

# Risk Identification

## Introduction

Exposures, perils, and/or hazards producing losses may interfere with achievement of the organization's objectives, resulting in an adverse financial impact. It is imperative these exposures be effectively identified using a comprehensive and systematic approach to minimize the possibility an exposure could be overlooked. An exposure overlooked is an exposure left untreated. Therefore, Risk Identification is the most important step of the risk management process, as an exposure must be identified before it can be effectively analyzed, controlled, transferred, or financed.

## Risk Identification Methods

Various methods are used to identify exposures. The method of choice depends on the type of exposure the risk manager is trying to identify. Some methods work better with some exposures and others work better with others. Oftentimes, two or more methods are used to address the same type of exposure. The following section describes the various methods, their scopes, advantages, and disadvantages.

**The Checklist and Survey Method** uses information-gathering documents (checklists and surveys) to systematically search for as many exposures, perils, and/or hazards as possible. It is standardized, provides a history for the risk manager, is easily classified and tabulated and, because very little training is required to use this method, can be utilized by non-risk management personnel.

Unfortunately, it cannot cover all areas or operations, and provides limited financial effects. It also does not prioritize exposures, since it does not identify the likelihood of occurrence or severity, and it may not identify new exposures.

There are five examples of checklists. The first is a List of Assets—a checklist best suited for property and tangible assets. The benefits of this method are that it provides a list of all resources and capacities, stimulates staff to account for assets, and identifies assets that are often overlooked.

It does not ordinarily address liability risks, though, and it must be updated regularly, especially when new assets are acquired. It also provides varying costs estimates, depending upon when the survey was completed.

The second is an Activity or Situation List. This checklist is best suited for liability and human resources. The benefits include instilling a thought process for loss prevention, evaluating equipment, personnel, and operations that function together, and, again, identifying activities that are often overlooked.

Unfortunately, it can become mired in minutia if too much detail is included, and the important exposures can get lost in those details. It does not focus on the financial aspect of identification, and operations and activities may vary by locale.

The third checklist is a Perils Analysis. The perils analysis is commonly used to identify the potential cause of loss from human, economic, and natural perils. It provides a list of common or likely causes of loss, uses insurance nomenclatures, and can assist in identifying perils that occur infrequently and might otherwise be missed.

On the other hand, new perils are created daily, old perils are forgotten or overlooked, and the analysis may become obsolete. Upper management may be skeptical of this method, as it may be perceived as a “Chicken Little the sky-is-falling” mentality.

The fourth checklist is the Insurance Checklist and it is used to determine the feasibility of contractual transfer. The insurance checklist has the benefit of being a definitive list of available coverage and exclusions. Completing an insurance checklist includes a process of evaluating exposures, and because insurance is the last resort for handling an exposure, it requires limited work by the risk manager.

An inherent problem with an insurance checklist is that it is, by definition, geared toward exposures that are currently insured or are conventionally insurable. In addition, swings in the insurance market can cause the scope of insurable exposures to expand and contract.

The fifth list is somewhat an amalgamation of several other checklists. The Industry List is a checklist specific to a certain operation or industry and is generally tailored to specific assets, activities, perils, and insurable exposures commonly found in that industry or operation. Since anyone in a given industry can easily use the checklist, it facilitates comparisons with peers. However, it can be too focused on the industry, overlooking assets and activities that are not common to all industry participants, or it can be too generic, capturing the obvious and not adequately addressing the unique issues facing industry participants. Also, if the checklist is not created or at least edited by others outside the industry, the users may continue to make the same mistakes other industry participants have made.

**The Flowchart Method** graphically and sequentially depicts the activities of a particular operation or process. It is process-driven and follows a logical flow. It uses product analysis, dependency analysis, site analysis, decision analysis, and critical path analysis. The flowchart method illustrates the interdependencies within the organization, can easily pinpoint bottlenecks, and can determine the critical path or activity.

However, the flowchart method does not indicate frequency or severity, nor show minor processes with major loss potential, and can be very process oriented. In addition, it has limited use for liability exposures and provides no information about financial impact.

