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Perspectives on Managing Risk

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Rising Trends in Risk Management

RIMS members tackle new challenges; role broadens

Change breeds success. With upheaval comes restructuring; with challenge comes innovation; and for risk managers, the overwhelming need for organizational problem-solving and loss prevention puts their unique skill set center stage as it never has been before.

Bill Coffin, head of publications for the New York-based Risk and Insurance Management Society (RIMS), a not-for-profit organization dedicated to advancing the practice of risk management, sees the evolving role of risk managers as a rising trend among RIMS's 10,500 members.

"Risk managers have been concerned about being marginalized in their organizations," says Coffin. "For years, they have fought for acceptance by upper management to get their distinct perspective and abilities absorbed into the senior decision-making process. Now, in light of current events, more risk managers are taking their seat at the table, and are being tasked with demonstrating how they can safeguard organizations and impact bottom-line performance on a strategic level."

The 2008 Ernst & Young Insurance Risk Leadership Survey confirms Coffin's observations. Although fewer than half of CROs or risk committees surveyed last year had explicit authority to influence key activities, such as strategic planning, financial planning, investment strategy decisions and product design and pricing, the vast majority anticipated taking on more oversight responsibilities in the future. Risk managers are increasingly expanding their expertise in to human resources, IT, security, legal, site construction – just about everywhere there's a solution needed. "For risk managers, it's a time of uncharted exploration and growth," he adds.

Dispelling Myths

Another trend Coffin sees is the puncturing of the myth of the single solution – the use of one-size-fits-all valuation tools to assess levels of risk in complex businesses with highly individualized operations, cultures and financial structures.

"Sound risk management requires varied expertise from a lot of different types of people across an organization," explains Coffin. "There's no one perfect tool to analyze or mitigate any organization's risk. We're seeing risk managers move beyond standardized rating systems and risk models to adopt customized valuation tools that provide the transparency necessary to identify and address the unique nature of risk found in their organizations," he notes.

It isn't just risk managers that are developing custom solutions. Insurers hope to gain the competitive advantage by delivering more personalized programs for their clients.

"Property casualty insurance just came off a rough year in 2008, putting pressure on insurers to differentiate themselves with a wider variety of offerings and a deeper level of service, both from the carrier side and especially from the brokerage side," says Coffin. "Risk managers welcome this development; greater solutions, with a heightened level of service coming from the insurance arm, enable them to serve on the front lines for their organizations, relying on insurers to deliver stronger support in insurance procurement, contract maintenance and other vital areas."

