Managing Risk by Shifting It to Consumers: Responsible Business Behavior?

Diane B. MacDonald
Pacific Lutheran University

Recent crises spotlight the need for enterprise risk management. Often managers employ techniques that mitigate risk for the enterprise but increase risk for consumer customers, shifting risk to a party who does not understand the risk and lacks means to hedge it. Risk mitigation that shifts enterprise risk to consumers weakens the customer's financial condition. When an enterprise shifts the risk consequences of bad business behavior, there is little incentive to change that behavior. Better risk management is achieved by aligning risk techniques with customer interests. ISO 31000 and the GRI Sustainability Reporting Guidelines suggest ways to achieve this alignment.

INTRODUCTION

Recent well publicized and spectacular failings have made everyone more risk conscious. The financial sector was replete with failures in risk mitigation long before the recent financial crises. In 1998, the hedge fund Long Term Capital Management failed even though it used sophisticated financial hedging techniques (Lewis, 1999). The subprime mortgage crisis and subsequent stock and credit market meltdowns are at least partly traced to a failure to limit the amount of risk taken on by the enterprise, as with AIG assuming excessive risk for subprime mortgage bond defaults. The industry which should be expert in managing financial risk failed miserably – and shifted some of the consequences of that failure to the US taxpayer.

Managing risk is a significant part of everyday business operations. The purpose is to identify present and anticipate future risks to the enterprise and control, eliminate or mitigate those risks, whether through changes in processes and procedures, insurance or other appropriate hedging techniques. "The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome and the linkage between effect and cause is hidden from us" (Bernstein, 1996, p. 197). One avenue is to pass the cost of the risk on to customers through price increases providing a revenue cushion for future losses, such as when banks establish reserves for loan losses. Risks indigenous to an industry are priced into products and services offered by that industry. Some types of risk are insurable for modest cost, such as premises liability insurance; other types of risks can be hedged in the financial markets, such as an exporter hedging currency fluctuations in a sale transaction. Still other risks may be negotiated away or mitigated by way of contract provisions with other merchants or vendors as part of the business relationship, such as a manufacturer indemnifying a distributor for product liability claims. A business can also chose not to provide a product or service when the fear of risk exceeds the expected benefit, such as insurance companies that choose not to issue homeowners' policies to cover flood or earthquake damage. Of particular concern for purposes of this article is the risk management option of shifting risk to other parties when those parties are consumer customers. Businesses with relatively equal bargaining power can negotiate to contractually allocate risk and have the ability to price the goods or services exchanged to reflect the risk assumed or deterred. A problem arises when the allocation of risk occurs between a sophisticated merchant and a consumer who may have little choice in the transaction or if there is a choice, little understanding or awareness of the risk being assumed, and no ability or opportunity to hedge or mitigate that risk. Is it a responsible business practice to shift risk to customers as an alternative to other forms of hedging or as a way to reduce the cost of other hedging strategies?

SHIFTING LEGAL RISK

Legal risk is an integral part of engaging in business. The description of legal risk shifting that follows is a sampling of business practices used to mitigate legal risk for the enterprise by shifting it to consumer customers.

Waiving Negligence: Exculpatory Clauses

Some legal doctrines were created to realign the economic consequences of negligence. The doctrine of respondeat superior, for example, is a risk allocating mechanism which shifts economic risk from a third party injured by a negligent employee to the employer under whose control the employee acted. The rationale for this risk allocation is twofold: the employer is in the best position to prevent the negligence by appropriate supervision, and the employer is better able to hedge the economic costs of that risk by raising prices, buying insurance or increasing employee training. The tort system as a whole is a mechanism to allocate the cost of wrongful behavior to the wrongdoer where it belongs. Many risk shifting mechanisms, in particular exculpatory clauses, are designed to avoid this risk allocation. Exculpatory clauses are incorporated into contracts to shift the risk of one party's negligence to the other party by forfeiting the right to sue the wrongdoer. For example, AIG signed waivers of liability in connection with its mortgage bond insurance transactions. Even as information is made public about the failings of the investment banks who were counterparties to those transactions, AIG cannot assert any legal claims because of the waiver contained in the termination agreements negotiated with those parties (Story & Morgenson, 2010). While some criticize the waiver, the New York Federal Reserve maintains it was a standard legal provision and it is common for business parties to negotiate over such provisions (Baxter, 2010). The same cannot be said for consumer transactions where such clauses have been and continue to be the subject of vigorous debate. Consumers do not have the opportunity to negotiate their contracts. Furthermore, consumers frequently do not understand the legal risks they assume nor do they have the capacity to hedge the risks even if understood. Consider someone without health insurance who signs a waiver of liability to engage in an activity and is injured due to the sponsor's negligence. If the injured party does not have the financial resources to pay the costs associated with the medical risk assumed, then the cost of that risk is ultimately shifted to the hospital emergency room, or a social welfare program. Although courts may invalidate exculpatory clauses when they excuse intentional harm or gross negligence (Schultheis & Hroblak, 1998), business lawyers, as part of their client advocacy, quickly redraft clauses as soon as courts point out deficiencies to enforcement (Lesser, 2001).