**The Insurance Policy Review Method** is used for reviewing an insurance contract or related documents to determine exposures and perils that are and are not covered, either because the insuring agreement does not extend to the asset or activity, or because terms, conditions, or exclusions are limiting. A common non-contractual document used in an insurance policy review

is a document generally created by an insurance company that explains the features of that carrier's insurance contract.

The risk manager can use internal or external resources for this review, but the focus usually is on what coverage is *available* in the insurance market rather than what coverage is *desirable*. With this method, many perils are given a precise definition, and the review will state what is specifically covered and not covered.

Unfortunately, it is difficult to analyze how an insurance policy will respond before a loss occurs. A judge or jury may even disregard or “change” the policy, lessening the reliability of the analysis and result. Lastly, not all policies are standardized, particularly for very large exposures or unusual situations.

**Physical Inspections** are conducted by informational visits to critical sites, both inside and outside the organization, to determine exposures to risk. They can be performed by internal personnel, e.g., risk manager, safety department, operating personnel, etc.; outsourced to professional consultants, community services such as the fire department, and regulatory agencies such as OSHA, EPA, etc.; or they can be provided by insurance company loss control professionals or agents. Physical inspections are usually personal and provide a visualization of processes and locations that cannot be captured by using a checklist or examining a flowchart. One of the significant benefits is that a physical inspection may be able to find unreported hazards and assets. One CRM faculty member—a risk manager by profession—reported the following conversation which occurred during a physical inspection visit to one of his client's facilities:

“What's in that building over there?”

“That's where we keep the Rolls Royce and the Bentley.”

“What Rolls Royce and Bentley????”

“Oh, didn't we tell you about those?”

“NO!!!”

Physical inspections can also be time consuming, and situations may change often, so inspections must be repeated periodically or whenever significant new properties are acquired or activities begun.

It is also important to keep in mind that if personnel are aware of the date and time of a physical inspection, the area may be cleaned, straightened, etc, for preparation for the visit and may not reflect the “true” working environment. Also, the inspections can be subject to steering by local personnel.

Some examples of a physical inspection checklist would be a Monthly Safety Inspection Checklist, Bank Location Questionnaire, Physical Inspection Report, Floor Safety Evaluation Form, Property Survey Report, Swimming Pool Safety Checklist, Office of Risk Management Survey, and Workers' Compensation Program Analysis.

There are several types of **Compliance Reviews**. They can either be statutory (local, state, or federal) or professional (voluntary, involuntary, industry, or governmental insurance programs). Most compliance reviews are “free” and provide you with an outside opinion, whether

you want it or not. Unfortunately, compliance reviews can carry their own problems, e.g., the insurance carrier declining or cancelling coverage because of an uncovered hazard, and the organization has little or no control over the review, either from it occurring or in its aftermath

The **Procedures and Policies Review Method** uses internal, external, and legal reviews to evaluate corporate by-laws, board minutes, mission statements, organizational charts, employee manuals, codes of ethics, procedures manuals, and risk management policy manuals. This method can uncover exposures that others in the organization create, but organizational politics and realities may prevent any effective treatment of the exposures.

The **Non-insurance Contract Review Method** reviews contracts (other than insurance policies), leases, hold-harmless or indemnification agreements, purchase orders and sales contracts, bills of lading, warranties, advertising materials, mergers and acquisitions, joint ventures and alliances, employment contracts, and service contracts. This type of review helps identify gaps in the risk management plan, revealing exposures the risk manager must address; it may identify failures to meet contractual obligations; and it may identify external sources of risk financing. Because the risk management department is often not involved in the drafting and negotiation of the contract, there may not be a chance for the risk manager to do much about the exposures revealed in the contract review. Also, the involvement of a second party may prevent control of exposures, and sole reliance on the findings from this review may thwart risk management objectives, e.g., finding indemnification from a second party without ascertaining the ability or willingness of the party to financially perform.

