Reference Topic: How to conduct a risk management program

What are the elements in risk management?

Risk management and insurance go hand-in-hand. Without assessing your risks it will be unclear what needs to be protected and what insurance policies will be best suited to your needs.

Risk management is fast becoming the buzzword of the insurance industry as more and more businesses and organisations work towards stronger protection of their business and investments.

There are four elements to the risk management process:

- **Risk Assessment:** this involves identifying and quantifying the exposures that threaten an organisation's assets and profitability
- **Loss Control:** this is an analysis of the frequency and/or severity of losses
- **Risk Transfer:** moving the financial burden of loss so that, when a loss occurs an organisation can continue to function without threat to its financial survival
- **Risk Monitoring:** this is a continual process of assessing existing and potential exposure.

Using this process you can asses the risks involved with your business, analyse what your potential losses could be, the steps needed to mitigate such loss and ensure you are kept up-to-date on your business' needs.

Assessing your risk

The first vital step in the Risk Management Process therefore, is to understand the scope of all your potential losses and identify those risks that are relevant to your business.

This may sound relatively easy but you should make sure you assess every business operation you perform. When it comes to risks, ask yourself questions such as:

1. How can things go wrong?

2. How can this happen?

3. How likely is it to occur?

You should also assess business operations which you don't carry out but which have a direct impact on your business. For instance, look at suppliers, contractors, stockists, etc. It also important to look at the "big picture". This means not just what is happening in your own "backyard".

Depending on the nature of your business, you may want to assess risks that could impact on your business from a state, national or international point-of-view. For instance, rising interest rates could be a risk to your business if you have, or plan to, take out a business loan.

You will also need to look at the likelihood of a particular risk becoming a reality. List these risks in regard to their possible occurrence from highly likely to not likely. This way you will instantly be able to recognise those risks which pose the biggest threats.

Once you have identified a risk, you must assess the consequences that could be inflicted on your business if such a risk was to occur, ie severity. You can also look at the likelihood or frequency of the risk occurring.

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By understanding what the consequences will be you can put particular measures in place to minimise loss and the severity of impact. Outline the worst case scenario and best case scenario for each risk. Assess each risk consequence against the following criteria:

1. Revenue
2. Cost
3. Investment
4. Time
5. Quality
6. Reputation
7. Health and safety
8. Damage/impairment

As part of your risk management approach you should also investigate and incorporate the following:

- **Developing a Loss Prevention strategy.** This strategy should investigate ways to alleviate the threat of loss to a particular business. This can be done on a number of levels, including security, safer business or workplace practices and adequate insurance coverage.
- **Creating a Contingency/Business Continuity Plan.** Such a plan will give you a clear direction of the tasks you need to undertake in the event of a loss or accident. It will mean your business will be prepared if it suffers a major loss such as a fire, theft or workplace accident.

It is also important to remember in some business decisions there are bound to be risks. Just because there is a risk does not mean you should avoid a particular business proposal all together. Put the risk management concept into play and break down the risk. Pinpoint the likelihood of risk, the severity of the risk and its consequences.

Once you have weighed up these options you can make an informed decision and put in place protective measures if, for instance, the particular deal turns sour and your business is left in a financially vulnerable position.

Loss control - The second phase

The second major element of the Risk Management Process is loss control. Outlined below are the steps necessary to evaluate and control possible losses which could have an impact on your business.

- **Identify controls.** You should now work on preventive controls/measures to put in place which can reduce the likelihood or consequence of the risks you have identified. As part of the process of identifying these controls, you should also formulate a budget to cover any additional costs involved in implementing loss prevention measures.

  You should then list these controls based on their importance and adequacy. Also assess the timeframe in which you will be able to successfully put these controls in place. Controls can include specific insurance policies to cover risk exposure or simply avoiding those activities that you have determined to be too hazardous.