Allowing a business to contractually insulate itself from legal risk can open access to goods and services that might otherwise not exist because of the fear of lawsuits. This makes sense when participants would otherwise be barred from a risky but desirable activity such as rock climbing, being a contestant on a reality TV show, or participating in a sports program. In these activities it is common for the participant to sign a release and indemnity waiving any claims against the provider even for its own negligence. A participant may freely surrender his or her claims because of a desire to engage in the activity – but in these cases the activity is a discretionary one. When the clauses are used in circumstances essential to daily living, however, such as renting an apartment, or in circumstances that are not strictly a necessity but in fact are unavoidable, such as allowing a child to participate in a school outing, there is little freedom for the consumer to refuse to agree to the exculpation clause. On the other hand, there is reduced incentive for a landlord to use care in keeping a building in good repair if a tenant cannot hold it accountable for negligence. In this case using an exculpatory agreement can provide legal cover for actions that may ultimately devalue the reputation of the enterprise.

Waiving the Right to Litigate

One of the most significant waivers of legal rights is the agreement to engage in binding arbitration and give up the right to sue. This waiver is encouraged by the Federal Arbitration Act of 1925 (FAA), a federal statute that is far reaching as it includes all commercial transactions in interstate commerce. The FAA mandates that agreements to arbitrate "shall be valid, irrevocable, and enforceable" (§2) and that judges may not hear appeals from arbitration awards unless the award "was procured by corruption, fraud, or undue means" (§10). In its decision in the case of AT&T Mobility LLC v. Concepcion (2011), the U.S. Supreme Court struck down state laws prohibiting mandatory arbitration clauses. Since that case there has been an increase in industries adopting such clauses, with the result that customers increasingly have no choice but to accept them (Segal, 2012). Transactions that require mandatory arbitration cover a wide range, including student loans, insurance contracts, utility bills, brokerage account agreements, nursing home agreements, consumer loans, employment agreements, and bank account agreements (National Consumer Law Center, 2010). An argument can be made that business, particularly small business, cannot afford to defend against frivolous lawsuits and therefore methods of risk mitigation that avoid lawsuits is acceptable. The danger is that relying on such terms also creates a false sense of security about the business conduct so protected. One of the cases that gave rise to the 2011 Supreme Court decision concerned alleged overcharges by Discover Bank for over limit fees on its credit card accounts and for incorrectly calculating the amount of available credit (Discover Bank, 2005). The AT&T v. Concepcion case concerned allegations of deceptive practices by AT&T in the way it charged tax on advertised free phones. In each case the enterprises relied on a prohibition of class action arbitration suits to deflect the potential damages if found liable for deceptive practices. Individuals are unlikely to arbitrate on their own when individual damages are too small to justify the cost of arbitration; the prohibition of class action arbitrations can be seen as depriving individuals of a remedy when damages are small even if alleged to be due to fraud. When the enterprise risk mitigation technique results in perceived predatory behavior and when the legal system cannot monitor such conduct because of waivers, the next remedy sought is regulation. The exploding use of arbitration in consumer and employment contracts prompted Senator Russ Feingold, among others, to introduce federal legislation to prohibit pre-dispute mandatory arbitration clauses in consumer disputes (Arbitration, 2009). Although passing the legislation has been unsuccessful so far, it remains to be seen how the new Consumer Financial Protection Bureau created under the recent Dodd- Frank legislative will address the issues of mandatory arbitration clauses.