The **Expert Method** can either be internal (staff or operations) or external (industry or some specialty). The organization can usually save time and obtain more immediate benefits from the expert's experience. On the other hand, a qualified expert may be difficult to locate and services can be expensive.

The **Financial Statement Analysis Method** is used to identify values that are subject to loss, the event(s) that could cause the loss, and the fiscal impact after the loss. These types of reports analyze both growth in expenses and reduction in revenues. The person conducting the analysis must review the complete financial statements, including the balance sheet, income statement, statement of cash flow, statement of indebtedness and loans, and the notes to the financial statement, as well as the auditor's opinion statement. This analysis can assist in prognosticating the financial losses from a specific event, and it can demonstrate how the loss would affect other areas within the organization. It can be the basis for initial insight in developing crisis contingency plans.

On the negative side, financial statement analysis usually does not take into account business risks and makes it difficult to predict the effect on the organization of losses suffered by key suppliers or customers. There also can be a tendency for the business to manipulate the financial records, debts, or other reports, particularly when scrutiny may disclose underlying problems.

The **Loss Data Analysis Method** can be performed on insurance company loss runs, internal loss runs, or accident and incident reports. Through collection, organization, and analysis, the loss data or loss history will reveal the effectiveness of the risk management program and will be useful for predicting and preventing future incidents, but since this information is historical

and created after an accident or incident, the method is reactive rather than proactive. Data credibility may be an issue and this method limits the number of exposures that can be identified. If a loss has not yet occurred, the exposure cannot be revealed.

## **Logical Classifications: Property, Human Resources, Liability, and Net Income**

The use of the four logical classifications of exposures is a systematic way of classifying and categorizing exposures, perils, hazards, and/or losses so they can be analyzed, controlled, transferred, and financed. While the four logical classifications (property, human resources, liability, and net income) are indeed separate categories, they are not necessarily mutually exclusive. A property exposure, peril, hazard, or loss may likely involve a net income exposure or loss. Further, a human resource and liability exposure to loss may arise from that same property loss. Similarly, net income losses may develop from a human resource loss or a liability loss. As confusing as these logical classifications may seem, the structure provides a starting point for analyzing exposures, perils, hazards, and losses.

### **Property**

Property exposures consist of intangible and tangible property.

Examples of intangible property include branding and reputation. Intangible property would consist of licenses, trade secrets, copyrights or patents, trademarks or trade names, licenses and franchises, and leases or leasehold interests.

Examples of tangible property are real property, personal property, and intellectual property. Another example of tangible property is personal property consisting of cash and securities, records and documents (e.g., accounts receivables, blueprints, corporate records, etc.), inventory, mobile equipment, machinery, furnishings and supplies, computer systems, hardware/software, and databases.

Examples of (tangible) real property are buildings, structures, and land. Buildings and structures have traditionally been described by insurance rating authorities using the COPE methodology. COPE is an acronym for construction, occupancy, protection, and exposures.

Construction describes the materials used and type of construction method of the building. Frame buildings have walls and roofs built with wood, even if the exterior walls are covered with brick or stone. Joisted masonry buildings have walls constructed of masonry, with roofs consisting of wooden joints and wood, tile, or metal roof covering material. Masonry non-combustible buildings have masonry, brick, or concrete block walls with unprotected steel joists or beams and a metal or non-combustible roof and a non-combustible floor. Fire-resistive buildings are masonry buildings with the steel beams or joists protected or covered with a fire-resistive coating or a completely non-combustible roof. Non-combustible buildings are constructed entirely from metal or glass. Further, the building can be divided into smaller “buildings” through the use of approved fire divisions. A fire division is intended to limit the source of oxygen and fuel by creating a smaller area and prevents migration of the fire from one part of the building to another. For example, a section of a building may be a fire division if there are parapets extending above the

roof, automated fire doors or fire curtains made of non-combustible materials, and protected windows or bays that preclude the upward reach of flames into other openings.

