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Business-Focused Risk Maps: An Approach to Improve the Effectiveness of Risk Identification

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IN RECENT YEARS, many insurers have sought to initiate an Enterprise Risk Management (ERM) program or strengthen their existing programs. In one form or another, ERM programs include a risk identification process. Companies often perform some sort of risk identification exercise early in the development of their program, and conduct periodic "refresher" exercises on an ongoing basis. In the past, this exercise has sometimes been more informal, with companies focusing on risks that are "top of mind" for the senior management team. However, the risk in this approach is that the results may be colored by the recency effect and other biases, which limit the universe of risks that a company might consider. To address this risk, companies are seeking broader approaches to risk identification. Though every company does this somewhat differently, one tool that seems effective in helping companies to develop a broader view of their risks is a risk map. Rather than being a static reference tool, risk maps can be used as a fundamental and dynamic part of the risk identification process.

BEFORE THE MAPPING: THE IMPORTANCE OF PLANNING AND STAKEHOLDER MANAGEMENT

Unfortunately, many companies dive into their risk identification exercise without sufficient preparation. For example, the company may create a risk register template, send it out to each department and ask for it to be filled out by a certain date. Very often, the output is too varied and complex. Risk identification should be conducted in live, interactive sessions rather than using this type of survey approach. Moreover, companies should be strategizing and planning for their risk identification exercises *well in advance,* thinking carefully about exactly who should attend the sessions, how to communicate with these individuals (both before and after the session) what materials will be used, what information will be collected and in what format, along with many other important considerations beyond the scope of this short article.

Stakeholder management is critical in the early planning stages. Put simply, people are more likely to support the risk map if they perceive that they influenced its development. It is very likely that the eventual users of the risk map will feel that they already manage risk on a daily basis and have significant experience in this area. They may resist anything that resembles a lecture in how to do their job, particularly from an outsider from another department. Soliciting stakeholder feedback early in the process can accomplish several goals:

- The feedback will likely provide an indication of whether the individual stakeholder is a supporter, a resister, or a passive participant in the overall risk identification exercise;
- Stakeholders feel that their opinion counts and develop a sense of ownership in the final product;
- Stakeholder feedback actually *is* essential in developing a useful risk map!

RISK MAPS: DEFINITION AND PURPOSE

Risk maps classify the company's risks into various categories and levels. A typical example might have three levels. Level 1 would consist of broad risk categories that affect most companies such as Strategic Risk, Operational Risk and Financial Risk. Level 1 might also include risk categories specific to a particular industry, such as Insurance Risk. The Level 2 risks would be slightly more granular, with categories such as Reputation (under Strategic Risk), Fraud (under Operational Risk). For Insurance Risk, Underwriting Risk might be an appropriate Level 2 category. The map can include as many levels as needed to properly capture the company's risk universe. However, there are practical considerations as discussed below.

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Usually the Level 1 and Level 2 categories are defined by a small working group based on prior risk events, the experience of the chief risk officer or ERM function, or (in the worst case) reasoning in a vacuum. The core group usually confers with subject matter special-

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ists to populate Level 3 and beyond. The result is a risk map that conforms to a *risk manager's* sense of risk, rather than a business user's sense.

A risk map should be a starting point for a discussion about risk and a facilitating tool for identifying risks that are not "top of mind." It should not, at first, be expected to necessarily capture all risks and classify them in exactly the right place. In fact, excessively complicated risk maps may invite controversy, leading to unnecessary distractions. It is not uncommon for different people to disagree on how the map should be structured or how risks should be classified (e.g., consider whether reserving risk for a life insurer be classified as "insurance risk" or "operational risk." Would your colleagues agree with you?). The more complex the risk map, the more time will be spent moderating unproductive debates about its structure and content. A deep understanding of the company's risks is an *output* of the risk identification process, not an input. Therefore it should be clear that the risk map is a working document at this stage. It's better to invest time having a thoughtful and lively discussion about the company's exposure to risk as opposed to debating the structure of the risk map.