RISK MANAGEMENT MAGAZINE

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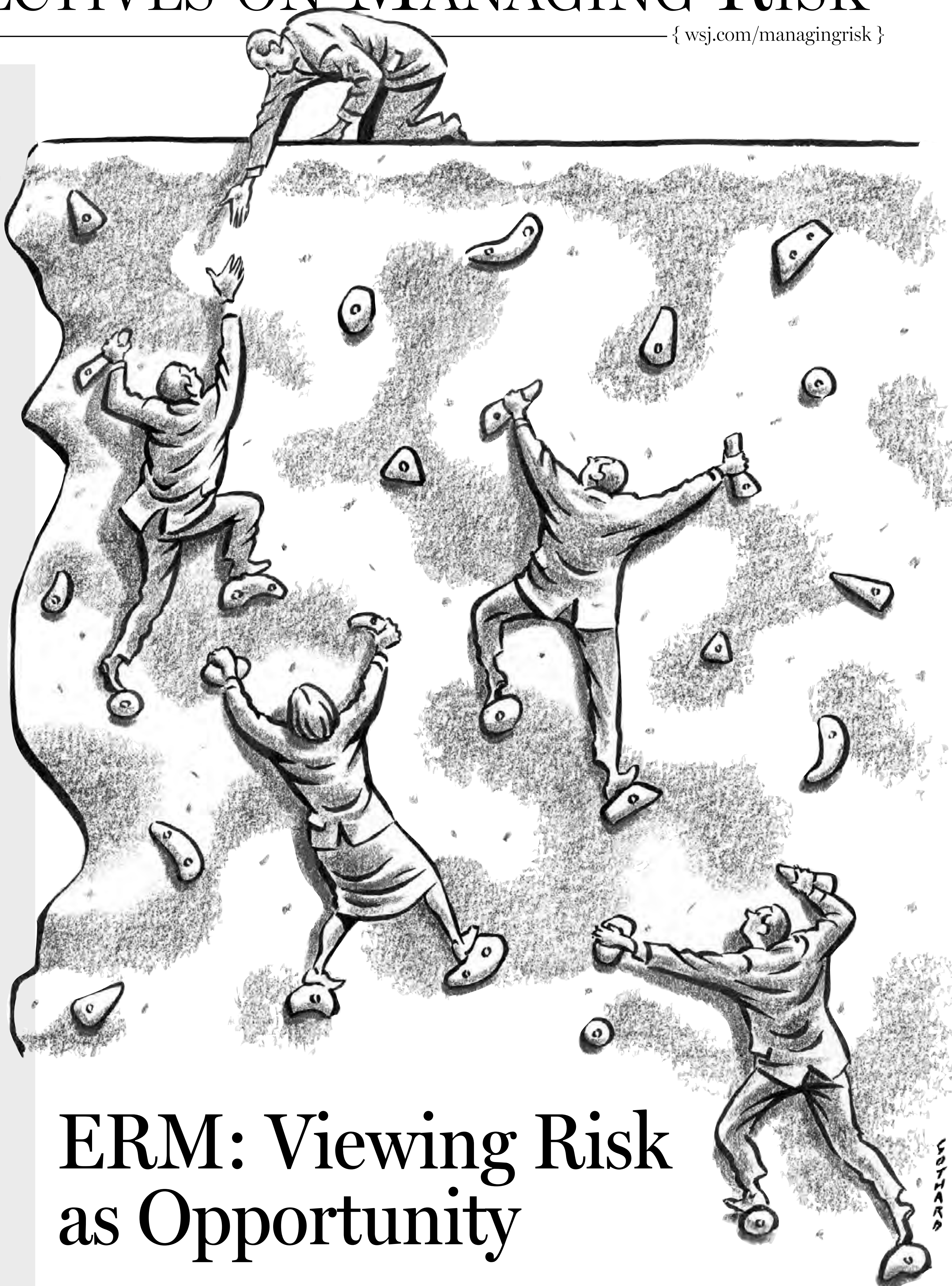

ERM: Viewing Risk as Opportunity

Risk-based approaches to decision-making gain traction

By Russ Banham

With the instability of many financial firms from the current economic crisis, the spotlight is on risk management and whether or not these and other organizations are assessing strategic and operational risks in their zealous quest for growth. As the federal government imposes stiff rules for companies receiving taxpayer bailout dollars from the Troubled Asset Relief Program, the onus is on all organizations to conduct more systematic analyses of their risks and more comprehensive risk monitoring and management.

The word "risk" has become pejorative in the harsh light of the economic downturn, and yet taking calculated risks often separates the winners from the losers on the competitive battleground. In the last decade there has been a movement toward a methodology to better identify, assess and quantify strategic, financial and operational risks. It's called Enterprise Risk Management or ERM for short. Most large public companies have implemented ERM, in some cases because government regulations, rating agencies or stock exchanges require it. Many others have executed the strategy simply because it makes tremendous sense.

ERM is an integrated framework for holistically managing every risk confronting the enterprise to achieve organizational objectives and minimize unexpected earnings volatility. It challenges organizations to view risk as an opportunity. Since companies must hold capital to absorb the risk of loss — hedging, absorbing or transferring the risk — there is less capital to invest in other profit-producing activities. In effect, ERM helps companies determine the right amount they should direct toward risk.

> *One can argue that the subprime mortgage fiasco was, at bottom, a failure of risk measurement.*

New Metrics for Valuation

Although the steps involved in an ERM process are essentially the same, each organization goes about implementation in different ways, depending on its strategic objectives, culture and operational structure. Nevertheless, says James Lam, who has written several books on the subject and is president of the eponymous ERM consultancy, James Lam & Associates in Wellesley, MA, a solid ERM framework should have four key components: governance structure and policies, risk analytics, risk management strategies, and dashboard reporting and monitoring. "Every organization, no matter its size or industry sector, will need to take these components into account in putting forth their ERM strategy," Lam says.

