A Summary of Risk Management for Business

A business faces a wide variety of risk exposures to economic loss arising from events such as destruction of property, interruption of business, adverse liability judgment, criminal activity and statutory authority. Each exposure threatens the assets and earning power of the business (without a chance for gain) and this "pure risk" must be identified, evaluated and treated prior to its occurrence.

The challenge for the business owner is to choose the best method of treating each loss exposure. Some losses can be financially devastating, literally wiping out the assets of the business; while others involve only minor financial consequences. The potential severity of a loss and the business's ability to absorb it financially are key factors in the process of choosing a risk treatment method. The six most common methods are to: reduce, eliminate, retain (assume) and transfer risk through the purchase of insurance. Self insurance and risk financing methods require broad analysis and planning.

The objective of risk management is to determine the most economically feasible method of treating risk which protects the assets and earning power of the business. The goal is to reduce the cost of risk by properly managing its consequences before a loss occurs. Here is the six-step procedure of a risk management plan:

1. Determine the financial goals of the risk management program.
2. Identify the risks facing the business.
3. Evaluate the risks for potential size and priority.
4. Select the risk treatment method(s), based upon the goals established in 1. above.
5. Implement the decision.
6. Continually review and evaluate its performance.

Step 1 above is crucial to the overall success of the procedure but is too-seldom used. It begins by determining the annual financial loss a business could sustain, assuming it retains all insurable risks and purchases no insurance what-so-ever. (Wouldn't that be grand?) It is a business stress point for pure insurable risk, above which not one additional dollar is to be retained; to do so would unduly threaten business working capital or credit. This stress point is termed the annual Aggregate Retention Level (AGR). It is broken down into its individual risk components, such as liability, property, surety, etc. Once again, any individual risk component value lying above its Maximum Retention Level is not to be retained. Calculating business Maximum Retention Levels is crucial to the success of the risk management plan. Similarly, a Minimum Retention Limit is calculated, below which risk may be retained through self-retentions and deductibles - more on the Minimum Retention Level below.

Steps 2 and 3 of the procedure utilize a commercial risk exposure survey to identify, quantify and prioritize pure business risk. Steps 4 and 5 provide for the selection and implementation of each risk treatment method. Step 6 adds the requirements of record keeping and performance monitoring.

Though risk component values lying above and below the limits defined above are generally handled as described, several risk management axioms provide additional guidance and add flexibility in risk treatment decisions. They permit limits to be moved logically up or down to maximize cost efficiency, i.e., find the sweet spot. Within axiom 2 below, a common example is to increase a deductible to its point of diminishing return; where a larger deductible no longer saves premium sufficient to warrant the increased exposure. The deductible can then efficiently differ from its risk component's Minimum Retention Limit. Here are a few risk management axioms:

1. When the potential severity of loss is great, retention is not feasible and the exposure to loss must be reduced to a manageable level or transferred. The probability that a loss may or may not occur is less important than the severity of the loss. Don't risk more than you can afford to lose.
2. When the possible severity of the loss is small, the risk should be retained. Set retentions and deductibles at appropriate cost effective levels to accomplish this task.
3. When the probability, or likelihood, of a loss is high, risk reduction through safety and loss prevention techniques are the most appropriate methods of dealing with the exposure, unless the severity is also great, at which time the Insured and insurance carrier engage in dollar trading, i.e., coverage premiums for claims settlements. Consider the odds.
4. The best buys in insurance are those in which the probability of loss is low and the potential severity is high. Don't risk a lot for a little premium.
5. The worst buys in insurance are those in which the probability of loss is high and the potential severity is low.