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Managing Risk: Identifying and Controlling Losses and Assuming Risks From Perils

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Abstract

Financial survival in the hotel and restaurant business can depend upon a mastery of the basic principles of risk management. This article explains the series of steps leading to the successful implementation of the risk management techniques most appropriate for a given hotel or restaurant.

Keywords

K. Michael Haywood, Managing Risk: Identifying and Controlling Losses and Assuming Risks from Perils, Risk assumption, Insurance, Hold harmless, Indemnity/Indemnify, Annual aggregate

Managing Risk: Identifying and Controlling Losses and Assuming Risks from Perils

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Financial survival in the hotel and restaurant business can depend upon a mastery of the basic principles of risk management. This article explains the series of steps leading to the successful implementation of the risk management techniques most appropriate for a given hotel or restaurant.

Today every lodging and food service business is well aware of its vulnerability to a variety of events, including fire, theft, and other perils. These catastrophies could result in major financial losses or, at the very least, in severe disruption of the day-to-day affairs of a business. Many preventative measures are being implemented in order to decrease the possibility of a loss occurring, or at least decrease the amount of the loss; however, these measures are not completely adequate. If by chance the worst were to happen, what can a company do to at least lessen the impact of the loss and to ensure that there is no major disruption to its cash flow and, ultimately, no direct threat to its financial survival? Exhibit 1 provides an outline of the process.

The identification of potential loss events is the first and most crucial step in the risk management process. This means analyzing and reviewing a company's entire operations — from receipt of purchases to the ultimate collection of cash — to see what areas are vulnerable to what specific kinds of losses.

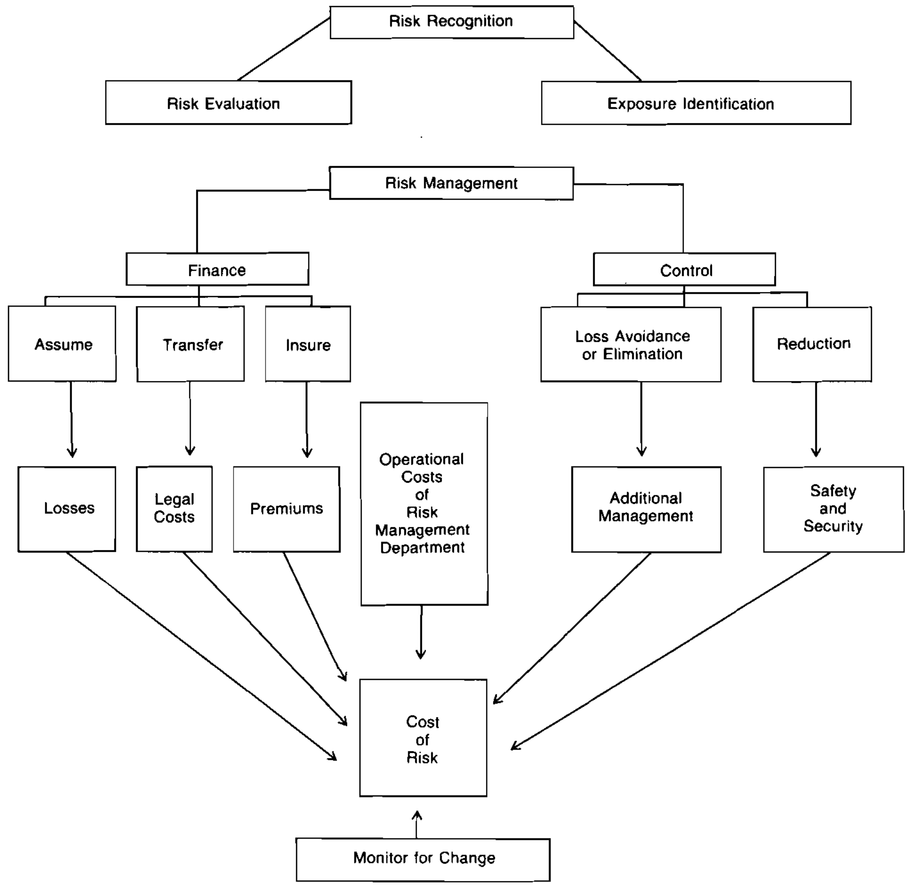
The next step is to assemble a list of all possibilities, an "inventory of loss events," which should also indicate the likelihood of each event occurring. Assembling such an inventory will make it easier to attach a dollar figure to each possible event and to determine its ultimate economic impact on the company's operations.