Some organizations, having implemented ERM internally, now pass on their best practices to others. Zurich Financial Services is a case in point, having first adopted ERM and now assisting others to do the same by conveying risk insights and solutions.

Over five years ago, the property and casualty insurance company experienced significant improvement in capital consumption when it switched from an asset-based approach, in which a company's target capital calculation is measured against assets, to a risk-based approach that factors in actual risks to these assets. This risk-based solvency standard encourages Zurich to thoroughly investigate its own risk situation, and to take this into account in its capital calculation.

In switching to a risk-based approach, Zurich Financial Services engaged a thorough review of its strategic,

Continued on next page

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Minimizing Transportation Risk

Driver selection key to getting goods safely to and from destinations

According to the Council for Supply Chain Management Professionals, U.S. expenditures on truck transportation alone – $635 billion – are larger than the GDPs of all but 16 countries. Having a shipment in any direction go awry is the last thing you want to think about, and yet it occurs all too frequently.

In 2007, the last year for which federal statistics are available, 139,587 large trucks were involved in non-fatal accidents in the U.S. and another 4,584 large trucks were involved in fatal crashes. Although data is elusive on the number of these vehicles that carried goods bound for or leaving manufacturing plants or distribution centers, the percentage could be significant. So is the cost — not only does a trucking accident create a business interruption loss for manufacturers, it also increases the volume of workers compensation claims, which fosters higher insurance rates.

"There is a direct relationship between crash frequency, supply chain bottlenecks and workers compensation experience," says Peter Van Dyne, loss control technical director with Boston-based insurer Liberty Mutual.

While many companies address the risk of a trucking accident via driver training programs, this alone fails to reduce risk substantially because it assumes that most crashes happen due to a lack of skill. Actually, substandard driver practices are responsible for many crashes.

"A driver may have a habit of carelessly making lane changes or using cruise control inappropriately even though he or she fully knows the proper procedures," Van Dyne says. "Reducing risk requires more attention paid to driver selection."

A recent Liberty Mutual survey of trucking companies revealed some surprising results about how to decrease your organization's risk of trucking accidents by choosing the right drivers for the job.

Crash course in best candidates: The study indicated that companies with fleets that hired drivers with four or fewer violations or accidents (below the survey median) lowered crash rates by 28 percent. Hire drivers with more violations and accidents than the median and the crash rate increases sharply.

Weed out the speeders: Van Dyne counsels companies to hire drivers with no more than two moving violations in the past three years. Data indicates that crash frequency reduced by one-third and crash costs were 47 percent lower than companies that hired drivers with three or more violations.

Don't back off on the background check: Companies that conducted comprehensive background checks on prospective drivers including citizenship, past employment, work history gaps and criminal history had a 23 percent lower accident frequency than companies that only conducted some of these checks.

Job hoppers need not apply: Job instability was a risk factor as well. Companies that hired drivers with six or fewer job changes over a 10-year period had a 14 percent lower crash frequency.

Take it on the road: "Fleets using road tests that are at least two hours long as part of their driver selection process experienced 45 percent fewer crashes and 23 percent lower crash costs than carriers using shorter or no road tests," Van Dyne says. "A driver's longtime habits are more apt to show up during an extended driving test."

– R.B.

ERM: Viewing Risk as Opportunity

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financial, market and operating risks.

The process yielded tremendous value — for example, the insurer discovered that its risk-based capital consumption could be reduced, freeing up this money to be better deployed in other profit-producing venues. Zurich's core business is insurance, not asset management or financial products, so today, more than 60 percent of Zurich's capital is allocated to insurance, as compared with 40 percent five years ago. "This was just one of the benefits of our ERM journey," says Linda Conrad, director of strategic business risk engineering at global insurer Zurich Financial Services.

