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The New Risk Environment

Managing risk remains a challenging undertaking... the good news in a somewhat deeply disturbing risk environment: the problem is soluble. "In the long run," emphasizes the "Risk Landscape" report, "even complex risks can be understood well enough to be successfully handled."

The scene was chilling. With several days' warning, government officials were quick to urge residents of coastal Texas to evacuate prior to the arrival of then-Category 5 Hurricane Rita. And residents responded: with memories of Hurricane Katrina still fresh in their minds, they loaded up cars, vans, and buses and headed northward.

And then they waited.

Freeways north of Houston and other communities were so jammed with traffic that cars sat idle for hours. Many vehicles ran out of gas and were left stalled on the roadways, only worsening the congestion. As the hurricane neared landfall, tens of thousands of people remained stranded, many only miles from their homes.

One is prompted to ask: are we really prepared to handle a crisis on a catastrophic scale?

THE GROWING CONSEQUENCES OF RISK

The question is more than theoretical. According to a recent report entitled "The Risk Landscape of the Future," by global reinsurance provider Swiss Re, the risk environment is changing dramatically in ways that are just now beginning to penetrate the public's consciousness. "Since the 1970s," the group writes, "the number of serious natural catastrophes and technical disasters has increased…. The period from 1900 to 1928 showed an average of 1.7 disasters a year in the U.S. whereas between 1980 and 1989 there were 18. Over the past ten years, the number has risen to more than 38 events" per year.

Beyond their obvious and painful effect on communities and families, such events can have devastating consequences for businesses as well. Scores of companies, including some large and well-established firms, were virtually destroyed by the 9/11 terrorist attacks. The power failures in California two years earlier caused business productivity losses of $12.8 billion. More recently, the International Risk Management Institute estimates, as many as half of the businesses affected by Hurricane Katrina had no disaster

from the top. David Nicastro of Sure Source, Inc., an international risk consulting firm, argues that "senior management needs to embrace the notion that it's worth investing time and money into the processes, procedures, and materials needed to protect employees, proprietary assets, and the communities they serve."

Finally, there must be a method in place that adequately identifies, evaluates, and protects against the impending consequences of high-expected-value corporate risks across the enterprise. In the past, many corporate risk management programs operated in rigid silos—industrial risk management was the responsibility of the facilities manager, investment risk the responsibility of the chief financial officer, and so on. With the increasingly enterprise-wide nature of risks in general and solutions like ERM in particular, risks need to be viewed on a broader scale, free of political or departmental barriers, if they are to be adequately contained.

INTELLIGENTLY MANAGING RISK

Managing risk remains a challenging undertaking, not only because the nature of the risk environment has changed dramatically, but because the future—the province of risk management—is inherently unknowable. But tools like Enterprise Risk Management, especially when accompanied by adequate knowledge and tools and high-level corporate commitment, now make it possible to understand and prepare for risk much better than ever before. And that's the good news in a sometimes deeply disturbing risk environment: the problem is soluble. "In the long run," emphasizes the "Risk Landscape" report, "even complex risks can be understood well enough to be successfully handled."

* PLANNING TO MANAGE RISK *

Developing an effective Enterprise Risk Management (ERM) program is a necessary but often challenging task in the new risk environment. As Mark Carey, CEO of DelCreo, Inc., a leading ERM consulting firm, points out, "Many risk managers lack formal training and experience in several areas that are critical to a successful risk management program, including strategic and business planning. As a result, many risk managers find it difficult obtaining necessary management buy in, time, and attention."

Fortunately, these problems usually can be remedied through a carefully thought-out ERM development plan. Carey, who serves as the ERM Expert Commentator for the International Risk Management Institute, suggests four key steps that not only will help secure adequate management attention and funding for an ERM initiative, but lead as well to an effective implementation once the program is launched:

- **Define objectives.** *Demonstrate that the ERM program recognizes and takes into account the company's ongoing corporate objectives, and define the program's role in ensuring that the company can continue to fulfill these objectives both during and after a crisis.*
- **Demonstrate value.** *Clearly document both the costs of the ERM program and its likely benefits for a range of potential risk scenarios. Specify how these costs and benefits will be measured, and then demonstrate for each of the scenarios how the ERM program yields significant value to the company by preserving its ability to fulfill ongoing corporate objectives.*
- **Focus the program.** *Even the most effective ERM programs cannot achieve everything. This is particularly true during a crisis, when normal procedures and communication channels may be impaired. Therefore, beginning in the planning stages, carefully focus the ERM program on a few well-defined goals, such as: (1) which specific risks the program will manage; (2) which risk management processes, technologies, and investments will be required; and (3) how these efforts will be coordinated across the enterprise. Once this focus is defined, clearly communicate it to all program stakeholders.*
- **Be thorough.** *Your program should cover all of the aspects of strategic planning that are vital to the program's success, such as a clear assessment of the company's current risk management efforts, the potential risks and associated costs the company is likely to encounter during a crisis, the road map for implementing the ERM program, the specific resources required, the performance measurement mechanisms to be used, and the benefits that will accrue to the company and the stakeholders when the program is in place.*

Carey emphasizes that a comprehensive ERM program, of course, involves other factors than these. However, he notes that risk managers who get these fundamentals right from the outset "tend to be more successful in implementing an effective ERM program."