- **Calculate exposure levels.** Evaluate the current exposure position based on combining the assessment of likelihood, consequences and controls. Here it is important to compare your level of exposure to risk in relation to the predetermined level of tolerance your business would be able to cope with. By this we mean analysing the risks and the impact on your business and identify those risks that your business would be able to tolerate while continuing to operate. This will give you an indication of the level of strain your business can be placed under before operations begin to crumble.
- **Treatment of your risks.** This may sound similar to identifying controls but in fact, it means prioritising those controls and analysing the correct treatment for the controls you have

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highlighted. You should select from the following "treatment options" ways to treat the highlighted control measures:

1. Accept
2. Avoid
3. Transfer
4. Reduce Risk
5. Reduce Consequences
6. Risk Financing
7. Insurance protection.

Once you have assessed the control measures by using the "treatment options" you will know from what angle to address the controls. For instance, in some cases you may not be able to do anything more to reduce the risk but you could take action to reduce the impact of the consequences as a result of that risk.

Having completed a risk management assessment, you should now be aware of the risks your business faces, the controls you need to put in place and the methods you will use to put these controls in place.

This will also give you a guide to the appropriate insurance policies to protect your business.

Risk transfer - The third element

The third element of risk management is deciding who will bear the risks. The options are for the business owner to:

- **Retain the risk:** Here the business owner decides that probability of loss is low and there is a manageable value of loss.

  An example might be a company with several well-maintained but older vehicles whose drivers have a good safety record. They travel country roads where the risk of collision is less, therefore the owner might decide not to take out comprehensive cover which would insure the vehicle against accidental damage.

- **Transfer all or part of the risk to an insurance company:** This involves either taking out full insurance coverage or taking out a higher excess or deductible.

  From the example above, this would mean taking out a higher excess or deductible with the comprehensive cover for the vehicles, thereby reducing the premiums.

- **Non-insurance options:** These would be alternative options to insurance where the decision is to transfer all or part of a risk.

  Continuing the example above, in this instance the company would sell its old vehicles and either hire vehicles as and when necessary or use a transit company.

One of the best ways to make sure your business is properly protected is through a well-designed insurance policy. Insurance gives you peace of mind that, in the event of a major loss, you will have financial support as you rebuild your business and cope with the impact.

You need to ensure you have adequate insurance coverage for several reasons:

- There is a chance that an event such as a fire, storm or flood will damage your business' assets to such an extent that you may have to close

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- You may depend on your business and its revenue for your livelihood and therefore you need to protect it
- Some forms of insurance are compulsory by law eg. workers compensation, motor vehicle third party
- Some financial institutions will insist that a business is insured before granting business loans or mortgages in order to protect their financial interest
- Some landlords will insist that a tenant is fully insured.

Many small businesses do not have the cash or borrowing capacity to even consider retaining any part of a risk by not taking out insurance. Therefore their main options are the insurance or non-insurance options mentioned previously.

Insurance coverage for one business can be different to that of another business. Many small businesses are now insured under package policies that cover the major property and liability exposures, as well as loss of income. Generally, these package policies provide the small business with a more complete coverage at a lower price than purchasing the individual policies separately with different insurers.

Besides, different types of businesses will have different insurance needs, for example, a restaurant will face different risks and have different insurance requirements than an engineering factory.

However, in some cases, business owners decide it is worth the risk not to take out full insurance. In effect, these businesses then are partly or wholly self-insured.

Self-insurance

Self-insurance is one option to consider when considering the issue of risk transfer. Following the collapse of HIH, many business operators questioned whether they should pay for insurance or consider self-insurance.

Self-insurance involves taking other steps to cover potential losses, such as putting money aside in case it is needed.

This can be an attractive option to many small businesses as they feel they are in control of their future and their surplus funds.

Many businesses feel that if they carefully assess their operations they will be able to identify their areas of risk. If they carefully manage anything considered to have low risk, and put in place good risk management strategies, they feel they will be better able to afford to put money aside or take out insurance for specific high risk factors.

However, there are a number of associated advantages and disadvantages of self-insurance.

Self-insurance advantages and disadvantages

One of the main advantages is that self-insurance eliminates the cost of an annual insurance premium. The money saved can go into a specific account and increase the wealth of the business.

Another associated benefit is that self-insurance tends to reduce the occurrence of incidents usually resulting in an insurance payout. This may be because insurance contributes to business complacency, thereby reducing the level of effective risk management practices and safety precautions adopted by the business. Moreover, self-insurance protects your business from the inconvenience or potential losses associated with the collapse of an insurer.

One of the main disadvantages of self-insurance is that it exposes a business to significant expense and hardship if the business operator fails to identify and improve the key risk factors associated with

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it. In particular, liability claims can lead to damages and legal costs amounting to millions of dollars, which few businesses can afford.