The toughest leg in the ERM journey is the first step: a course of action in which risk overseers from across the enterprise come together to share the respective risks within their own spheres of influence. Zurich Financial Services opted for a top-down process it has since trademarked as Total Risk Profiling. It begins with an understanding of the company's strategic priorities emanating from the top of the pyramid; the C-level suite and board of directors established these objectives.

The next step is what Conrad calls a "workshop-driven exercise," in which the primary risk managers in each business unit assemble to examine the strategic objectives, the operational solutions to achieve them and the risks these raise. "It is amazing what you find when you get people from different disciplines in a room together, with a range of different opinions about what they consider to be the 'Top 10' risks," Conrad says. "It increases the buy-in to mitigate the risks and come to a consensus about key risk drivers."

Once this consensus is reached, the risk drivers are aggregated and rolled up for C-level and board review, a bottom-up process that completes the circle. Senior management now has the ability to determine where best to allocate resources to achieve business objectives, fully cognizant of where the risks reside, their cost, and the mitigation strategies in place.

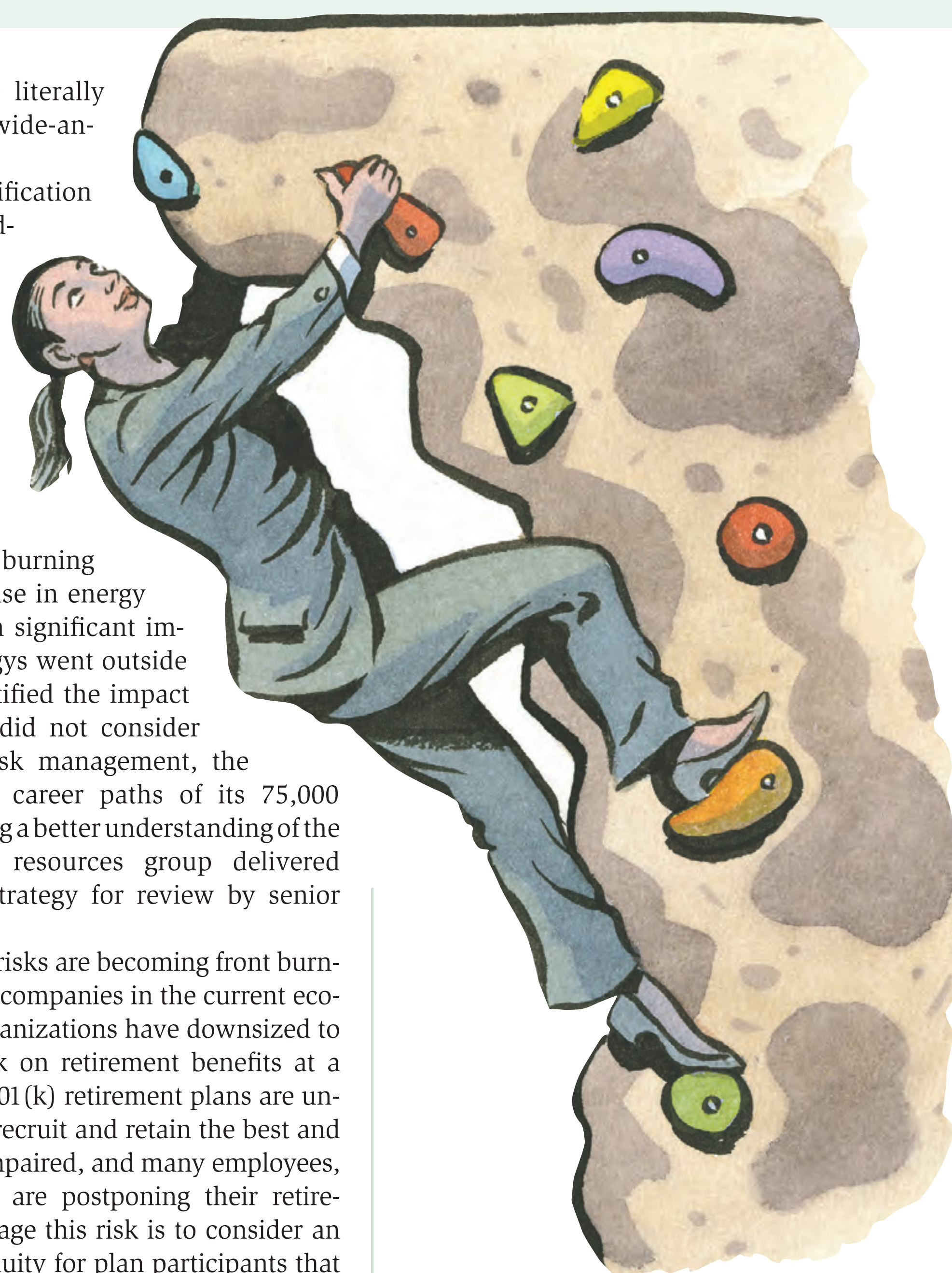
A Wide-Angle View

Risk identification is not a walk in the park. At Blue Cross and Blue Shield of Florida, the strategic risk identification process alone involved 35 people drawn from different parts of the organization. A review of operational risks, both top-down and bottom-up, was similarly thorough. "We conducted 60 process and subprocess interviews to identify operational risks in the company," says John Phelps, director of business risk solutions at the Jacksonville, FL-based health insurer.

Convergys, a Cincinnati-based relationship management services company with $2.8 billion in 2008 revenues, followed a similar path in erecting its ERM structure. In its case, business leaders across the organization were identified and asked, "What risks keep you up at night and how do they impede your ability to meet strategic and operational objectives?" The company's risk management department then prioritized the risks in terms of their probability and impact.

"We rank them insofar as their financial impact on the company and how they might affect our reputation," says Carol Fox, Convergys senior director of risk management. "We literally plot the risks to get a wide-angle view."