Disclaiming or Ignoring Statutory Rights

Often when the legislature or regulators act to create statutory rights for consumers, those rights are waivable; that is, a business may require consumers to waive their statutory protections as a condition to purchasing a good or service. In other cases the protections afforded by statute are rendered ineffective because of the way a transaction is structured. For example, many residential mortgages were packaged into collateralized bonds and sold to investors, including loans where the lender engaged in predatory and deceptive lending practices. Lenders are legally accountable for these actions and they may be raised as a defense in a foreclosure action. Investors who subsequently purchased the mortgage loans or the securities collateralized by these loans, however, were not legally accountable for the lender's action and could foreclose notwithstanding the violations. In effect the process of securitization circumvented many of the consumer protection statutes relating to mortgages (Peterson, 2007).

A more common example of circumventing statutory protections is the ability of product sellers to avoid damages for selling defective products. Under the Uniform Commercial Code (the Code) Article 2, a merchant seller makes an implied warranty that the good being sold is free from defect and fit for its ordinary purposes, the warranty of merchantability (§2-314). Sellers also have the ability to disclaim or limit that warranty and to limit damages that may result from a breach of that warranty. In return for a 90-day promise to repair or replace defective goods, a seller can limit the warranty of merchantability to the duration of the express warranty – 90 days -- and the buyer foregoes any claims for damages after that time. In practical effect, unless a product immediately malfunctions, an individual is buying the product at his or her own risk. Warranty disclaimers shift the business risk of defective products to the customer. While individuals are generally aware of warranty limitations when purchasing large items like a car and will consider warranty terms when making such a purchase, the same seldom holds true when purchasing items of lesser value. While one can argue that shoddy products simply will not be purchased and the seller will learn to make a better product or no longer engage in selling that product, the lesson is learned at a cost borne by the first purchasers.

Sometimes a business practice violates the law, but the consumer has no ability to seek a remedy for that violation. One recent example was the practice by banks of seizing social security benefit funds to satisfy a garnishment order or attachment. By government rule, all social security benefits must be electronically deposited. By law, all social security and other federal benefits are entirely exempt from creditor claims. Once the benefits are paid and electronically deposited, banks made a practice of ignoring the exemption and seizing the funds when served with a garnishment or attachment order and paying themselves a fee for handling the transaction (Schultz, 2007). It was alleged that although banks knew the hardships caused by this practice, the fee income in connection with executing a garnishment or attachment outweighed the obligation to determine whether funds were exempt or not (Frozen Out, 2007). The legal risk (enforcement of federal law) was shifted to those who could least afford to pursue their statutory rights. This practice has now been prohibited by Treasury Department rules, regulation being the only effective remedy to stop this practice (Schultz, 2010).

No Remedy to Right a Wrong

Risk shifting is not always as obvious as using contract provisions to allocate risk in a transaction. Oftentimes the risk is shifted to consumers, not by what is said in a contract but by what is omitted from it or simply from a failure to provide a remedy in the event of loss.

Congressional intervention may provide a remedy once a particular practice is widespread and has already caused considerable financial damage. For example, in 1958 universal revolving credit cards were first introduced to the U.S. market through blanket mailings of cards to consumers' homes without any prior notice. The small print in the early credit card agreements included language that made the person to whom the card was issued responsible for any purchases made, even if the card were lost or stolen (Nocera, 1994). Unauthorized charges on lost or stolen credit cards were the customer's problem -- a case of business shifting its risk of loss to the consumer. The Consumer Credit Protection Act of 1968 (CCPA) shifted the risk back to the card issuer, limiting consumer risk to a maximum of $50 for unauthorized charges, and making it illegal to send unsolicited credit cards.

