Rethinking Risk Strategies: The Efficient Risk Frontier and Risk-Bearing Capacity

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"We've always done it this way" is a familiar expression in business, despite the constant stream of industries and companies in which significant changes in thinking and approach upend what corporate leaders widely accept as timeless best practices. It's all too easy to reel off a long list of corporate titans that once dominated sectors but are now viewed as anachronisms for failing to keep up with the global economy and rapidly transforming marketplaces.

As ever-more-sophisticated data analysis tools become available to a new generation of risk managers who refuse to accept the "we've always done it this way" justification, a more effective approach to risk management is emerging. It centers on examining and managing corporate risks through an entirely different framework, protecting the viability of organizations as they support competition and growth within the evolving global economy.

It begins by considering what has traditionally been seen as risk management and insurance, not as an unavoidable operating expense but as an integral capital component of management strategies and decision-making. The approach uses proven tools and philosophies to examine, shape, and structure strategies that create competitive advantages and enhance an organization's ability to achieve its growth objectives.

Danger of Inaction

Many of today's most highly market-capitalized companies have been around for a comparatively short time. When observers look at their meteoric growth, it's easy to assume the potential is limitless. However, for every company that rockets to the top of the class, many others are quickly fading into obscurity. More than half of the companies on the Fortune 500 listing since 2000 have gone bankrupt, been acquired, or no longer exist. The average company's lifespan on the Fortune 500 is expected to be only 14 years by 2026, down from 33 years in 1965.

If an organization fails to aggressively focus on survivability, statistical evidence suggests a bleak future. As for the companies that disappeared into a merger or acquisition, it's likely the acquirer was able to identify target issues they knew could be addressed, but that current leadership failed to recognize.

Five Key Elements

Rethinking risk strategies in this contemporary framework involves five critical factors.

1. **Risk culture and appetite.** Organizations must be able to define their appetite for and attitudes toward risk, informing decisions about retention, mitigation, and alternatives.
2. **Risk prioritization.** Given the potential impacts of the various risks endemic to every organization, the greatest attention should be focused on the handful of risks with the most significant potential to affect an organization's business and growth strategy.
3. **Financial risk-bearing capacity.** In order to make informed decisions, leaders must have a clear understanding of exactly how much risk an organization can bear and how that capacity can best be deployed.

4. **Predictive loss modeling.** When tracked over multiple years, losses can become predictable. By modeling those losses in a forward-looking manner, organizations can forecast the expected risks and address them accordingly.
5. **Adjusted return on capital.** Company leaders have long computed their adjusted return on capital but rarely as part of the risk management and insurance purchase process.

Ability To Execute Strategies

Another chilling point in the data about top companies is that more than 87 percent have failed to execute their business strategies successfully, and experience clearly underscores the role risks can play in such shortfalls. Often, company leaders face unforeseen risks that require dramatic shifts of capital. Additionally, companies that underevaluate the risks they face discover that their optimistic approach comes back to haunt them.

350 to 380 Specific Risks

Experts know there are 350 to 380 quantifiable risks facing every company at any given time. Those risks vary in their severity and complexity. Nearly always, a handful of those risks have the most significant impact on the company at any moment. Most companies will have 5 to 10 significant and immediate risks. No matter what these risks may entail, they have the greatest possibility of knocking a business off its growth strategy and trajectory. Most can be mitigated or minimized.

For example, if a company has done a great job with cyber security and its intellectual property appears well-secured, those areas won't need to be of top concern. However, if turnover is killing the business in a tumultuous job market, employee hiring and retention should be among the company's top targets for risk management.

What Rethinking Risk Can Do

When risk is examined and approached through a strategic framework, it is easier to keep it aligned with an organization's overall business and growth strategies. That's one of two key advantages rethinking the nature of risk can give a business. The second is that it allows organizations to convert risk management and insurance decisions from an unavoidable expense into a competitive business advantage.

Using this view of the risk framework demands rethinking what some organizations have learned. They should primarily approach insurance as an investment decision rather than as an operating expense.

Integral to Organization

When an organization rethinks its approach to risk, the process begins with the business strategy. Next, the many unaligned or misaligned areas of a business—think finance, marketing, product development, operations, supply chain, and many other operational silos—are examined to see how closely they're aligned with the business plan. They must understand their roles in achieving strategic objectives. The purpose of the process is to improve alignment of the various areas and utilize their combined proficiencies within a risk management framework to pursue the business plan aggressively.

The result is a unified effort to support the organization's business and growth strategy and a comprehensive risk analysis that examines the company with a broad lens. When an organization is in its annual planning process, it will be better able to identify the issues that could interfere with the growth strategy. The organization will then have a model that allows it to explore different ways to manage risks and test them across various economic conditions.

Disciplined Process

This type of analysis demands a disciplined process for discerning what is unique about the business and creating potential strategies to manage the most concerning risks. Developing a framework requires a comprehensive understanding of how those risks are currently being addressed. For example, is the risk being insured or financed? Are there efforts toward prevention? Is the potential for loss being mitigated, or is the organization simply assuming the risk as a cost of doing business?