Without properly defining the risks, it is impossible to move on to the subsequent risk management steps of loss avoidance, elimination, reduction, risk assumption, and risk transfer.

Exposure Identification Is Essential

To identify the risks confronting a hotel or restaurant, a systematic approach is essential. The exposure identification process can be custom tailored to each company, but there are several common steps,

Exhibit 1
The Risk Management Process



including the use of checklists, physical inspections, interviews, financial statement review, contract review, and case history analysis.

• **Checklists:** There are checklists available from insurance companies that identify and highlight potential exposures to loss. These checklists provide a starting point and will ensure that at least minimum standards and a systematic approach are employed in the exposure identification process. When properly designed, the questionnaires will capture the data required to properly rate a risk and measure the quantifiable determinants of exposure such as type of operations, payroll, gross sales dollars, occupancy rate, number of covers, etc. This underwriting and pricing information will become crucial in the exposure/risk evaluation process.

• **Physical inspections:** As with internal control evaluation, a walk-through of the property, including the operations and production facilities, is necessary for determining loss possibilities. The walk-through should entail a close examination during normal operations and, preferably, should be a surprise visit. This will give a true picture of the safety procedures in effect, housekeeping, normal on-the-job operating procedures, and many other indicators of loss control.

- **Interviews:** Interviews with employees and management personnel should provide valuable insights into the operation of the current risk management systems. In the course of these interviews, probes for information about safety programs, hazards, losses, experience, etc. should be made.

- **Financial statement review:** The financial statements provide a tremendous amount of risk management information. In their review, the assets of risk should be listed, as should any contractual obligations provided for in the loan agreements on the balance sheet. Within the income statement, major revenue and expenses should also be highlighted for later analysis regarding their vulnerability to interruption or escalation in the event of a loss. In addition, the financial statements will provide the key to a company's ability to assume loss and provide for risk assumption in its day-to-day operations through the use of deductibles, self insurance, or actual funded reserves.

- **Contract review:** Contractual objections can create loss possibilities. Waivers of subrogation, duties and rights, bonding requirements, etc. can all affect a company. A company's contractual arrangements must be reviewed to make certain that adequate provisions have been made for any risks assumed by contract. Obviously, a system must be in effect so that contractual obligations are centrally controlled and monitored to ensure the company's or individual's consistent risk management treatment.

- **Loss-history analysis:** Past loss data is an invaluable source of information about the management and control of a company. The 20/20 hindsight provided by actual incurred losses is an indelible reflection of what actually did go wrong in the past and its economic implications. By examining and investigating this information, a loss profile can be developed and normal loss patterns defined.

While none of the approaches just mentioned will, on its own, ensure complete exposure identification, combining them will make it possible to develop a useful risk inventory; developing this risk is crucial to the establishment of the frequency with which losses occur and the severity of those losses.

Data Must Be Evaluated

Once the risk inventory has been developed, the data must be evaluated and qualified in terms of the following:

- **Expected annual loss:** This is the dollar value representing the total of all losses that should occur throughout the year on a normal basis and, generally, can be statistically computed as frequency times the expected value of the loss.
- **Probable maximum loss:** This is the value of the loss that has a statistical probability of occurring on a predictable but infrequent basis, that is, once every 10 to 15 years. The maximum loss is the worst that can be expected under average conditions.

- **Possible maximum loss:** This value represents a catastrophic loss, but one that has a statistical probablility of occurring perhaps once in the company's history. The worst possible conditions and results must be assumed in this event.

Both risk identification and risk evaluation are ongoing processes. The hotel or restaurant and its accountant must be on the alert for changes that will create new exposures, concentrations of value, or increased chances of loss. Such continuing appraisal and reappraisal will protect the company in a changing business environment. An effective risk management program is never outdated; it is dynamic.

Once the exposures inherent in a company's operations have been identified and evaluated, the next decision to be made is how to best handle them economically and, at the same time, protect the company against a truly catastrophic loss.