Business operators may also become more adverse to taking risks and become tentative in their decision-making. This could inhibit the growth potential of the business. Additionally, self-insurance may curtail business activities. This is because many financial service providers, especially banks, want to see evidence of risk management efforts and may require certain types of insurance before they provide business finance. Suppliers may also be deterred from dealing with a business that is not insured.

Risk monitoring - The final phase

The final major element of the Risk Management Process is risk monitoring. Like any managerial or organisational planning process, the risk management process should be continual or on-going.

Once you have created your Risk Management Plan, including a contingency plan and loss prevention strategy, you should ensure that steps are in place to monitor, review and update it at regular periods. This ensures that any risks that are no longer relevant can be eliminated and any new risks are picked up.

Inevitably, after the business has identified and assessed each of the business risks, there may be a need to change/alter/modify the risk approach. Making sure you monitor risk is important.

There is no point having protection in some areas but leaving your business open to new risks in other areas because your periodic risk monitoring assessments have lapsed.

The review can also highlight whether there have been some risks you catered for which were underestimated and could therefore cause potential financial concerns to the business if they were to occur.

Risk monitoring can be made an annual event, however, it is also worthwhile undertaking a risk assessment whenever your business undergoes minor or major changes. These changes can include new machinery or equipment or additional staff.

Using a risk management specialist

If you feel you cannot carry out your own risk management assessment or you do not have the time, there are specialists in the field who can conduct one for you.

The best place to start is by looking in the **Yellow Pages** under risk management consultants. You may also want to ask friends, business associates or your insurance agent or broker.

According to research, small businesses can expect to pay approximately $300 to $500 for a basic risk management review.

There are also consultants available in specialised fields such as engineering, sport, financial risk management, environmental, aviation, etc. It is extremely important to make sure any consultant your choose has the necessary experience.

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Risk management software

If you want to take your risk management assessment one step further, there is also specialised risk management software available.

Palisade is one of the world's leading developers of software for risk and decision analysis. Its @RISK software product is a risk analysis and simulation add-in for Microsoft Excel or Lotus.

It integrates and uses a technique known as Monte Carlo simulation to allow you to take all possible outcomes into account. For more information see the company's Web site at www.palisade.com.

Decisioneering is another software company which produces forecasting and risk analysis products. Its Crystal Ball 2000 – Standard Edition also uses Monte Carlo simulation for risk analysis with Excel spreadsheet models. See www.decisioneering.com for more details.

Risk management work sheet

Having identified the risks specific to your business, use the following table to assess the impact those risks could have on the listed areas of business. This will help you to prioritise the risks.

RISK #1:			
	HIGH IMPACT	MEDIUM IMPACT	LOW IMPACT
Revenue			
Cost			
Investment			
Time			
Quality			
Reputation			
Health & Safety			
Impairment			
Damage			
RISK #2:			
	HIGH IMPACT	MEDIUM IMPACT	LOW IMPACT
Revenue			
Cost			
Investment			

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Time			
Quality			
Reputation			
Health & Safety			
Impairment			
Damage			
RISK #3:			
	HIGH IMPACT	MEDIUM IMPACT	LOW IMPACT
Revenue			
Cost			
Investment			
Time			
Quality			
Reputation			
Health & Safety			
Impairment			
Damage			

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Checklist

Use this checklist as a guide to starting the Risk Mangement process. Its aim is to make you aware of the different aspects of risk and loss prevention you will need to conisder.

RISK MANAGEMENT POINTS	YES	NO	COMMENTS
Have you identified your risks?			
Have you determined the severity of each risk?			
Have you determined the likelihood of the risk eventuating? For example, how likely is it to occur?			
Have you outlined the worst case scenarios if a particular risk was to eventuate?			
Would there be any business opportunities that could result from a particular risk?			
Have you identified the key objectives of your business?			
Have you put controls in place to minimise the possible loss or impact on your business?			
Have you developed a timeframe for the risk controls to be implemented?			
Have you developed a budget to cater for the necessary risk controls as part of your Risk Management Plan?			
Have you developed a loss prevention strategy?			
Have you developed a Contingency Plan?			
Have you considered the issues of risk transfer? For example, have you considered whether you will accept, avoid, transfer, reduce risk or take out insurance?			
Have you developed a risk monitoring program to review business risks?			

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