The process should also examine how the organization's risk strategies compare to those of peers of the same size, geography, and industry. This knowledge will help the organization identify and adopt the best practices that provide the most significant return on investment or the most considerable risk mitigation.

Accountability Is Key

Each significant risk must have a risk owner who is responsible for owning the plan to address that particular risk. That means more than a cursory glance at a graph once each quarter. It involves integrating changes into the functions associated with those risks and creating ownership and responsibility among your company's team. Of course, that begins at the top, with the board and the CEO.

This process becomes a visual framework illustrating the greatest risks and the strategies for better aligning them with the company's goals, supported with measurable outcomes and clear metrics. It identifies the biggest threats to the organization's growth strategy and the best way to mitigate the potential impacts of each.

Risk-Bearing Capacity

A risk optimization process helps an organization determine its financial capacity to absorb risk. When someone chooses a deductible on their standard automobile insurance policy, they decide how large an out-of-pocket loss they can handle without putting themselves into a bind. A critical question in every organization's strategic planning process is how large an unexpected loss the company could absorb. Another question is how would it be absorbed. Should it be financed or assumed, or can concrete steps be taken to mitigate the risk?

Before making decisions about individual risks, it's essential to have an accurate assessment of the organization's financial risk-bearing capacity (FRBC). Today, every business has access to the metrics financial analysts, bankers, and investors use to study a company's liquidity, financial strength, and earnings strength. So, an organization can determine its own FRBC. Key levers to FRBC could be a unique mix of the current credit facility, cash reserves, and stockholders' equity that addresses the portion of risk an organization is willing to take.

FRBC is not some foreign or esoteric concept. It is rooted in responsibly examining an organization's financial strength, assets, liabilities, covenants, lending arrangements, and amount of shareholders' equity to determine what is available and the best use for it.

An Investment Decision

This is also the point at which organizations are ready to determine the best way to convert their insurance spend from an operational expense to investments that can be leveraged to support growth objectives. Before organizations spend a dollar on risk transfer, they need to know exactly at what point they would rather absorb the risk than spend one more dollar.

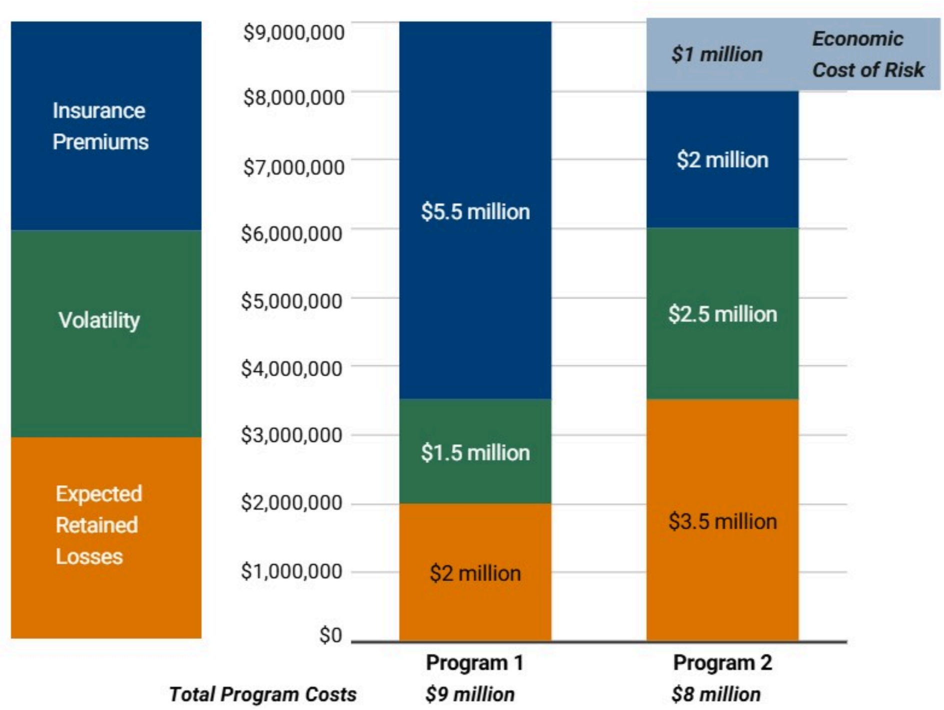
Why would an organization want to absorb more risk? It is simply that spending more to transfer risk delivers a poor return on the company's capital. By instead absorbing the risk, the organization can invest what it would have spent into new product development, a bigger sales force, a footprint in a market it has eyed, or whatever the board may be looking to accomplish.

Economic Cost of Risk

The better an organization understands the risks it faces and how much of that risk it can assume, the easier it becomes to make more informed decisions. Should the organization invest in protection from physical damage to its own property, plant, and equipment, or should it transfer those risks? How well does it protect workers, and how does it affect throughput and revenues?

