Risk Management Loss Control and Lean Management:

Winning the Game Before the Loss

Introduction

Risk management is a strategic way for a company to effectively identify risks, and control and manage their impact. Risk management should be seen more as a function throughout the company and not juist a specific person with the title "Risk Manager". Risk management should be a part of the company's overall planning and strategy, and be involved in more than the assessment of risk faced by the company. Lean risk management improves the risk management function in an organization.

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"A lean risk-management program seeks to improve the financial performance of a business by identifying and minimizing the causes of loss; identifying and removing sources of waste; and focusing on outputs that are critical to the company's customers."

A company's risks fall into four quadrants: hazard, operational, financial and strategic. Figure 1 shows the causes of loss categorized according these four quadrants. See Figure 1.

Figure 1[1]

Hazard Risks Many of these risks are transferred by insurance policies. Examples include: • Property damage • Third-party liability • Directors-and-officers liability • Health and safety • Nature (flood, earthquake) • Asbestos • Terrorism	**Operational Risks** Although many operational risks are pure risks, traditional risk management deals less frequently with operational risks. Examples include: • Product recall • Discrimination • Embezzlement • Workplace violence • Kidnapping • Turnover • Service-provider failures • Supplier business interruption
Financial Risks Financial risks traditionally are handled by the treasury or CFO function. These risks normally are speculative and can sometimes be managed with financial tools such as options or futures. Examples include: • Debt rating • Liquidity/cash • Asset valuation • Legislative changes • Commodity prices • Interest rates • Currency/foreign exchange rates • Economic growth/recession	**Strategic Risks** Many strategic risks are directly linked to management decisions. Examples include: • Intellectual property • Ethics • Planning • Technology • Union relations • New competitors • Media coverage • Industry consolidation • Product design

A lean risk-management program ensures that losses in the four quadrants of risk do not have a negative financial impact on the company.

Manufacturers were the first companies to use lean principles and tools to reduce waste in production processes, but as more companies (including those outside of manufacturing) applied the same principles to business processes, they discovered that lean methods supported many strategic, i.e., financial, goals. In the case of risk management, the elimination of waste often directly minimizes risk potential.

A *lean risk-management program* seeks to improve the financial performance of a business by identifying and minimizing the causes of loss; identifying and removing sources of waste; and focusing on outputs that are critical to the company's customers. Thus, the company has less frequent and less severe losses. A key principle of lean risk management is that it focuses on what's important: what matters to the company and what delivers value to customers and shareholders. Often, lean risk management helps give executives a broader perspective on processes, making it easier for them to see possibilities for improvements.

1 | 1 Foundations of Risk Management and Insurance, 2nd Edition, Charles M. Nyce (2006)

Financial Benefits of Lean Risk Management

"The best way to begin a lean risk-management loss-control program is to identify a risk, map the entire process leading up to that risk, and then look for ways to make the process more efficient.

Many executives have basic knowledge of lean, but getting them to incorporate lean within the company's risk-management program can be challenging. Some executives don't understand that lean risk-management loss-control techniques will help to improve the organization's overall financial health and/or mistakenly believe lean requires standardizing every part of a process. It doesn't. It's more about getting smarter about execution. Applying lean principles to a company's risk-management program is a very effective way to mitigate risk and to better control loss, much of which arises from errors at the front line. By applying the appropriate loss-control techniques and empowering front-line employees, companies can reduce risk, and therefore costs.

A good example is records management. For many companies, filing and management of the various forms, invoices, meeting notes, development ideas, customer information, employment applications and everyday e-mails are ad hoc, i.e., left up to individuals and/or department heads. This increases risk in many ways, such as leaving open opportunities for intellectual property theft and violation of employee privacy laws. It also causes waste because employees have to spend time trying to find information they need. Making a phone call or sending an email to locate a document — and then waiting for someone to find it and send it back — wastes time and money. Customers do not pay for employees to look for documents; so anytime an employee is doing this instead of creating value for a customer, the company is losing money. Having a standard (called standard work by lean practitioners) document-archiving process that everyone follows for *vital documents* reduces risk, eliminates waste and frees up resources to create more value for customers.