The credit card story may be an old one, but consider business' response to the problem of identity theft and its impact on consumers. A thief would obtain a consumer's personal information through hacking a business' computer system or otherwise intercepting customer data and then use the information to engage in fraudulent transactions. The consumer had the burden of discovering the theft, usually when a creditor came looking for payment, proving to creditors that the transactions were fraudulent, and then convincing credit reporting agencies to delete the fraudulent transactions from the consumer's credit history and credit score. Often the consumer did not know of the theft until one to two years after it occurred (Newman & McNally, 2005). Consumers had no recourse against the business that compromised the data or even against the thief since the data were the business' property and not the customer's. Business asserted its exclusive right to the customer data and the value derived from commercializing it, but shared with the customer the cost of the data theft. Any loss the business suffered could be hedged by pricing the product or service to make up for anticipated fraud, for example pricing credit cards at 20% interest rates. While the CCPA gave customers the right to contest charges for fraudulent credit card transactions, if the fraudulent transaction took a form other than a credit card charge customer rights of recourse are not so clear. It took the passage of the Identity Theft and Assumption Deterrence Act of 1998, individual states passing laws that required companies to notify consumers of information thefts, and action by the Federal Trade Commission (FTC) to begin to give consumers some ability to protect against identity theft risk (Federal Trade Commission, n.d.).

SHIFTING BUSINESS RISK

Risk shifting is not limited to legal risk. There is a growing trend to shift ordinary business risk.

Protect My Intellectual Property Rights – At Your Expense

There is great competitive advantage in obtaining intellectual property rights. There is a cost to protecting those rights, particularly in a digitized and global business environment. Nowhere is this more obvious than with the music industry's inability to protect its copyrighted works from being downloaded on the Internet. The Recording Industry Association of American (RIAA) engaged in a high profile initiative using legal action to force the payment of thousands of dollars for copyright violations, even when those individuals being charged may not have been directly responsible for infringement. Statutory damages for copyright infringement allowed the RIAA to threaten parties found to have aided and abetted copyright infringement by furnishing the computer or the URL or otherwise providing the ability to link to the Internet (Bangeman, 2007). It is unclear whether the policy of lawsuits was successful in reducing downloading, but the publicity surrounding the lawsuits eventually led the RIAA to pull back on its strategy of suing its customers. The RIAA remains unrelenting in pressuring colleges and universities to monitor and eliminate student peer-to-peer file sharing and other methods of sharing music and movies. While there may be little sympathy for those who take their chances in illegally downloading, there is concern when a private business requires university information technology personnel to spend time dealing with copyright takedown notices or demands for student information. The Higher Education Opportunity Act of 2008 requires colleges and universities to combat the unauthorized distribution of copyrighted material by users of the institution's network or risk losing their eligibility for federal student aid. At a time when financial resources are stretched and families struggle to pay the costs of college, schools must find a way to meet the law while not stressing their budgets, leading some to question how appropriate it is that the cost of copyright enforcement be shifted from the businesses that profit from the copyright to colleges and their students (Young, 2010). Ironically, proposed anti-piracy legislation in Congress pits copyright owners against Internet based companies, such as Google, Wikipedia, and Craigslist. The argument is one of who should pay the cost of policing copyright violations, the copyright owner or the websites that may inadvertently contain copyrighted material (Schatz, 2012).

I'm the Expert in Pricing Credit, but You Absorb the Risk of Fluctuations

Over the last thirty years there has been a wholesale transfer of interest rate risk to borrowers through adjustable rate loans. Credit cards, home equity loans, mortgage loans and other forms of consumer credit no longer have a fixed rate but rather carry rates that vary with a designated benchmark. For some credit the benchmark is the prime rate or the London Interbank Offered Rates; others use Treasury securities of varying maturities. Most consumers do not understand what the index or benchmark is, much less have the ability to anticipate how it will change in the future and how to hedge in the event it rises. Ironically, this shift of interest rate risk was the result of yet another banking crisis. In the 1970s and 80s savings and loan institutions engaged in practices where they used short term money in the form of high interest rate deposits to make fixed rate long term residential and commercial mortgage loans. Although the cost of money continued to rise, the income from fixed rate loans remained the same. The economy deteriorated and loan defaults rose wiping out much of the capital in those institutions. Part of the legislative solution was to begin deregulating the financial services industry. Title VII of the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain) allowed banks and savings and loans to engage in alternative residential mortgage transactions including adjustable rates, maturities shorter than the amortization schedule, or "any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed –term transactions, including, without limitation, transactions that involve the sharing of equity or appreciation" (§3802). In his remarks on signing Garn-St. Germain, President Reagan remarked: "What this legislation does is expand the powers of thrift institutions by permitting the industry to make commercial loans and increase their consumer lending. It reduces their exposure to changes in the housing market and in interest rate levels" (Reagan, 1982, para. 4). The risk of absorbing the cost of rising interest rates was shifted from the institutional lender to individual borrowers. While bankers are the financial experts and have sophisticated tools for financial modeling, algorithms to anticipate changes in the economic climate, hedging opportunities to mitigate the risk of fluctuating interest rates, the consumer borrower is the one bound to absorb the rate fluctuations.