RISK MAPS: SELECTING AN APPROPRIATE FRAMEWORK

As a way to avoid some of the traps that can occur when starting with a blank sheet of paper, a company may develop the corporate risk map around a framework established by an authoritative third party, such as the company's rating agency. Companies tend to be sensitive to their rating agency's perceptions and expectations. While some participants may be initially skeptical about the value of the risk identification exercise (or ERM in general, for that matter) everyone should acknowledge the clear benefits of improved standings with the rating agency.

Depending on the context, different rating agency frameworks may be employed. A life insurance company rated by Moody's may wish to review *Moody's Global Rating Methodology for Life Insurers* and construct a risk map around that methodology. Both Moody's and S&P also provide ratings specific to companies' ERM capabilities. Companies who view a positive ERM rating as a market differentiator may wish to build their map accordingly. Regardless of the specific selection, it is critical to maintain a clear connection to the company's business drivers. At first blush, a risk manager may feel that the frameworks mentioned above do not lend themselves to risk maps in a natural way. But it's important to build the risk map around the business drivers, not the other way around.

While translating a rating agency framework into a risk map can be very effective, other approaches can also work well. For example, a generalized risk map published by a third party can be adapted to the company's particular situation. Our U.S. firms utilize a "Risk Intelligence Map" as an objective framework for discussing risk. At its highest level, this map organizes risks into six broad categories:

- Governance
- Strategic Risk
- Financial Risk
- Insurance Risk
- Operational Risk
- Regulatory and Compliance Risk

To construct a risk map, the six broad categories above could be used as Level 1 categories, and relevant subcategories could be used as Level 2 risks. As an example, a Level 2 risk category under Governance might be "Board Structure," which in turn would include several Level 3 risks such as "Fiduciary Duty," "Effectiveness of Subcommittees," "Strategy/Execution Alignment," and so forth.

We have found that a risk map constructed in this way has several advantages:

- **Less churn:** Devising a risk taxonomy from scratch can be a very time-consuming process and fraught with angst, because reasonable people have valid disagreements about the most appropriate way to classify risk. Using an objective framework, on the other hand, keeps the focus on risk identification rather than risk categorization. As illustrated above, an objective framework does not necessarily have to be generic. For example, the Moody's framework is highly specific and relevant to life insurers.

- **Business focus:** Some of the displayed categories will be familiar to any risk manager (e.g., brand, capital adequacy, liquidity), but others are seen less frequently (e.g., market position, financial flexibility). This is because risk managers tend to work backwards from the risks to the business impact. That is, they will consider a variety of risks that implicitly affect the company's market position or financial flexibility, rather than beginning with the business consideration and drilling down to the associated risks. By demonstrating a concern for the company's business needs, the risk manager can show that he is willing to meet the business leaders on their turf rather than forcing them to speak his language.

- **Risk Metrics:** Occasionally companies invest a great deal of time formulating a desired set of risk metrics, only to find they lack the necessary data to calculate them, or they lack the resources to do so on a regular basis. Even when the metrics are feasible to calculate, they often lack a clear relationship to profitability. The Moody's rating guide, for example, provides numerous illustrative metrics that are considered in the rating process, and it is highly likely that a company rated by Moody's is already routinely monitoring these metrics. Corporate ERM can use these same risk metrics directly, or leverage the underlying data to derive additional metrics. More generally, practical risk metrics tend to be more readily available when a risk map well-aligned with a company's business processes and value drivers.

- **Rating Agency Relationship:** There are benefits to using a framework that is already familiar to a company's rating agency. First, it should be somewhat easier to discuss that framework with the agency during an ERM review. Second, the agency should readily agree that the framework is broadly aligned with the company's business drivers, at least at the Level 1 and Level 2 dimension.

USING THE RISK MAP TO DRIVE A DEEPER UNDERSTANDING OF THE BUSINESS

Risk maps are customarily used as a reference tool, akin to an encyclopedia or blueprint of the company's risk exposures. A risk, once identified, will be compared against the map to determine that it is filed correctly within the risk register. However, risk maps can be used in a much more focused and active way. They can play an integral role in the risk identification process, particularly when leveraged in a workshop environment with a properly equipped facilitator.
A high level approach to conducting a risk identification exercise is described below, using the risk map as a key component. Note that there are many considerations involved in facilitating a workshop such as this. This article does not attempt to list them all, but provides a sketch of the overall process and highlights the role of the risk map.