Several techniques are available, the most common of which is a transfer of risk through the purchase of insurance. While this is a valid technique, there are other ways to reduce the cost of loss rather than by simply insuring against it. Among them are "risk elimination" or "avoidance" and "risk reduction." Alternative methods for dealing with risk are "non-insurance risk transfer" and "risk assumption." Not only do these techniques provide a basis for controlling risk and building up financing for it, but they are also normally totally within management's control. Therefore, when these techniques are incorporated into normal job descriptions, financial controls, budgets, etc., they will incur nominal additional costs and can prove to be cost effective.

- **Risk reduction:** "An ounce of prevention is worth a pound of cure." The techniques of loss prevention and loss reduction are used to lower the chances that a loss will occur or, if it does, to lower its economic impact. These techniques deal with the elimination and reduction of the mechnanical, physical, or human causes of loss.

Risk reduction requires the constant monitoring of control techniques. These two functions will be most useful if supported by the use of "incident reports" (reports detailing, for example, guest or employee accidents or mistakes that could have resulted in accidents), inspection reports and past loss reports (setting up a legal team, getting the investigation going, ranking priorities of clients involved, protecting undamaged assets, etc.). Setting up safety programs and safety groups will also aid the risk reduction effort by controlling the human element.

- **Risk assumption:** The risk of this technique — the acceptance of losses through the use of an insurance policy deductible, self-insurance or non-insurance — falls into two categories: (1) passive risk assumption (non-insurance), which occurs when a company is unaware that a loss exists (overlooked in the exposure identification process) and, therefore, takes no action to deal with it, and (2) active risk assumption, which occurs when the risk has been evaluated and management consciously decides to pay for actual losses as they occur, with operating resourcs or from a funded reserve.

Every company must consider assuming some risk and determining at what levels risk assumption is economical. This will provide the following advantages: reduced costs, better control, and a greater accountability for losses.

- **Risk avoidance:** As an alternative to risk assumption, this technique is simply making the decision to stay away from certain risk situations. For example, the decision may be made not to introduce certain menu items because they are potentially hazardous. Or a hotel chain expansion into certain foreign countries might become suspect because of increasing political risk. Obviously, this is a last resort technique in many circumstances because avoidance not only eliminates the risk activity, but also eliminates the chance for business gain.

- **Non-insurance risk transfer:** Normally we think of risk being transferred to professional risk bearers (insurance companies), rather than to customers, vendors, leases, etc. A company should, however, also consider its contractual obligations to other parties as an opportunity to reduce risk. It is only fitting that, when someone else has control over your assets, you are indemnified in the event of a loss. In addition, it is sound management not to accept risk unnecessarily when the contracting company is in control of operations. In essence, if the operators know they will be liable for damages, there will be more care in their operations or in their use of the property. Also, if they are more familiar with the process, they will be able to better control risk in the operating environment.

One of the most common and widely used forms of risk transfer, other than an insurance policy, is the "hold harmless" or "indemnity" agreement. This clause within a contract is a means whereby one party transfers the liability for a loss that would normally be retained to the other party within the contract.

- **Purchase of insurance:** This is the final alternative in the risk management process. If the potential economic consequences of a loss are too great for a company to bear, insurance is in order. If insurance premiums represent a good buy and a risk can be transferred – based on the reasoning "why risk a lot for a little?" – insurance can provide the protection management needs without having to resort to alternative risk treatment techniques.

At the heart of the analysis so far is the cost of risks. This is the final result when all of the costs of dealing with risk are accumulated. For example, risk reduction requires expenditures for safety, security, engineering, etc. Loss assumption will result in actual incurred losses. Risk transfer will require legal costs or an increase in the costs of services or goods provided when liability is assumed by the provider. Finally, insurance generates premiums and, when using the avoidance or elimination techniques, the costs of additional management time or lost profit opportunities must also be considered. Maximizing the interrelationships of the components requires accurate and timely information. Therefore, none of the above techniques can operate in a vacuum or in isolation from the marketplace.

These risk management techniques are not mutually exclusive, and the most cost-effective risk management program for any given exposure to loss usually results in a combination of the various alternatives.

Funding Has Several Avenues

Traditionally, risk has been funded through the purchase of insurance. Premiums are paid to the insurer, who then manages them to insure that there are enough funds available to pay all claims under the insurance contracts, to pay all administrative expenses, and, also, it is hoped, to provide a profit or, in the case of a mutual fund company, dividends to the policy holders. Over the past 10 to 20 years, as losses have increased and premiums escalated, the use of deductibles, self-insurance, and captive insurance companies (companies established as subsidiaries of a corporation solely for the purpose of providing insurance for that corporation's own property and staff) increased at a tremendous rate. It became obvious to most corporate insurance buyers that an in-depth analysis of their ability to fund loss themselves was required.