I'm the Merchant but You Get the Merchant Risk so I Can Be Efficient

There is much criticism about applying the commercial law contained in the Code to consumer transactions. This article briefly discussed the warranty provisions of Article 2 that allow merchant sellers to disclaim or limit implied warranties. Revisions to other sections of the Code have also shifted business risk to customers. For example, the 1990 amendments to Article 3 of the Code were intended to update the law of negotiable instruments in light of new technologies that enhanced the ability of banks to more efficiently and cost effectively process checks and to accommodate future developments in the payment system (Rasmussen, 1995). At the time the revisions were proposed there were a number of consumer protection issues raised: allowing truncated statements (elimination of paper checks in statements replaced by information about the check transaction), rules regarding post-dated checks, the banks' ability to post checks and deposits in any order during the course of the day, lack of caps on charges and fees, and questions surrounding the allocation of risk of loss for checks with forged signatures (Robertson, 1995; Sabbath, 1994). Concerns over consumer protection lost to the need for efficiency in handling checks. For example, the Code shifted risk from banks to customers by introducing a comparative negligence rule to allocate losses due to forged signatures or alterations: a bank that pays a forged check will not be liable if it can show that the customer's negligence contributed to the forgery. The bank may be liable if it failed to act in accordance with reasonable commercial standards. One of the commercial standards in banking is that banks generally do not review check signatures. So a customer may be negligent in leaving a checkbook somewhere where a forger could have access to the checks and therefore be liable, but a bank is not negligent in failing to look at the signature to determine authenticity. It has been argued that the Code created a climate that makes it easier to shift the risk of check forgery losses from the bank to the customer (Zekan, 1992). Speaking to the practice of not reviewing checks for signatures, one state law revision commission said, "The decision not to examine signatures on checks is the bank's decision. While that decision may be commercially reasonable, the cost of the decision should be borne by the party that made it, the bank" (New Jersey Law Revision Commission, 1995, p. 6). This reallocation of risk removes the incentive on the bank's part to develop technology to detect forgeries, and even though the bank would remain liable for its own negligence, a customer would have great difficulty in proving what the industry custom is and that the bank failed to follow that custom (Budnitz, 1992). Compare this to credit card losses. The maximum loss to an individual for transactions on a lost or stolen credit card is $50, with the card issuer absorbing any loss over that amount. The industry has developed very sophisticated software to detect fraudulent transactions even as they are occurring. Could the same have happened with forgery detection if banks were subject to a similar liability standard? Paper checks may well be phased out, perhaps to extinction, in the coming years, but the evolution of the law regarding liability and how it may be shifted for paper checks is an example of how risk shifting can discourage the development of better business practices that contribute to enterprise sustainability, and should offer guidance as rules for debit cards and other electronic payment systems evolve.

CONTINUING A TREND

The risk shifting mechanisms described here are a continuation of a trend that began with pension risk shifting from employers to employees, from employer provided defined benefit retirement plans to defined contribution plans. Defined benefit plans include parties with the fiduciary duty to act in the best interests of the employee/beneficiaries; defined contribution plans are designed to limit as much as possible any fiduciary duties, including those relating to investment choices, leaving employees on their own to figure out how to invest for their future. One author noted, "Pension mavens (myself included) have framed the choice between the defined benefit and the defined contribution formats as a matter of risk allocation in the design of retirement savings programs," shifting to employees investment risk, funding risk and longevity risk (Zelinsky, 2004, p. 454). Depriving employees of professional pension plan investment management is a significant disadvantage to the employee and a significant risk to the employee's retirement.