In this risk identification phase of ERM, Lam advises companies to consider events that may be "outside the bell curve," he says, such as a scenario that might affect customer demand. Such risks often do not hit the radar screen — they're not as obvious as a plant burning down or a severe increase in energy costs — yet they pose a significant impact on capital. Convergys went outside the bell curve and identified the impact of a risk it previously did not consider as significant: talent risk management, the retention, training and career paths of its 75,000 employees. After gleaning a better understanding of the exposures, its human resources group delivered a talent management strategy for review by senior management.



Talent management risks are becoming front burner issues for many other companies in the current economic environment. Organizations have downsized to cut costs or pulled back on retirement benefits at a time when employees' 401(k) retirement plans are underwater. The ability to recruit and retain the best and the brightest has been impaired, and many employees, particularly older ones, are postponing their retirements. One way to manage this risk is to consider an employer-sponsored annuity for plan participants that make a 401(k) plan act more like a traditional pension.

"The value for the employer is having employees with greater peace of mind, since the annuity will provide a regular stream of income over the course of their lives," says Mark Foley, a vice president in insurer Prudential's innovative simplicity unit.

Painting a Risk Profile

Insurance broker Aon counsels that simply identifying a risk does not constitute ERM. Companies must understand risks at granular levels of detail. "You need to know if there is sufficient information about the risk, will it be timely delivered to the right people to accept or avoid the risk, and then if the risk is accepted how it will be managed," explains Laurie Champion, director of enterprise risk management at Aon Global Risk Consulting.

Once a risk profile is painted, ERM calls for companies to quantify risks in several metrics, such as the potential frequency of an event occurring, the potential severity of financial loss if the event occurs, and whether or not one risk might actually offset another.

Once a risk is accepted, it must be monitored through the organization with a consistent approach and central view.

One can argue that the subprime mortgage fiasco was, at bottom, a failure of risk measurement. While providers of mortgage-backed securities may have had an understanding of their own commitments, they had failed to quantify the extended impact of a credit crisis involving other organizations on these commitments. Since subprime mortgages and risk-spreading mechanisms like mortgage-backed securities and credit default swaps involved an unprecedented degree of interrelationships, when one organization caught a cold others were soon infected.

"There was no intra-industry communication, no centralized understanding, of what was happening in a broader economic sense, relative to some pretty garden-variety risks," says Mat Allen, enterprise risk services and solutions practice leader at insurance broker Marsh.

