fuel costs.

Implementation

1. Many organizations use a committee approach for issues of public safety. Committee members may be from staff areas such as risk management, human resources, purchasing and facilities and also include operational personnel such as plant managers. A holistic approach will include representatives from other areas such as finance, legal, and audit/compliance.

2. The chief financial officer is considered the de facto chief risk officer in most organizations. The CFO may designate an individual to represent CFO concerns on the enterprise risk committee highlighted in 1 above.

3. This committee will be charged with identifying risk from each of the five risk categories and developing appropriate strategies for elimination and mitigation techniques. The risk manager can assume a leadership role and help fellow committee members understand the risk management process.

4. All identified risk of loss by category will need to be classified as to the possible frequency of the event as well as its financial severity to the organization if the event occurs. The table shown below may help the committee to summarize risk by category and also by frequency and severity. Each risk category will have a separate table.

	← Low **Frequency of Loss**	High →
High ↑ **Loss**	*Low Frequency* *High Severity* • • • • • •	*HighFrequency* *High Severity* • • • • • •
Severity ↓ Low	*Low Frequency* *Low Severity* • • • • • •	*High Frequency* *Low Severity* • • • • • •

5. The committee assigns each identified risk to a quadrant based on the perceived frequency and severity of the risk. This portion of the process may require assistance from outside parties such as auditors, consultants and actuaries.

6. A summary document is created by taking the highest priority risks from the individual tables created for the five risk categories by risk quadrant. For example, treat high frequency/high severity risks first, low frequency/high severity second, high frequency/low severity third and low frequency/low severity last. Elimination and mitigation strategies and the cost/benefit of each strategy can be created as a companion document to the summary document. These final documents can be the basis of a meeting with the CFO for input and approval of a course of action.

7. The monitoring phase of the risk management process should be on a continual basis. New products and services as well as other changes in the operations and profile of the organization should be frequently reviewed by the enterprise risk committee.

Conclusion

Enterprise risk management for most organizations should not be a difficult process to begin, implement and maintain. The blending of all risks of loss faced by an organization into a cohesive management strategy will be a natural step from managing hazard and operational risk.

Please send comments and suggestions for future *Emerging Risk Issue* **newsletters to:**
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