The employer risk shifting paradigm is continued in healthcare benefits. One solution proposed to contain the rising cost of health care for employers is to make individuals more responsible for their healthcare choices. In some cases this means shifting more of the cost of premiums from employers to employees; in other cases this means using tax policy to entice individuals to enroll in high deductible health plans coupled with a health savings account, also called consumer-directed health plans. Business controls its costs and legal risk by transferring the cost and provider choice risk to employees. The problem with consumer-driven health care plans is that consumers have fewer resources to rely on than do employers in making decisions about qualified providers and the financial stability of insurers. The premise that consumer-driven plans will help to contain healthcare costs is based upon an assumption that individual consumers are in a position of knowledge and bargaining power to cause healthcare providers and/or insurers to contain their costs, even though business, with its experts, resources, sophisticated knowledge, and bargaining power, failed to do so (Porter, Teisberg, & Wallace, 2008).

FINANCIAL SERVICES AS A CASE STUDY IN HOW SHIFTING RISK IMPACTS ENTERPRISE SUSTAINABILITY

Understanding how risk mitigation tools impact the enterprise-customer relationship is essential in assessing enterprise sustainability. The credit card industry provides an example of what can happen when managers rely too heavily on risk shifting to individuals. Credit card issuers impose the highest fees on the riskiest transactions, such as over limit fees, return check fees, late payment fees, along with high default rates of interest. Some of the circumstances under which the fees are assessed are under the control of the issuer. The issuer can deny a transaction that exceeds the debtor's credit limit; by allowing the over limit transaction, the issuer then can impose the fee and perhaps even a penalty interest rate. While this practice increased the enterprise's immediate profits, in the long run it weakened the financial stability of the customer. The balance owed increased due to the fee, and the fee accrued interest charges, decreasing the borrower's ability to repay the debt. The financial crisis of 2007-08 coupled with an economic recession and high unemployment increased the credit risk faced by issuers, particularly for those borrowers who were recipients of previous easy credit policies. The time to plan for credit risk management was at the time that issuers were expanding their customer base. A risk analysis would have made projections of various financial scenarios on the quality of the credit card portfolio and processes to mitigate the enterprise-customer risk would have been part of the credit review process for each applicant. Instead issuers competed with each other for customers of all levels of credit worthiness offering low or no interest for a period of time on balances transferred from a competitor's card, an incentive to borrowers to increase debt rather than manage and reduce it. Affinity cards attracted specifically targeted individuals based on a common experience rather than credit worthiness. Incentive programs such as awarding airline mileage points or cash back rebates were additional incentives to increase debt. Credit card issuers relied on fees for a substantial part of operating profits, and the highest fees were assessed on those least able to manage their debt. Other risk mitigation practices were used that further eroded the customer's financial ability to pay: raising interest rates without notice, reducing credit lines or terminating credit accounts without notice, charging interest on transaction fees, allocating payments first to the lower interest rate purchases rather than those with higher rates, not allowing sufficient time to make payments or charging for payments made by phone, ending promotional interest rates with inadequate notice, raising interest rates in excess of 25%.

When an industry turns on its customers and customers have little or no avenue of recourse (including no litigation recourse since that was waived in the account agreements), individuals turn to government. Consequently, the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (Credit Card Act) was passed by Congress to reign in some of the more egregious practices, such as requiring banks to obtain specific authority from customers to pay overdrafts and for credit card issuers to allow over limit transactions. The recently passed Dodd-Frank legislation on the financial services industry promises to further cap the ability of the industry to rely on fees for the source of increasing profits, and more regulation is likely to come as the new Consumer Financial Protection Bureau begins its work.

GUIDANCE FOR MANAGERS IN ASSESSING CUSTOMER RISK

When is it appropriate for an enterprise to increase customer risk as an alternative to other forms of risk management? There are two sources that can be used to give managers guidance on risk shifting to customers. ISO 31000 addresses how an enterprise should approach risk management in general. The Guidelines of the Global Reporting Initiative address how an enterprise should assess responsible product design.

ISO 31000

The International Organization for Standardization provides guidance relating to the enterprise-customer risk relationship through ISO 31000, which provides principles, a framework, and processes for managing enterprise risk. ISO 31000 includes sections on designing risk management frameworks (for the enterprise and particular projects), implementing, monitoring and reviewing the established framework with the goal of continually improving it. While ISO 31000 is intended to be a general overview of how organizations should approach risk management, there are sections that give guidance on how to allocate risk between an enterprise and its customers. One of the processes to modify risk is sharing the risk with another party or parties (sec. 5.5.1). In choosing a risk treatment, such as sharing risk, it advises selecting options that are most appropriate for balancing the costs and efforts of implementation against the benefits derived, including legal, regulatory, and other requirements such as social responsibility (sec. 5.5.2). This risk treatment choice should be made in light of the principles identified in ISO 31000, including:

- creating and protecting enterprise values, including reputation (sec. 3a);
- taking into account the human and cultural factors of the organization, both internally and externally (sec. 3h); and
- making risk management dynamic and responsive to change (sec. 3j).