Such lessons are not Wall Street's alone, of course. Indeed, the subprime debacle trickled down to cause problems for all companies that failed to assess how the risk of a housing downturn or credit crunch might affect their own businesses.

After a company has identified and measured strategic and operational exposures, a consistent strategy for managing and monitoring the risks is required. Technology, particularly dashboard-type "business intelligence" reporting — an early warning system alerting the organization when a potential crisis may be at hand — will assist this risk governance obligation. Like all technology, the system is only as good as the data within and the processes created to report this data.

Many organizations have given the responsibility for monitoring enterprise risk to a Chief Risk Officer (CRO) or another high-level executive like a CFO. This is a reaction to the previous "silo-based" approach to risk, in which insurance risk managers address hazard and liability risks, internal audit manages financial reporting risks, business units handle project risks, treasury deals with foreign-exchange risks and so on.

"Once a risk is accepted, it must be monitored through the organization with a consistent approach and central view," Champion says. "Whether this is a CRO or someone else depends on the culture of the organization and the structure of the leadership team. What matters is that someone is responsible for risk on a centralized basis."

Russ Banham is a veteran business journalist. His articles have appeared in Forbes, The Economist, CFO, Time *and* U.S. News & World Report. *Banham is the author of 15 books, including* The Ford Century.

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Reducing Disruption in the Global Supply Chain

When Henry Ford built Ford Motor Company more than a century ago, he relied on a legion of suppliers that had sprung up like crocuses not far from his factories along the Rouge River in Dearborn, MI. Ford had more control over a supply chain when it was local in nature; the variables affecting supply were more clearly understood and manageable. If one of the suppliers failed to meet Ford's manufacturing demands, another filled in with minimal delay.

Today, most global manufacturers source raw materials and other supplies from companies all over the world. When one of them fails to deliver, chaos reigns.

