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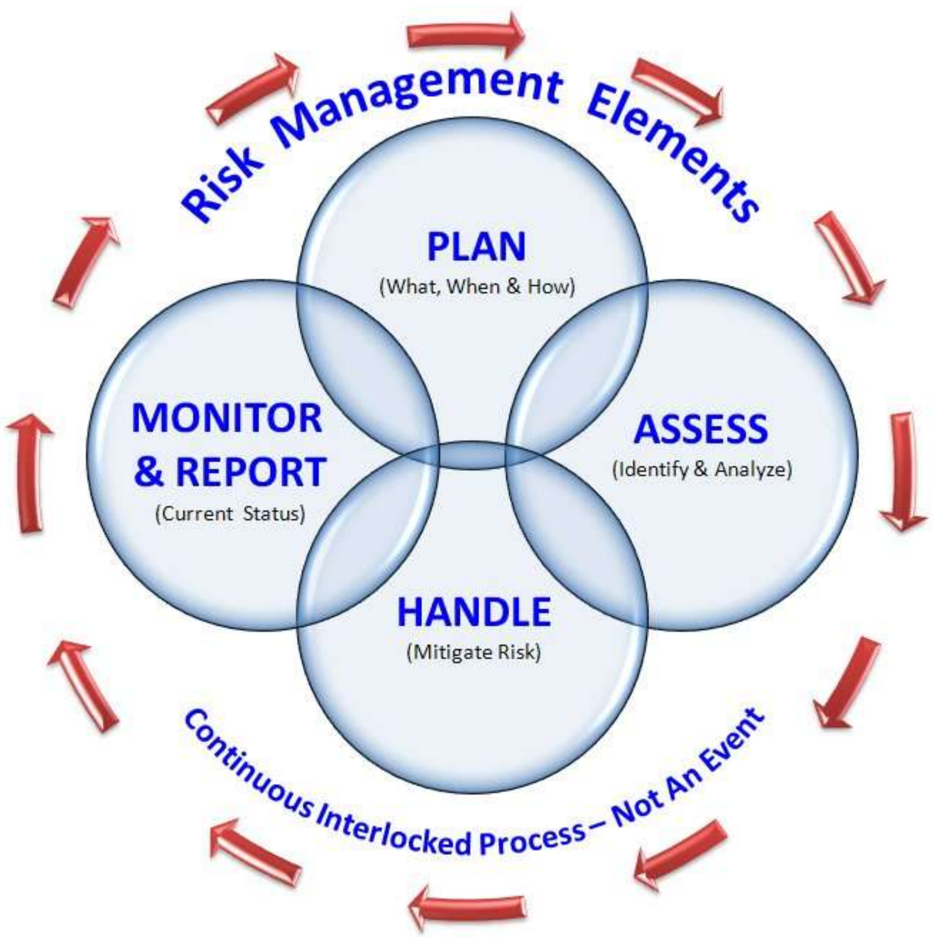
Key Elements of the Risk Management Process



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Key Elements

Four foundational elements frame what executive management and directors need to consider when evaluating the best way to implement enterprise risk management (ERM). These four elements – process, integration, culture and infrastructure – are intended to be flexible in application because strategies, organizational structures, operating philosophies and risk profiles vary in complexity across industries and firms.

Like any other worthwhile business activity, risk management requires a process with a clear purpose, reliable inputs, well-designed activities and value-added outputs. The risk management process typically includes such activities as the identification, sourcing, measurement, evaluation, mitigation and monitoring of risk.

A well-articulated process view of risk management provides a benchmark for companies to help them formulate THEIR proprietary view of THEIR process that is responsive to THEIR needs.

We discuss each activity of the risk management process below.

Identify Risk

An enterprise risk assessment process identifies and prioritizes a company's risks, providing quality inputs to decision makers for the purpose of formulating effective risk responses including information about the current state of capabilities around managing the priority risks.

Risk assessment spans the entire organization, including critical business units and functional areas. Effectively applied using business strategy as a context, risk assessment considers such attributes as impact, likelihood, velocity and persistence.

Source Risk

Once priority risks are identified, they are traced to their root causes. If management understands the drivers of risk, it is easier to design risk metrics and proactive risk responses at the source.

Measure Risk

There is an old adage that says, "If you can't measure risk, you can't manage it." Because not all risks are quantifiable, increasing transparency by developing quantitative and qualitative risk measures is common practice.

Measurement methodologies may be simple and basic, e.g., risk rating or scoring, claims exposure and cost analysis, sensitivity analysis, stress testing and tracking key variables relating to an identified exposure. More complex methodologies for companies with more advanced capabilities might include VoR or Velocity of Risk**,** value at risk, earnings at risk, rigorous analytics that are proprietary to the company and risk-adjusted performance measurement.

Just remember: Inability to measure a risk doesn't make it go away.

Evaluate Risk

Based on the priority risks identified, their drivers or root causes and their susceptibility to measurement, management decides on the appropriate risk response. There are four categories of risk responses – avoid, accept, reduce and share. These responses may be applied to groups of related risks consisting of natural families of risks sharing fundamental characteristics (e.g., common drivers, positive or negative correlations, etc.) consistent with a portfolio view.

The organization first decides whether to accept or reject a risk based on an assessment of whether the risk is desirable or undesirable. A desirable risk is one that is inherent in the entity's business model or normal future operations and that the company believes it can monitor and manage effectively. An undesirable risk is one that is off-strategy, offers unattractive rewards or cannot be monitored or managed effectively.

If an entity chooses to accept a risk, it can accept it at its present level, reduce its severity and/or its likelihood of occurrence (typically through internal controls), or share it with a financially capable, independent party (typically through insurance or a hedging arrangement).

Mitigate Risk

Depending on the risk response selected, management identifies any gaps in risk management capabilities and improves those capabilities as necessary to implement the risk response. Over time, the effectiveness of risk mitigation activities should be monitored.

Monitor Risk

Models, risk analytics and web-enabled technologies make it possible to aggregate information about risks using common data elements to support the creation of a risk management dashboard or scorecard for use by risk owners, unit managers and executive management.

Dashboard and scorecard reporting should be flexible enough to enable the design of reports to address specific needs, including reporting to the board of directors.

The purpose of the risk management process varies from company to company, e.g., reduce risk or performance variability to an acceptable level, prevent unwanted surprises, facilitate taking more risk in the pursuit of value creation opportunities, etc. Regardless of purpose, the good news is that a large body of knowledge on the risk management process is readily available so that companies can adopt a process view that best fits their circumstances.

About the Author

Michael McCormick founder of MPCS, Inc and Management Professional with 35 years of experience managing over $4 billion in projects for both the Commercial and Federal Government sectors and is a well-known project management (PM) author, consultant, and authority on the subjects of Construction Management (CM), Facility Management (FM), Business Process Management (BPM), Project Management Office (PMO) and Project Portfolio Management (PPM), Risk Management (RM), software development and technology integration.

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