Creating the framework for risk management under ISO 31000 requires an understanding of the context of the organization (the internal and external parameters), including: “the social and cultural, political, legal, regulatory, financial, technological, economic, natural and competitive environment, whether international, national, regional or local . . . (and) relationships with, and perceptions and values of, external stakeholders” (sec. 4.3.1). Stakeholders are defined as “person or organization that can affect, be affected by, or perceive themselves to be affected by a decision or activity” (sec. 2.13). Customers fit into the category of stakeholders and customer relationships are part of the context of the enterprise. Risk management frameworks also require that someone be accountable and responsible for developing, implementing and maintaining the framework and the risk management tools used within that framework. Oftentimes when an enterprise is seeking to mitigate legal risk, such as using mandatory arbitration in a customer contract, responsibility for choosing the risk treatment is left to corporate counsel. ISO 31000 suggests that responsibility for the risk framework should be identified in people at all levels of an organization (sec. 4.3.3). Managers therefore should be cautioned to avoid simply deferring to corporate counsel’s legal risk mitigation without subjecting the risk treatment to the same review, assessment, and development as they would for other risk mitigation tools.

Many of the practices identified in this article, such as exculpatory clauses and warranty disclaimers, are so ingrained and extensively used that they become part of the risk mitigation framework but are not monitored, reviewed and continually improved as suggested under ISO 31000: “Risk treatment itself can introduce risk. . . . Monitoring needs to be an integral part of the risk treatment plan to give assurances that the measures remain effective” (sec. 5.5.2). Monitoring a risk treatment to see that it remains appropriate creates intentionality about its use and an understanding of its effects on both the external stakeholders and on the behavior of the enterprise. Routinely employing risk treatments without monitoring can lead to an unjustified reliance on a tool that has actually increased enterprise risk by inviting regulation or customer defection or even new competitors who can take advantage of the dissatisfaction experienced by customers. So, for example, when banks were busy raising fees on credit cards, checking accounts, and debit cards, Wal-Mart advertised that it was dropping debit card fees. Wal-Mart is slowly increasing its presence in the financial services market. While banks fought granting Wal-Mart a bank charter in the U.S. when it applied for one in 2005, Wal-Mart has been granted bank charters in Mexico and Canada (Dougherty, 2011). When addressing the selection of risk treatments, ISO 31000 suggests assessing the effectiveness of the treatment and to realize that secondary risks can be introduced by the risk treatment itself. It notes: “Decisions should take account of the wider context of the risk and include consideration of the tolerance of the risks borne by parties other than the organization that benefits from the risk” (sec. 5.4.4).

GRI Standards

There is another perspective for managers to consider in assessing the impact of risk management on individual customers, namely does it contribute to enterprise sustainability. The Global Reporting Initiative (GRI) is a global network of business, NGOs, nonprofits, and labor and professional organizations tasked with developing standards for reporting on sustainability and socially responsible business practices. GRI Guidelines (Guidelines) were developed to establish principles and performance indicators that enterprises can use in reporting on economic, environmental and social performance as well as product responsibility. The Guidelines give managers insight into the kinds of sustainability initiatives they should be considering for their own enterprises and factors that are important to enterprise sustainability.

