Enterprise Risk Management – A strategic tool for the middle market

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Learning Objectives

• Introduce Enterprise Risk Management (ERM) framework and Strategic Risk Management (SRM) concepts

• Develop business case for SRM in the middle market

• Provide participants with know-how and tools to implement SRM in their organizations
Traditional Risk Management

• Organizations often make substantial investments in personnel, processes and technology in an attempt to mitigate and control business risk.

• Risk control efforts are often focused on insurance, financial controls, and regulatory compliance.

• Senior executives may fail to recognize the importance of risk management as strategic to the enterprise.
Risk Management Process

• The identification, analysis, assessment, control, and avoidance, minimization, or elimination of unacceptable risks or uncertainty

• Techniques include:
  − Risk Avoidance
  − Risk Reduction
  − Risk Transfer
  − Risk Retention

• Traditional risk management is focused primarily on negative risks and outcomes.
Risk is the effect of **uncertainty** on objectives
Impact of Unidentified Risk

What keeps you up at night

What *should* keep you up
Insured and Uninsured Risk Exposures

**Physical Asset Risk**
- Property Insurance
- Fire/Water Damage
- Flood, Sewer Back-up
- Earthquake
- Theft/Employee Dishonesty
- Computer Equipment
- Business Interruption
- Extra Expense
- Transit Insurance
- Equipment Breakdown
- Owned or Leased Vehicles
- Contractors Equipment

**Commercial Liability Insurance**
- Bodily Injury / Property Damage Liability
- Tenants Legal Liability
- Personal Injury Liability
- Advertising Injury Liability
- Employers Liability
- Non-Owned Automobiles

**Legal Risk**
- Directors & Officers Insurance
- Securities Actions
- Employment Practices
- Statutory Liabilities
- Competitor Disputes
- Fiduciary Liabilities
- Side A DIC

**Errors & Omissions Insurance**
- Financial Damage to Customers and Third Parties
- Intellectual Property Right Infringement
- Disclosure of Confidential Information

**People Risk**
- Employee Benefits / Life Insurance
- Employee Benefits
- Flex Benefits
- Executive Benefits
- Life Insurance
- Long Term Disability
- Critical Illness
- Shareholders Coverage
- Key Person Life
- Group Retirement Planning

**Other**
- Kidnap & Ransom
- Cyber Data Risk
- Environmental / Pollution
- Political Risk
- Trade Credit
- Personal Insurance
- U.S. Admitted Paper
- Contract Review
- WSIB Audits
Risk Categories

Control Source

Good Decisions

Good Rules

Risk Categories

Enterprise

Strategic

Financial

Operational

Compliance & Reporting

Level/Representative Risks

- **Board-level concern**
  - Threats to firm viability—considered mission critical

- **CEO and executive committee—level concern**

- **Business unit and functional-level concern**

- **Business unit and functional-level concern**
Risk Optimization

The Payoff: Companies with more mature risk management practices generate the highest growth in revenue, EBITDA and EBITDA/EV.

* 2011 YTD reported as of 18 November 2011.
Risk Optimization

• Consider both the upside and downside of risk taking activities

• When threats and opportunities to the organization are fully understood, risk taking can be optimized by senior leadership

• Informed decision making enables the organization to quickly deal with emerging risks and challenges in the marketplace
ERM Framework

1. Risk Identification

2. Risk Analysis

3. Risk Assessment

4. Risk Treatment

5. Monitoring

6. Evaluation

Enterprise Risk Management Framework
ERM Quadrants

Strategic
- Competition
- Growth Strategy
- Customer Preferences
- Reputation
- Marketing

Operational
- Accounting Processes
- Manufacturing
- Information Technology

Financial
- Market Risk
- Liquidity
- Cost of Capital

Hazard
- Employee Injuries
- Natural Hazards
- Third Party Liability
Strategic Risk Management

• Uncertainty presents risk and opportunity

• SRM applies across an organization to determine how much uncertainty to accept in the achievement of its objectives.