Far too few companies have established a loss assumption program based on a logical approach to self insurance. Often the purchase of deductibles or self-insurance is based on premium credits rather than on the financial ability to pay. If premiums and losses for a 5 to 10-year period are reviewed, it soon becomes obvious that a company will pay more in insurance premiums than a carrier would in settling claims. The insurance company uses a company's historical loss data to establish its rates and rating plans. Insurance premiums, therefore, are structured for the large corporate buyer as a device to smooth over losses from one accounting period to the next — for a fee. In addition, the fee structure includes charges for services the buyer may not need or, conversely, can provide more efficiently or economically internally or on a specific contract basis.

An aggressive loss assumption program will reduce the ultimate cost of losses and actually help to provide a positive cash flow. In rate setting and within most retrospectively rated insurance policies, the losses used to compute premiums include loss reserves. These reserves for unpaid losses are invested by the insurance company until the claims are actually paid. Therefore, a hidden cost of the "total service" insurance concept is the loss of the use of funds on loss reserve balances. A loss assumption program should not only be used as means of reducing insurance premiums, but should also become a means of reducing the total cost of risk.

Once the full use of the techniques of risk avoidance, risk reduction, and risk transfer has been made, the problem of loss assumption must be addressed. For example, the company should assume the risk of losses of a noncatastrophic nature, even though insurable, which occur with predictable frequency and which cannot be eliminated or reduced.

A cost-effective loss assumption level on either a "pre-occurrence" or an "annual aggregate" basis should be gauged. It is important to note that both assumption levels, aggregate and pre-occurrence, are averages for a minimum of three to five years. The individual annual calculations can be increased or reduced based on actual experience to date under the assumption program. The main concern is with the total net effect of all losses from every source during the annual accounting period.

Four Steps Can Secure More Efficient Insurance

Financial advisors and managers of both large and small lodging or food service companies can undertake a series of maneuvers that will result in a more efficient insurance dollar. The analysis itself is, in a sense, its own reward, but if a company with difficult-to-place insurance coverage is being serviced, it becomes even more crucial to use higher deductibles and/or self insurance programs properly. Four basic steps are involved.

First, the determination of normal loss (often called "expected value of loss" or "actuarial loss") can and should be forecasted for the next year. Normal loss can be predicted mathematically with varying levels of confidence by analyzing a company's past losses – if it is large enough to have created a credible claims history. Normally, it will take $500,000 to $600,000 of losses to create a credible data base.

If the company does not have an adequate claims history, or is smaller in size, normal loss may be established by using industry data and the exposures found within the company. Forecasting loss is a difficult process and for sophisticated losses requires actuarial determination. By dealing with loss forecasts, which will tie into historical claims history, increased by inflation factors and trend factors, you can leave the more sophisticated techniques to the actuaries.

Once the normal loss has been calculated, the second step is to determine a company's loss retention ability. This analysis is necessary to determine what resources are available to pay for assumed losses over and above the normal loss (that is, the ability to pay for the unexpected loss).

Normal loss is typically included in room and food pricing and in other costs of doing business. Obviously, how high deductibles are set and how low premiums can go will be in direct proportion to the amount of variation (losses above normal loss) a company can assume.

The third step is to look at the available insurance and funding mechanics for a company's exposures. The alternative could include total self-insurance, self-insurance with excess coverage, high deductible retrospectively-rated programs, cash-flow plans, and captive insurance companies. Based on the exposures faced by a company and the computed ability to assume loss, the most economical loss funding mechanism can be determined.

Step four is to work out the most feasible and economical risk management program. The program should be capable of reducing loss through effective loss reduction programs, transferring risk of loss that the company cannot assume at a reasonable transfer cost, and reducing the total cost of risk through a combination of risk management and operating management techniques.

Risk management is a universal management discipline that will allow lodging and food service businesses to systematically control losses and assume risk. At the root of the system is a coverage effective, cost-efficient, and comprehensive insurance program. However, the appropriate insurance program for any company must be based on identification and definition of risks and the subsequent implementation of risk management techniques — loss avoidance or elimination, reduction, risk assumption, and risk transfer.