Occupancy refers to the particular type of business or activity conducted within the building. Each type of occupancy has its own peculiar perils and hazards that may give rise to a loss. For example, office occupancy typically has furniture that is metal, wood, or glass, carpeting, draperies, and supplies of combustible materials like paper—all of which are fuel sources. However, the office occupancy typically does not have significant ignition sources like open flames or sparking. A restaurant, on the other hand, presents not only cooking surfaces with open flames and high heat, but also the hazards of grease-laden vapors that may accumulate in venting and support a fire. Welding shops, manufacturing facilities, or machine shops have the hazards of open flames, combustible supplies, and electrical arcing.

There are two types of protection: public and private. Public protection is graded by insurance rating authorities using a class system that considers the general level of fire protection provided by fire departments, e.g., location of fire houses, equipment, training, status of personnel (such as full-time or volunteer), and accessibility to and quality of the water supply at the rated location. Private protection consists of the protective measures provided at and for the exclusive use of the building, such as a sprinkler system, alarm system, fire extinguishing equipment and fire brigade, watchman, and water pressure and pipe size at the location.

Exposure is the occupancy of other buildings within specified distances from the rated location or within adjacent fire divisions.

Exposures and perils for property have three criteria:

- A value exposed to loss
- A peril that causes a loss
- A financial consequence of the loss

A value exposed to loss and the financial consequences of the loss are closely related, with the difference essentially being the pre-loss value and the value of the property post-loss—that is, the property that is damaged or destroyed.

## **Human Resources**

Human resources exposures consist of relationships between the organization and its owners or constituents, board members, officers, employees (management and non-management), outside employees (leased, temporary), independent contractors, primary clients, suppliers and/or vendors.

Employee perils include employment practices, death, disability (on or off the job and those including family members), illness (on or off the job and those including family members), retirement, resignation, termination, strikes and labor unrest, moral, and morale. Hazards consist of workplace conditions and characteristics, as well as personal characteristics such as honesty or dishonesty, activities such as smoking or drug and substance abuse, and avocations such as playing bridge, jogging, or skydiving.

Some auxiliary concerns include international employment, benefits programs, and employee contracts, including covenants and non-compete agreements, trade secrets, and incentive programs.

The risk manager may not have authority over human resources, but will likely have some responsibility, nonetheless. The scope of human resources is very broad and cross-functional.

## **Liability**

Liability exposures are related to property, human resources, and activities—including those conducted on the premises and away from the premises—and the products or services provided to customers and others. It also includes exposures related to personal injury, libel, slander, and defamation. The exposure is essentially one arising out of harm to society in general and to individuals and property.

The interests of society are protected by criminal law and the interests of individuals are protected by civil law. In some instances, both criminal law and civil law will be involved in the event of harm or injury. The outcomes of either are likely to cause some degree of net income loss (income foregone or lost opportunity) or property loss (through fines, penalties, damage payments, or confiscation), and possibly human resources (through incarceration, for instance).

Criminal liability is a breach of duty owed to society. The result of criminal liability may involve fines, penalties, or punishment in the form of probation, public service, or incarceration. Criminal liability ranges in extreme from simple matters such as speeding or causing an accident by improper lane use, to serious or heinous crimes such as arson, robbery, or murder.

Civil liability can be addressed through the use of insurance—most commonly, an individual's or organization's negligence. An unintentional act, negligence is the failure to exercise the degree of care a reasonably prudent person would exercise under the same circumstances. Negligence is usually expressed in terms of these four elements: 1) a duty is owed, 2) there is a breach of that duty, 3) the breach of duty is the proximate cause of the injury, and 4) damages result from that injury. For example, a person has a duty to protect others from a flaming barbecue grill, but through carelessness, the flames, without any intervening cause, catch a neighbor's property on fire and destroy it. The destroyed property is the injury. The first three elements of a negligent tort are established. If the destroyed property is the neighbor's garage, there is damage resulting from the injury. However, if the property was the neighbor's trash bag, there is no damage resulting from the injury as the trash is deemed to have no value when it is discarded.