The best way to begin a lean risk-management loss-control program is to identify a risk, map the entire process leading up to that risk, and then look for ways to make the process more efficient. Companies are much more likely to be successful carving up and defining specific processes with a beginning point and an endpoint.

Companies should focus first on some basic, easily implemented and meaningful applications of change. Once these succeed, the company can build momentum by identifying other processes for improvement and changing them. Achieving sustainable improvement is more important than working quickly or aiming for a certain number of improvement projects over a period of time. It's a marathon, not a sprint. But analysis and implementation are extremely different. In theory, lean tools and techniques are pretty simple, but the execution — getting to success — is complex. One reason: It's a people process, and it could require a big change in the company culture and in the way the company manages activities. Getting management and employee buy-in is key. Any lean risk-management plan should include a component to encourage buy-in at all levels of the organization.

A lean risk-management program should also have specific target goals. These goals usually are broken down into pre-loss goals and post-loss goals. This paper will discuss managing the company's pre-loss goals. Post-loss goals are the subject of another paper.

Developing the Game Plan: Establishing Pre-Loss Goals to Evaluate the Company's Loss Exposure

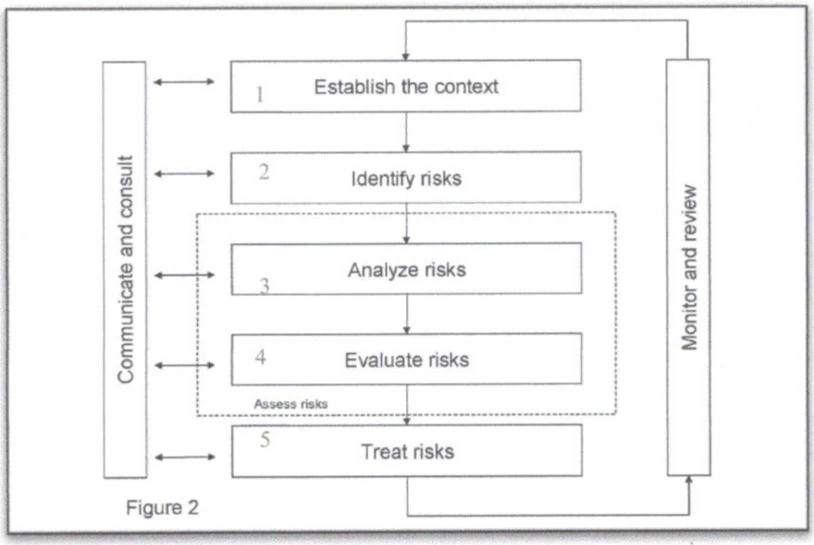
Risk management pre-loss target metrics should map back to an assurance that:

- The company does not incur substantial costs in exchange for minimum benefits. This can be done through a Total Cost of Risk Analysis (TCOR).
- Uncertainty about losses is kept at tolerable levels so that senior management knows that incidents that occur will be within the bounds of what was anticipated and will be effectively treated by the risk-management program.
- The company's legal obligations are satisfied. These legal obligations include: (1) making sure that the standard of care that is owed to others is met; (2) helping the company with its contractual obligations, both those that it has as well as those owed to it; and (3) complying with federal, state and local laws and regulations.
- The company behaves in an ethical manner and meets its obligations to the local community.

To fulfill the goals, the risk manager undergoes a planned and structured process as part of the risk-management strategy and applies several steps to evaluate the loss exposures. See Figure 2.

> *"A company recognized the need to improve its workers compensation program. As a part of that project, key roles and responsibilities of management were identified; an incident-notification-and-claims-reporting process was created; a methodology for incident response and investigation was created; each location was worked with to set up procedures for handling medical emergencies; and a transitional-duty program, case-management program and litigation-management program was created."*

Figure 2



Step 1: Establish the context

Step 2: Identify risks

Step 3: Analyze risks

Step 4: Evaluate risks

Step 5: Treat risks

Step 6: Communicate and consult

Step 7: Monitor and review

(continued)

Step 1: The risk manager establishes the goals and context to understand the environment in which the company operates. This includes evaluating both the external environment as well as the internal culture of the company. This requires reviewing the regulatory requirements, codes and standards, relevant corporate documents, internal policies, and the goals and objectives of the company.