The concept of economic cost of risk (ECOR) helps business leaders understand the true economic value that is created using differing strategies, such as by capitalizing insurance spending or transferring a particularly volatile risk to someone else's balance sheet because it exceeds the organization's FRBC. The ECOR considers expected losses, cost of volatility, and premiums. Premiums are paid for transferring risk out of the company's financials (net of tax). Cost volatility is the cost associated with the underlying strategy exceeding expected losses (up to the 95th percentile). As for expected losses, those losses are retained in the long term and a cost of doing business that should be reflected in how the company prices its products and services. An example of a renewal program in which an organization retains more of its expected losses and the associated volatility in exchange for reducing its risk transfer cost via insurance is shown in "Economic Cost of Risk."

Economic Cost of Risk



Actuarial Approach

If an organization knows with complete confidence that it will pay workers compensation claims of $100,000 yearly, does it make sense to buy insurance to cover that amount, or would the organization's finances be better served by paying those claims out of normal cash flow?

Thinking like insurance actuaries makes it possible to forecast the expected value of the workers compensation losses an organization can expect in the coming year based on its history, number of employees, and industry. Actuarial thinking also informs the most important consideration when using insurance and risk transfer: the difference between what is expected and absolute certainty. In the actuarial world, certainty is considered to be the 95th percentile or what is typically called the confidence interval.

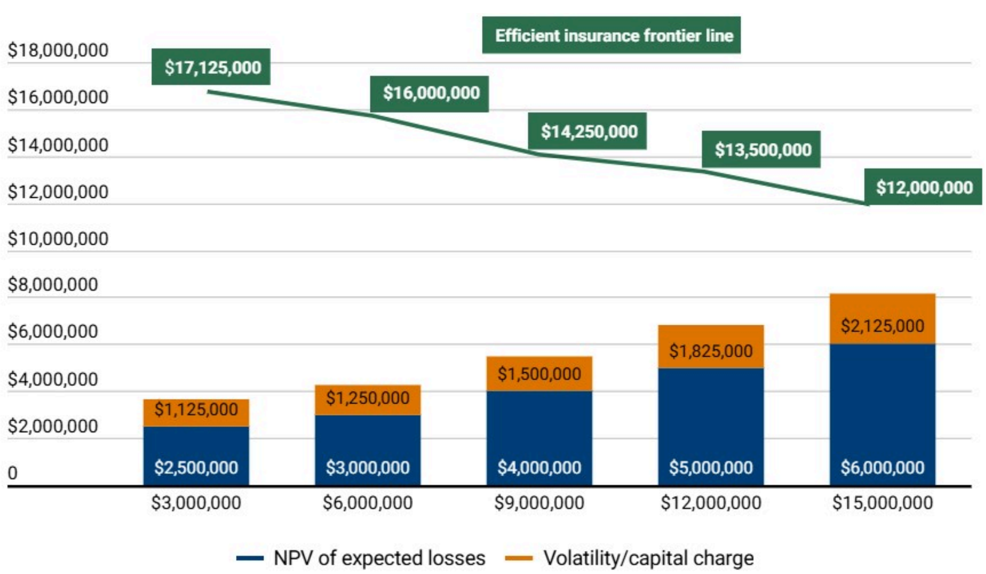
Financial Dollar Volatility

The gap between what is expected and absolute certainty is known as financial dollar volatility, and it should be the target for risk transfer strategies. Organizations should not buy risk transfer for what is normal and expected. Instead, risk transfer should be utilized to cover the dollar value of the difference between what is expected and absolute certainty.

Knowing the rate of return on capital an organization expects to earn and its financial dollar volatility creates a financial framework that reveals the point of optimization. That is when the cost of transferring the risk to someone else's balance sheet generates a return on capital that meets the organization's hurdle rate. It also identifies the point beyond which transferring additional risk to a third party or paying more for the same amount of risk would be a poor return on investment. After all, the overlay of insurance premiums should create economic value.

By evaluating the volatility between average expected losses and projected losses at the 95th actuarial confidence interval for an organization, the point beyond which the organization should not capitalize an additional dollar on insurance premiums can be established. Repeating this evaluation at various retention levels produces the organization's efficient insurance frontier, which illustrates an organization's economic cost of risk at a given hurdle rate at the selected retention levels. Everything on the resulting efficient insurance frontier line is the point of optimization, where the insurance premium provides a return on capital sufficient to justify the risk transfer. See the illustration of an efficient insurance frontier.

Efficient Insurance Frontier



Another Advantage

Beyond the decision-making insight that rethinking risk delivers to corporate leaders, it also increases negotiation strength when an organization is ready to market its risk. Given the depth of knowledge of its financials, an organization can approach the marketing process like an investment banker would. Knowing the exact amount of risk it would like to transfer and what levels of premium and deductible are acceptable—and sharing the details behind those figures with its insurers—puts more control in the organization's hands.

The Time Is Now

Organizations respond to marketplace advances by either enthusiastically embracing and participating in them or resisting them and losing business and reputation. Rethinking risk strategies and developing a strong grasp of the organization's FRBC, the ECOR, and the efficient insurance frontier provide a blueprint for reducing risk management expenses and converting risk management into a competitive advantage, one that treats the use of insurance as an investment decision. The best way to start is to find an expert more interested in helping you optimize your risk than in selling you insurance policies.

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