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recovery plan, and most may never be reopened.

In addition to natural disasters, corporations face a growing panoply of operational risks—serious challenges that have come to attend nearly every phase of day-to-day corporate operations. The accounting scandals that destroyed Enron, WorldCom, and Arthur Andersen produced a tougher compliance regime that now costs the average public company some $5 million to $7 million a year. The cost of Internet interruptions in terms of lost business transactions, the Insurance Information Institute estimates, can easily reach into the millions. Computer viruses alone cause more than $13 billion in damage a year, according to the American International Group's eBusiness Risk Solutions. The tort liability price tag for small businesses in America is quickly approaching $100 billion a year. And the list goes on.

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These risks can multiply as companies move overseas, notes Atradius, Inc., a global leader in credit insurance. Insolvencies, protracted defaults, and other creditor problems that are difficult to handle within a single country can become virtually impossible to resolve in a timely fashion across borders. With international trade becoming a more central part of most companies' operations, payment problems with a single large foreign creditor can be potentially devastating for companies without credit insurance.

THE EXPECTED VALUE OF RISK

This exponential increase in the consequences of risk requires that corporations begin thinking about risk in a dramatically new ways. Previously, notes the Swiss Re report, corporations typically worked to reduce the probability that the most commonplace risks would take place. Hence, fire-prevention measures, industrial safety precautions, product quality control procedures, and investment safeguards were at the top of most risk managers' agendas. Less likely risks received considerably less attention because their probability of occurrence was so low.

As the consequences of potential risks increase, however, the probability of a given risk's occurrence cannot be the only concern. Economists use a measure called "expected value" to assess risk. Expected value is simply the predicted cost associated with a risk weighted by its likelihood of occurring. A $10 million catastrophe with a 1% chance of occurring, for instance, has an expected value of $100,000. One key implication of this calculation is that, as the predicted costs increase, the expected value can skyrocket, even if the risk's probability remains low. To continue the example, if the predicted cost of a risk rises to $10 billion, even an extremely low probability of 0.01% yields an expected value of $1 million.

To be sure, corporate risks that have very high expected costs but that are unlikely to occur within any given time period require a much more careful balancing of costs and benefits than more commonplace but less costly per-incident risks like shop floor accidents. They also require assessments that encompass the entire enterprise. In the past, the cost of a defective product may have been nothing more than the replacement fee. Now, when defective products can lead to multi-billion-dollar class-action lawsuits and scathing media coverage, a company's very existence can be imperiled. Suddenly, every corporate department becomes a vital player in the risk assessment and prevention process.

ENTERPRISE RISK MANAGEMENT

In response to the spreading ramifications of risk, a growing number of corporations are adopting a strategy called "enterprise risk management," or ERM, to improve their risk management capabilities. A recent survey of 271 risk management executives by the Conference Board and Mercer Oliver Wyman discovered that, while only 11% of firms had completed their ERM implementation, fully 90% were either building or intending to build such processes into their organizations.

Enterprise Risk Management is exactly what it appears to be: an enterprise-wide method of gauging, preparing for, and responding to risk. ERM requires an entirely new way of thinking about risk, and is not without its own challenges (see box). But it also may offer corporate leaders their best hope of managing the widening array of ever-more dangerous risks.

Assessing and implementing risk management strategies like ERM that are designed to deal with unlikely but high-expected-value risks starts with adequate knowledge. Recognizing this need, XL Insurance, a leading international insurance firm, has created a database called LossLink that documents the known costs of a wide variety of potential disasters and other insurable incidents that help corporate risk managers improve their risk calculations. Beyond requiring baseline facts like these, risk managers also need to be able to translate what can be vast arrays of information into actionable intelligence. Indeed, notes Jerry Miccolis, a former principal with Tillinghast-Towers Perrin, one major reason that many corporate managers have been frustrated with their progress on risk management is the lack of adequate risk modeling tools. But newer, causally based models offer substantial improvements over previous statistically based models.

Once the knowledge and tools have been developed, they need to be accompanied by commitment. And almost always, that commitment must come