Step 2: The risk manager identifies the risks (loss exposures). This includes direct losses, indirect losses, key personnel and operations. These loss exposures can be identified through balance sheets, income statements and other records, compliance reviews, inspections, flow charts, questionnaires, and expertise within and beyond the organization. The objective is to clearly identify the possible losses a company faces.

Step 3: This step involves analyzing the loss exposures by estimating the likely significance of losses previously identified, and determining the loss frequency, loss severity, total dollar losses and timing of the losses. From these estimations, loss projections can be developed, and loss exposures prioritized.

Step 4: The risk manager develops a strategy to control the losses (loss control) by examining loss-exposures and risk-control techniques to minimize the frequency or severity of losses, and examining risk-financing techniques that generate funds to finance losses that risk-control techniques cannot entirely prevent.

Step 5: The risk manager selects the appropriate risk-management techniques to address the cause or causes of the loss.

Step 6: The risk manager implements the risk-management techniques by purchasing loss-reduction devices, contracting for loss-prevention services, funding-retention programs, implementing and continually reinforcing loss-control programs, and/or selecting agents or brokers, insurers, third-party administrators and other providers for insurance programs.

Step 7: The company monitors the results, revising the risk-management program as necessary and communicating the results as appropriate.

Swinging Away at Loss Control Can Improve a Company's Profitability

Loss control, as a part of the lean risk-management strategy, focuses on reducing and eliminating potential losses from those identified risks. Taking a strategic approach to loss control is important for managing a company's risks and making them less severe or more predictable. It can result in direct-cost savings for the company through reduced workers compensation costs, less overtime, increased productivity, reduced turnover and improved labor/management relations. A loss-control program should be an integral part of the company's culture. If a company does not have an effective loss-control program, costs increase.

There are six loss-control techniques used by risk managers to manage identified risks: avoidance; loss prevention; loss reduction; separation; duplication; and diversification. Each of these techniques makes losses more predictable and can reduce loss frequency or loss severity. Loss-control techniques must be effective and efficient, comply with legal rules and regulations, protect employees from injury or illness, and ensure that the company can continue to operate during and after a loss.

1. **Avoidance** involves stopping or never undertaking an action so that the possibility of a future loss occurring from that action is eliminated. The aim of avoidance is not just to reduce loss frequency but also to eliminate any possibility of loss.

2. **Loss prevention** reduces the probability or frequency of a particular loss. Loss-prevention measures that reduce probability or frequency may also affect the loss severity of the specified loss exposures. Usually, a loss-prevention measure is implemented before a loss occurs in order to break the sequence of events that leads to the loss. Determining effective loss-prevention measures usually requires carefully studying the cause or causes of particular losses. This is when mapping the process(es) leading up to the rise becomes an essential tool.

3. **Loss reduction** reduces the severity of a particular loss. Some loss-reduction measures can prevent losses as well as reduce them.

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4. **Separation** isolates loss exposures from one another to minimize the adverse effect of a single loss. Separation is appropriate if an organization can operate with only a portion of these separate units left intact. If one unit suffers a total loss, the portion of the activity or assets at the other unit must be sufficient for operations to continue. Otherwise, separation has not achieved its risk-control goal.

5. **Duplication** uses backups, spares, or copies of critical property, information, or capabilities and keeps them in reserve. Examples of duplication include maintaining a second set of records, spare keys, spare parts, etc. Duplication differs from separation in that duplicates are not part of an organization's daily work resources. Duplication is appropriate only if an entire asset or activity is so important that the consequences of its loss justify the expense and time of maintaining the duplicate. Duplication is likely to reduce the average expected annual loss from a given loss exposure because it reduces loss severity without increasing loss frequency. Similar to separation, duplication can also make losses more predictable by reducing the dispersion of potential losses.

6. **Diversification** spreads loss exposures over numerous projects, products, markets or regions. It is commonly applied to managing business risks, rather than hazard risks. Organizations engage in diversification of loss exposures when they provide a variety of products and services that are used by a range of customers. Diversification has the potential to increase loss frequency because the organization has increased the number of loss exposures. However, by spreading risk, diversification reduces loss severity and can make losses more predictable.