• The organization should clearly define its risk appetite, which in turn should support the overall growth strategy of the company
SRM – Key Concepts

Strategic risk management encompasses:

• Aligning risk appetite and strategy
• Enhancing risk response decisions
• Reducing operational surprises and losses
• Identifying and managing multiple and cross enterprise risks
• Seizing opportunities
• Improving deployment of capital
Strategic Risk Categories

- Market Risk
- Customer Risk
- Reputational Risk
- Investor Risk
- Partnership Risk
- Planning Risk
- R&D Risk
- Supply Chain Risk
Example of SRM – Crisis Communications

• The advent of smartphones and social media platforms has created a 24 hour news cycle, organizations must be nimble and prepared to respond

• Proactive crisis communications could reduce overall reputational risk and preserve brand reputation in the face of a catastrophe

• SRM is used to identify and treat reputational risk exposures

Play Video Clip
An NYC based general contractor and construction manager, with annual revenue of ~ $50M, specializes in tenant fit-outs and renovation projects. Opportunity arises to do a ground-up new construction project, which the firm hasn’t done in over 10 years.
Case Study: Two Tales of One City

When half a year’s rain came down in one day, numerous communities in Alberta, Canada, were flooded. High River, a small town south of Calgary, was evacuated. What’s worse: the water didn’t recede on its own; it had to be pumped out.
SRM Analytical Tools

- SWOT
- Risk Metrics (KPIs and KRIIs)
- Risk Registers
- Risk Matrices / Heat Maps
SWOT Analysis

- **Strengths**: Helpful to achieving strategic goals
- **Weaknesses**: Harmful to achieving strategic goals
- **Opportunities**: Internal attributes of organization
- **Threats**: External attributes of environment

**SWOT**

- **Strengths**
- **Weaknesses**
- **Opportunities**
- **Threats**
Metrics – KPIs & KRI s

KPI – Key Performance Indicators
• KPIs help the organization understand how well it is performing in relation to strategic goals.
• Lagging indicators
• Must be measurable to be effective
• Examples: Revenue, hours worked, customer satisfaction, order lag or wait time, etc.

KRI – Key Risk Indicators
• Indicators of risk to overall business performance
• KRI s are leading indicators
• May provide early warning to potentially disruptive event
• Examples: Number of suppliers with no disaster plan, turnover of mission critical IT personnel, identification of production bottlenecks, “near miss” incidents, etc.
Risk Evaluation: Quantitative Scaling

• Determine whether a risk is acceptable or unacceptable

• Compare estimated levels of risk against pre-established criteria – *risk tolerance*

• This enables risks to be ranked according to identified management priorities

• Risk registers are excellent tools to conduct quantitative risk evaluation
Risk Matrices / Heat Maps

The diagram illustrates a risk matrix with axes for Likelihood and Severity.

- **Very Low** to **Very High** scales are used for both Likelihood and Severity.
- The matrix uses different shades to represent severity levels, with lighter shades indicating lower severity and darker shades indicating higher severity.

### Explanation:

- **Very Low** to **Very High** on the Likelihood axis corresponds to **Very Low** to **Very High** on the Severity axis.
- The matrix uses color gradients to visually represent the risk levels, with colors transitioning from green (low severity) to red (high severity).

By mapping likelihood and severity levels, organizations can identify areas of high risk that require attention and mitigation strategies.
# Quantitative Risk Scoring Example

<table>
<thead>
<tr>
<th>Impact (Rating 1-10) 1=Low, 10=High</th>
<th>Likelihood (Rating 1-10) 1=Low, 10=High</th>
<th>Assurance (Rating 1-10) 1= Good Controls, 10=Not Controlled</th>
<th>Inherent Risk Index (Impact x Likelihood)</th>
<th>Residual Risk Index (Inherent x Assurance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>7</td>
<td>5</td>
<td>56</td>
<td>280</td>
</tr>
</tbody>
</table>
## Creating a Risk Register