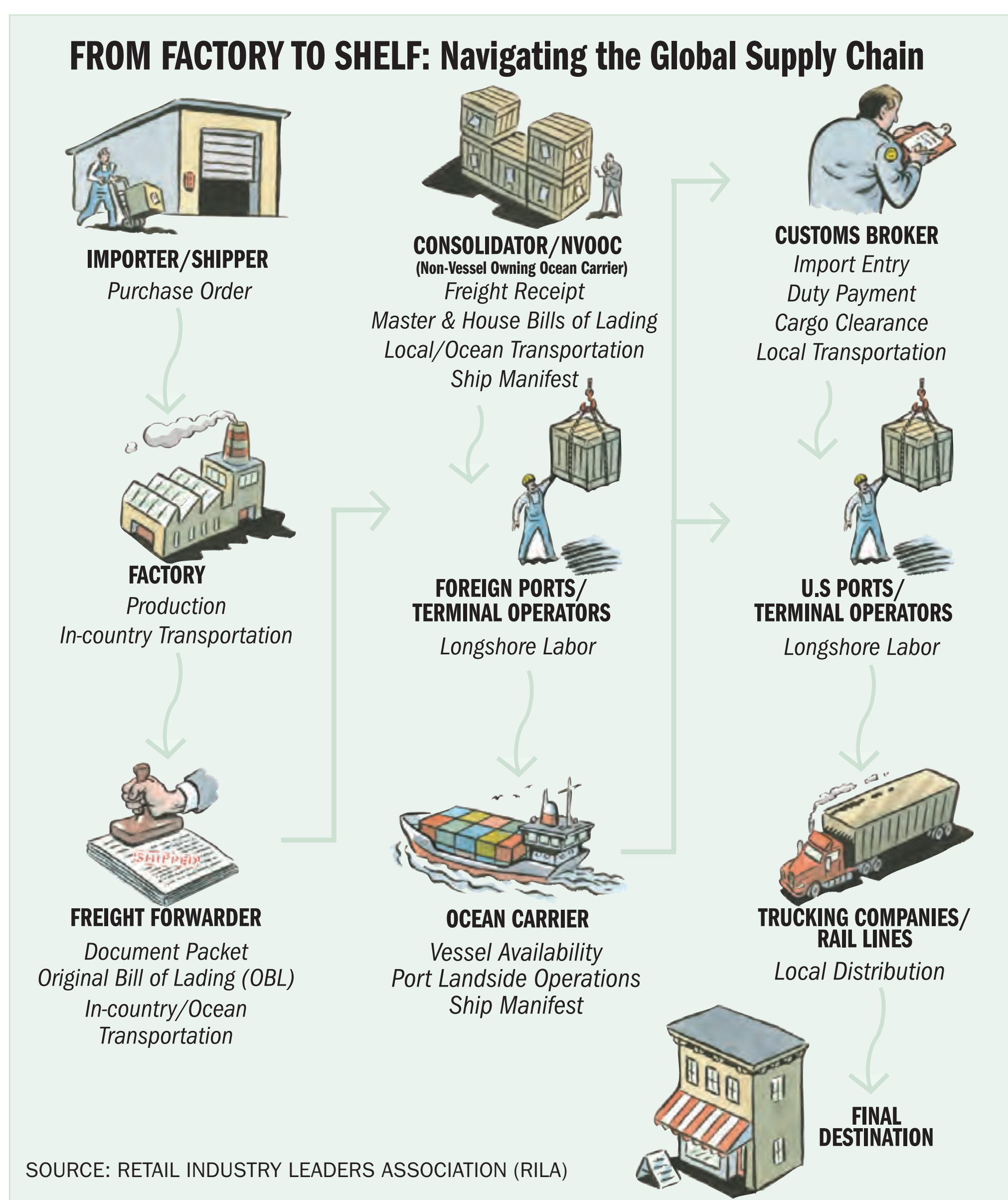
Breaking the Chain

There are so many documented threats to global supply chains: political instability, natural disasters, dock strikes, poor product quality, communications failures, currency risks, cyber attacks and even terrorism and pirates can break the chain of interlocking partnerships forged to achieve just-in-time manufacturing objectives, predicated on improving the return on investment by reducing in-process inventory.

Last year, the severing of undersea cables in India caused a communications blackout — telephones, computers and the Internet — that disrupted the flow of goods from that country to a broad range of global buyers. Domestic supply chain risks are another threat. A labor management dispute that closed several ports along the U.S. West Coast for nearly two weeks last year interrupted business as usual at hundreds of companies and cost the U.S. economy an estimated $19.4 million.

But of equal threat to the supply chain today is the weakened economy and unprecedented credit crisis. At stake is suppliers' ability to maintain necessary lines of credit and finance the working capital necessary to run daily operations.

A recent study released by Bain Corporate Renewal Group, a subsidiary of global consulting firm Bain & Company, predicts bankruptcies of U.S. companies with $100 million or more in assets will approach 100 in 2010.



"The body blows to industry supply chains will keep on coming through the end of the decade," says Sam Rovit, author of the study and managing partner of Bain CRG.

The risk of suppliers — or *their* suppliers — shutting down for one reason or another, putting the brakes on the orderly flow of goods, is all too real. Small wonder why "supplier failure and continuity of supply" was the primary risk factor cited by respondents to a survey last year by AMR Research of 89 U.S. manufacturing and retail organizations.

"Clearly, the supply chain is one of the biggest exposures a company confronts, since it affects its ability to meet its own customers' demands," says Linda Conrad, director of strategic business risk engineering at global insurer Zurich Financial Services.

Rich Rewards, Risky Business

The global supply chain is a phenomenon of the last quarter century, a cost-effective way for manufacturers and service companies to procure less expensive products and services from suppliers in emerging economies where labor expenses are low. How low? In China last year, the typical factory worker earned a bit more than one dollar per hour, compared with up to 30 times that in the U.S and Western Europe.

The U.S. is China's largest trading partner and China is now the second largest supplier of U.S. imports, trailing only Canada. It accounts for more than 40 percent of U.S. import container shipments. Along with some of the obvious rewards of sourcing in China come myriad risks that can impact supply chain stability.