Products liability is an area where the manufacturer may be deemed negligent if their product is defective and causes injury to a person or damage to property. This is absolute liability. If, in the previous example, the barbecue grill exploded due to a manufacturing defect and caused a fire and property damage to the grill owner's house, the manufacturer would be liable for the damages. There are many court cases and decisions regarding products liability to be considered in determining negligence and liability in more complex scenarios.

## **Net Income**

The cause of the net income exposure can be the organization's problem or someone else's problem, but in either case, the result is the organization's problem. Causes may be related to property (destruction of owned or leased property), human resources (personnel losses), or liability exposures (imposition of legal liability). Other causes may be speculative in nature, such as market risk, operational risk, business risk, fluctuations in financial markets, or weather (even without property damage, as when a flood prevents customers from accessing the organization's business).

The causes that are someone else's problems are generally related to the organization's primary supplier or primary customer, or they can be environmental in nature, or they are related to local government, enticement businesses, or the economy. The effect of a net income loss would either be decreased revenues or increased expenses. Decreased revenues would include business interruption, narrowing of a profit margin, weakening sales, or investment income reduction. Increased expenses would include the cost to repair or replace, expediting costs, incremental cost of normal operations, and/or other expenses related to minimizing revenue reduction or expense increases.

## **The Four Logical Classifications of Exposures**

### **I. Property–Owned, Rented, Controlled**

- A. Exposures (real, personal property, intellectual property, intangible property, legal interest for property)
- B. Perils (windstorm, theft by employees or outsiders, infringement of intellectual property, loss of reputation, obsolescence)
- C. Hazards (faulty wiring, lack of security, neglect in protection, poor public relations practices)
- D. Losses (accidents and occurrences)

### **II. Human Resources**

- A. Exposures
  1. Owners, partners, shareholders
  2. Board members and officers
  3. Employees—management and non-management
  4. Outside employees (leased, temporary and borrowed employees, and volunteers)
  5. Independent contractors
  6. Others (primary clients, suppliers, vendors)
- B. Perils
  1. Employment practices
  2. Death
  3. Disability—on and off job, family members
  4. Illness—on and off job, family members
  5. Resignation, termination, retirement
  6. Strikes and labor unrest



- C. Hazards
  1. Unclear personnel practices
  2. Non-adherence to safety practices
  3. Poor morale, poor performance, or natural aging process
  4. Terrorist acts
  5. Management attitudes
- D. Losses
  1. Damages awarded to employees
  2. Cost to replace deceased key employees
  3. Cost to replace retired employees
  4. Extortion payment
  5. Loss of productivity

### **III. Liability**

- A. Exposures
  1. Types (premises and operations, personal injury, products, statutory)
  2. Basis (tort law, contract law, statutory law)
- B. Perils (slip and fall on premises, product malfunction, work-related injury to employees)
- C. Hazards (poor housekeeping, poor quality control, lack of safety training and equipment)
- D. Losses (legal damages, statutory damages)

### **IV. Net Income (including speculative risks)**

- A. Exposures (loss of use of property, loss of productivity, reduction of income/assets, speculative risk)
- B. Perils (property, human resources, liability, loss of primary supplier/customer, weather, market, fluctuations in financial markets, governmental action, fluctuations in economy)
- C. Hazards (poor product positioning, overextension of credit or excessive borrowing, inadequate investment in research and development)

## **General Rules**

Six general rules apply to risk identification:

1. Risk Identification is the most important step in the risk management process.
2. Risk is present in every business activity.
3. Risk is not always self-evident.
4. Risk is subject to diagnosis and treatment.
5. More than one identification method should be used to diagnose and identify risks.
6. Often one method will reveal the greatest number of risks.

Risk Identification is the most important step, as an unrecognized exposure cannot be intelligently managed. The risk manager's primary task is to identify the exposures, and once identified, the exposures must be quantified and analyzed. After quantification and analysis, the risk manager can create the matrix of avoidance, control, transfer, and financing methods to manage the risks. Until the exposure is identified, however, nothing else can happen.