<table>
<thead>
<tr>
<th>Risk Category</th>
<th>Category</th>
<th>Question</th>
<th>Risk</th>
<th>Risk Description</th>
<th>Who</th>
<th>Year</th>
<th>Impact (Rating 1-10)</th>
<th>Likelihood (Rating 1-10)</th>
<th>Assurance (Rating 1-10</th>
<th>1- Good Controls</th>
<th>Inherent Risk Index (Impact x Likelihood)</th>
<th>Residual Risk Index (Inherent Risk Index - Impact)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Risks</td>
<td>S</td>
<td>S10</td>
<td>Market Decline Risk</td>
<td>The risk that advances or changes in technology, the business environment, and/or consumer habits will drastically shrink the number of available clients</td>
<td>Internal Audit</td>
<td>Yes</td>
<td>8</td>
<td>7</td>
<td>5</td>
<td>56</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Strategic Risks</td>
<td>S</td>
<td>S11</td>
<td>Merger &amp; Acquisition Risk</td>
<td>The risk that the organization engages in a merger and acquisition process that improperly values and prices the target, lacks sufficient due diligence and/or executes poorly.</td>
<td>Marketing</td>
<td>Yes</td>
<td>8</td>
<td>5</td>
<td>5</td>
<td>40</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Strategic Risks</td>
<td>S</td>
<td>S12</td>
<td>Outsourcing Risk</td>
<td>The risk that our outsourcing company becomes too large and/or third parties may result in third parties not acting within the intended limits of their authority.</td>
<td>Underwriting</td>
<td>Y</td>
<td>8</td>
<td>5</td>
<td>5</td>
<td>40</td>
<td>200</td>
<td></td>
</tr>
<tr>
<td>Strategic Risks</td>
<td>S</td>
<td>S13</td>
<td>Staff Shortage Risk</td>
<td>The risk that the company does not have an employee talent pool deep enough to absorb staff departures.</td>
<td>Legal</td>
<td>Y</td>
<td>6</td>
<td>6</td>
<td>5</td>
<td>36</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>IT and Systems Risks</td>
<td>I</td>
<td>I</td>
<td>Data Risk</td>
<td>Network breaches by third parties resulting in our systems or our network going down, loss of data, violation of data privacy or unauthorized access to confidential information</td>
<td>Underwriting</td>
<td>Y</td>
<td>7</td>
<td>5</td>
<td>5</td>
<td>35</td>
<td>175</td>
<td></td>
</tr>
<tr>
<td>Strategic Risks</td>
<td>S</td>
<td>S14</td>
<td>Geographic Dispersion Risk</td>
<td>The risk that the concentration of certain aspects of the business causes the company to be overly dependent on certain geographic markets.</td>
<td>Internal Audit</td>
<td>Yes</td>
<td>5</td>
<td>7</td>
<td>5</td>
<td>35</td>
<td>175</td>
<td></td>
</tr>
<tr>
<td>Legal and Compliance Risks</td>
<td>L</td>
<td>L13</td>
<td>Labor/Staff Risk</td>
<td>The risk that failure of the company to protect the rights of the employees, including but not limited to violations in child labor, disability, employment discrimination for all hiring, class, race, or gender</td>
<td>Underwriting</td>
<td>Y</td>
<td>7</td>
<td>5</td>
<td>5</td>
<td>35</td>
<td>175</td>
<td></td>
</tr>
</tbody>
</table>
Risk Treatment

• Utilizing a Risk Register enables the organization to prioritize treatment of individual risks, based upon strategic goals of organization.

• Risks considered “mission-critical” should be prioritized.

• Treatment strategies:
  − Avoidance
  − Risk transfer
  − Risk control
  − Acceptance / risk bearing
  − Combination of above methods
Best Practices

Organizations that succeed in turning risk into results will create competitive advantage through:

- More efficient deployment of scarce resources,
- Better decision-making and,
- Reduced exposure to negative events.
Best Practices

Enable Risk Management, Communicate Risk Strategies

• Move from being risk-averse to risk-ready
• Communicate risk strategies across the organization
• Champion risk management strategies at the executive level
Best Practices

Enhance Risk Identification

• Unforeseen events will occur
• Actively identifying the current and emerging risks an organization faces enables it to develop reactive strategies to ensure they have the agility, and ability, to respond quickly

Mitigation → EVENT → Recovery
Best Practices

Embed Risk Management

• Understand that risk is inherent.
• Develop risk management strategies that enable the business.
• Recognize the links between business activities, technology, and risk strategies – how do they fit together?
Best Practices

Optimize Risk Management Functions

• Siloed activities will undermine an organization, increase costs, and create confusion and duplication of activities.
• Align monitoring and control functions to the risks that matter most.
• Apply a consistent approach to risk management across the organization to ensure risk functions “speak the same language.”
Best Practices

Improve Controls and Processes

• Optimize controls around key organizational processes
• Continuously monitor critical controls and KPIs
• Establish KRIs that predict and define risks to the organization
THANK YOU!

Questions?

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