After considering alternative loss-control techniques, risk managers decide which techniques are appropriate for a particular loss exposure and which are not. The techniques will vary depending on the type of loss exposures — property losses, liability losses, personnel losses and net income losses. In the end, the techniques used result in the company avoiding the risk, retaining the risk (and managing it), or transferring the risk through insurance or a non-insurance vehicle.

Although implementing lean risk-management loss control techniques begins as an operations issue, it quickly becomes a change-management exercise that requires companies to deal with risks and its employees in new and sometimes unfamiliar ways. For instance, the lean principle of engaging employees in the problem-solving process requires leaders and managers to ask employees involved in a process how they think it could be simplified or improved. Company leaders can't just say, *"Let's apply this process to manage this risk, and we'll worry about how the employees will respond later."*

Managing change and people's behaviors is a continuous process that must be addressed from Day One. Managers might see this as slowing down the lean risk-management effort, but ultimately it can improve the outcome. Employees are more likely to resist new approaches if they don't understand how the change will improve the process, how the improvement will benefit them, and how their efforts add value. If they are a part of the process from the beginning, companies have a better chance of success.

Lean risk management works best as a balanced top-down and bottom-up effort. The company needs to share a common goal and set of expectations of value that the lean risk-management program will deliver, and have the executive commitment and appropriate governance to enable its success. There have to be accountabilities. However, companies also want to heavily involve front-line employees and encourage them to share their ideas. Companies need to let them know that it's O.K. for them to speak up and make mistakes as they drive the definition, testing and validation of the new process.

Applying Lean Risk Management Can Help Companies Manage Their Loss Control and Hit "Home Runs"

Applying lean thinking to loss control is not a new idea, but more companies are recognizing the value that lean risk management can bring with solid solutions to the company's identified risks. Too many companies attempt to cut costs without undertaking an actual lean program. Lean isn't simply about cost cutting but about changing the way a company works.

For instance, a lean risk management department recently implemented a Property Asset Protection Process. Various problems were identified: difficulty in scheduling site surveys at each of the company's locations; the locations rarely responded to recommendations for improvement; and the process was seen by the managers at each location as an insurance process, not a company process. The risk manager recognized that there needed to be baseline prevention and mitigation programs at each location. He implemented change management, emergency response, continuity planning, storage rearrangement, and other improvements at each location. In addition, a Property Asset Protection Process was developed whereby after the site surveys, all recommendations for each location were submitted to the location manager for an action plan. Once the action plans were created by the location manager, then there was follow up with the risk manager before the action plans and completed recommendations were sent to the insurance carriers. Several benefits resulted:

- The Asset Protection Process was embraced internally as a continuous-improvement process.
- The locations began initiating discussion when issues arose.
- Responsiveness to recommendations improved to 100%.
- The recommendation-completion rate improved to 73%.
- The client's Property Asset Protection Process is viewed as "best in class" by the insurance market.

By putting the Property Asset Protection Process in place, risks of loss were kept to a minimum.

Another risk manager sought to improve his company's workers compensation program. As a part of that project, the risk manager identified key roles and responsibilities of management; created an incident-notification-and-claims-reporting process; created a methodology for incident response and investigation; worked with each location to set up procedures for handling medical emergencies; and created a transitional-duty program, case-management program and litigation-management program. A data-management and reporting system was implemented, as well as a process for selecting a TPA. In addition the human resource department was included as a key partner in the process. Training and orientation of employees, supervisors and managers was undertaken so that they became familiar with the Workers Compensation Program and understood their roles and responsibilities. With this approach, the company has seen savings on its workers compensation costs.

Conclusion

A poor risk-management loss-control process can be costly, particularly when allowed to continue long-term. With lean risk management applied to loss-control issues within a company, the company can standardize the loss-control program, homogenize it, roll up uniform processes, significantly cut exposure, and improve the bottom line.

Done right, lean risk-management loss-control improvements aren't one-off projects but instead part of a pervasive approach to operations that brings lasting cultural change. It transforms the way employees view their work by encouraging them to continually think about ways to improve it. Companies should not overlook this need for change when managing loss control. It's incredibly important to do. Otherwise, lean just becomes a project and a one-time event, and the costs and the risks will creep back in a few years.

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