Two years ago this was brought into sharp relief by serious quality issues associated with many goods sourced in China. A major U.S. toy manufacturer was forced to recall nearly one million toys — 83 products in all — produced with lead paint. In June 2007, 1.2 million space heaters, 5,300 earrings, 19,000 children's necklaces, 68,000 folding chairs, 2,300 toy barbecue grills, and 1.5 million Thomas the Tank Engine toys were recalled, all of them stamped "Made in China."

There is also the risk of a power failure in China shutting down supply: two thirds of the country's provinces regularly experience power shortages. "There is a tremendous concentration of manufacturers in China operating in regions vulnerable to floods, typhoons, earthquakes and potential electrical blackouts," explains Kenneth W. Davey, senior vice president of the international division at FM Global, a major business property insurance company. "In fact, one of those manufacturers employs nearly 300,000 people and is a key supplier to many major American brands."

Rising to the Challenge

While supply chain risks are challenging, they are not insurmountable. There is much companies can do to minimize risk. Ironically, global sourcing — the very thing that can jeopardize the supply chain — inherently has the means to provide solutions for maintaining business continuity. A solid strategy is identifying alternate suppliers in other parts of the world with desirable attributes that lower-costing primary suppliers may lack: reliable power grids and transportation, political stability, close proximity to raw materials and moderate weather, for example. This way, if a primary supplier fails on one continent, there is a "Plan B" supplier on another, ready to pick up the slack, circumventing major disruption.

Another strategy is preventing site disruptions by controlling where facilities are located within a given region; how they are constructed and maintained; and what work rules and safety regulations will govern employees, using engineering data to protect the site against fire, wind, water and other potentially catastrophic damage.

"FM Global had a client come to us that wanted to build in a flood plain," Davey recalls. "Our engineers produced an assessment recommending the company erect the plant with a raised first floor. The client was concerned given the extra cost — until a major flood hit the following year and they completely avoided any damage or business disruption."

A trend picking up momentum, borne out of necessity, is that of organizations building collaborative relationships with primary and secondary suppliers, extending assistance and support further down the supply chain to help ensure suppliers' continued health and competitiveness. The CEO of a major apparel maker in the U.S. recently reported that he loaned money to a secondary supplier for its routine operating costs because the company could no longer access credit from the commercial paper market. Were the company to fail it would create a domino-like cascade that would engulf other companies in its supply chain, he noted.

FM Global recently broadened its coverage to include secondary suppliers and beyond — the companies that supply its clients' suppliers. If business operations are interrupted because a supplier's plant burns to the ground, for instance, insurance coverage is provided.

The coverage enhancement sits well with Ensign-Bickford Industries, a Simsbury, Conn.-based diversity manufacturer of explosives assemblies, aerospace equipment and pet feed additives. "If we have a local supplier that sources its supply from companies in foreign countries, we now have insurance if those suppliers impact our ability to operate," says Rick Roberts, corporate risk manager at Ensign-Bickford.

Bottom-Line Benefits

Managing supply chain risk can prove costly. Choosing alternate suppliers in more developed countries with reliable infrastructure will undoubtedly prove more expensive than manufacturers in most emerging nations. Guarding against shortages by stockpiling raw materials adds cost, too. Building facilities according to stringent safety and engineering codes, having backup centers in place and investing in new-to-market technologies that provide greater pipeline tracking and transparency also come with a hefty pricetag.

But benefits are likely to outweigh cost when it comes to the bottom line. Mounting evidence suggests that well-run supply chains continue to outperform other companies. The average total return of companies on Boston-based AMR Research's "Supply Chain Top 25" in 2007 was 17.89 percent, compared with returns of 6.43 percent for the Dow Jones Industrial Average and 3.53 percent for companies in Standard & Poor's 500 Index.

Another study examined more than 800 public companies with reported supply chain disruptions between 1989 and 1998 and found when a company announces a supply chain malfunction such as production or shipment delays, its stock price tumbles nearly 9 percent, with losses that can be as great as 20 percent over six months.

Global supply chains are bound to become longer and therefore more tenuous — hence the need for effective risk management. Says Gary Lynch, global leader of the supply chain risk management practice at insurance broker Marsh and author of *Single Point of Failure*, "The onus is on companies to identify points of failure now, before one link fails and unravels the entire supply chain with it."

— R.B.

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