First, an objective taxonomy should be selected, such as one based on a rating agency, as described above. Level 1 and Level 2 categories are based largely on the published rating methodology, with some deviations as needed based on the company's specific situation. Level 3 categories are pre-populated with *suggested* areas for further discussion by the management team.

Next, a risk identification workshop should be convened consisting of selected functional and business unit leaders from across the organization. It is important that key leaders attend the workshop rather than delegating this responsibility. At the workshop, a large poster-sized copy of the risk map can be prominently displayed and introduced as a tool to guide the discussion. If the appropriate advance work has been performed, the risk map should clearly show a close relationship to the company's business drivers. A relatively free-ranging discussion is preferred, but a work-

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shop facilitator can help keep the discussion on track. The facilitator should ask the participants to freely discuss the different risk categories and brainstorm specific risk events that could occur, without regard as to whether they can be easily quantified. Effective facilitators typically come prepared with a large "question bank" designed to revive the conversation in the event of a lull. (Examples: "What are our hedging objectives? Are we achieving those objectives? What could cause our hedging to become ineffective?")

The results of the discussion should be captured in a risk register. This information can then be used as the starting point for a risk quantification exercise. Compiling a risk register in a live workshop setting is a technique in itself, and outside the scope of this article. It suffices to say that careful planning is recommended, well in advance, because risk identification workshops tend to be highly dynamic and critical information can be easily lost.

The process described above is quite different from what many companies typically do. Usually, different departments are asked to identify a set of risks in each category. In other words, risks are identified in silos. This is ironic, because it is commonplace nowadays to decry the folly of *managing* risks in silos; yet *identifying* them in this manner is not viewed as problematic. By discussing risks as an departmental management team, unforeseen relationships and correlations naturally begin to emerge. (Memorably, one manager pointed out that a natural disaster would likely increase the risk of a privacy breach, due to the need to activate emergency backup systems that may have unexpected vulnerabilities.)

It may appear that the risk map plays only a small part in the larger process described above. In fact, however, workshop participants tend to constantly refer back to the risk map as they brainstorm different scenarios. This may be due to the fact that the risk map is presented as a starting point and also visually appears as such, due to its simple design. It invites users to work with it, to elaborate on it, and to be creative. Presenting a solid, well-reasoned framework up front frees the participants to invest their creativity and brainstorming around the risks themselves, rather than the classifications. In contrast, when managers are confronted with a highly complex risk map they tend to fight it, dismiss it or shut down.

CONCLUSION

Effective risk identification requires active, thoughtful participation from the senior management of each major functional area within the company (Finance, Investments, Underwriting, Claims, etc.) These individuals should understand that they are participating in a valuable process that can help them achieve business goals. Otherwise they are likely to feel they are participating in a compliance exercise—an unwelcome distraction from their core business objectives. Based on our recent experiences with several forward-thinking clients, we see a new type of dynamic thinking beginning to emerge around risk identification within an ERM program. The monolithic, bureaucratic (and usually unsuccessful) approaches of the past are being discarded in favor of nimble, highly collaborative processes which are easy to refresh on a regular basis.

If your company has invested a great deal of time and energy into a risk identification exercise which ultimately proved unsatisfactory and did little to further the company's ERM objectives, take some comfort that you are not alone. Consider implementing a more business-focused and strategic approach. You may find that the outcome is much more successful, and also that it is easier to work out the bugs and iterate the process compared to the more traditional approach.

Finally, one word of caution is noted concerning risk categorization and risk maps. The exact categorization of the risks within the risk taxonomy should not be a primary concern during the risk identification process. For almost all companies, risk taxonomy is simply not that important at this stage of the game. Like early biologists, we should concern ourselves with identifying as many different and interesting creatures as possible and then worry about phylum, genus and species at a later time. In fact, a positive outcome of the risk identification process may be the development of an entirely new risk map for use in the next round. Such creative destruction should be embraced and encouraged. As the company's ERM program matures and risk identification becomes ingrained in the consciousness of management, reliance on risk maps and similar tools will decrease. In this sense, the risk map can be seen as a ladder that we use to ascend to a new level of understanding. But the understanding is what counts, not the ladder.

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