The Guidelines are useful in thinking through and defining the impacts on customers from the use of various risk management tools. They address product responsibility performance indicators covering an organization’s “products and services that directly affect customers, namely, health and safety, information and labeling, marketing, and privacy” (Global, 2011, p. 38) and suggest disclosure on management’s approach to those product responsibility aspects. Industry specific guidelines tailor the general Guidelines to determine appropriate policy approaches to product development and product design for particular industries. For example, in the Financial Services Sector Supplement Indictor Protocols (FS), FS15 calls for policies for the fair design and sale of financial products and service (Global, 2008, p. 1). Among other aspects, the policies should require the enterprise to identify how it “manages potential conflicts of interest between the (Financial Institution) and the customers,” how it “encourages use of products, services and advice in a fair and reasonable manner . . . and ensures the responsible marketing and selling to higher risk segments” (Global, 2008, sec. 1). FS15 calls for the enterprise to “identify policies, principles and/or codes of conduct that have been designed to ensure that the interests of the institution and its employees are aligned to the interests of existing and potential customers” (Global, 2008, sec. 2.2). Examples include limiting product features that might place a customer at undue risk and creating conflict of interest policies for those situations where personal interests would conflict with the interests of the customer, such as compensation policies that encourage customer use of products with features that put customers at an undue risk (Global, sec. 2.2). Consider the different outcome if subprime mortgages had been designed to limit instead of to increase customer risk (i.e. affordable initial payments followed by unaffordably high payments) and if mortgage brokers had not been compensated based on selling the highest interest rate product regardless of creditworthiness of the customer. FS15 also calls for mechanisms to ensure the implementation of policies, to identify the parties accountable for implementation, and to increase transparency, making policies publicly available (Global 2008, sec. 2.4). If credit card issuers, as part of risk assessment, would have had articulated policies in place that evaluated product features in terms of creating undue risk for customers, perhaps some of the most egregious practices, now regulated under the Credit Card Act, would have been avoided. The failure of issuers to design a credit card product with greater restraint on fees and business practices motivated regulators to issue new rules giving customers greater legal rights and creating more regulatory compliance issues for the issuers.

SUGGESTIONS FOR ASSESSING CUSTOMER RISK

Mangers should evaluate the enterprise-customer relationship for risk factors as part of a risk management procedure. While managers will not directly involve individual customers in risk mitigating decisions, managers can create an accurate and detailed profile of customers that will give insight into how those customers will be impacted by risk mitigation practices. Enterprises already create customer profiles for marketing purposes and use the target market profiles to carry out customer acquisition activities, including media campaigns and direct marketing. A successful enterprise will have a good understanding of the demographic profile of its best and worst customers. That customer profile can be used for risk planning as well.

The process should further identify those risk management techniques that will mitigate enterprise risk without endangering the customer base upon which the enterprise depends. Techniques should also be evaluated in light of the regulatory risk: those techniques that blatantly disadvantage customers to advantage the enterprise invite government oversight and regulation. Even when the regulatory review process does not result in new regulations, the publicity given to the proceedings seldom create a positive image of the industry or the enterprise seeking that advantage.

CONCLUSION

One can argue that the specific examples cited above of risks shifted to customers are not an undue burden on individuals, and therefore not a threat to enterprise sustainability, since it is unlikely that one person is so unlucky as to have all of the above risks visited upon him. But it is not unusual to have two or more such situations and over a lifetime a significant number of them. Professor Robert Shiller, discussing economic risk in his book *The New Financial Order*, cautions that "each [economic risk] considered alone may appear to be insubstantial or to have low probability or to be hard to quantify. But the sum total of the effect of all these risks in the long term can be downright staggering" (p. 58). He uses an analogy of forty thieves, each with a ten percent chance of stealing ten percent of your money, a probability-based estimated loss of one percent of your money for any one thief. While the risk of loss to any one thief is quite small, if all forty thieves steal, you will lose forty percent of your money. The same may be posited with the risks described here: aggregate the cost to the consumer and the costs to all consumers and the amount will be significant. Individual consumers cannot be healthy when they are asked to shoulder a disproportionate share of legal and business risk. If these risks are borne by the business enterprise instead of being shifted to customers, there would be an incentive to become more efficient or to find financially acceptable ways to hedge the risk. If an enterprise offloads its risk there is reduced incentive to change business behavior.

How can this risk shifting trend be changed? Some avenues immediately come to mind. First, legislators and regulators should be mindful of the consequences when deregulating business behavior increases the risk burden of consumers. It is accepted practice to exclude small business from many regulations because of an undue burden on the business. It should become accepted practice to take into account the impact of regulations or lack thereof on the risk burden of consumers. Consumers who cannot financially absorb the risk burden will ultimately shift it to some other party, such as a social service agency or perhaps back to the business via bankruptcy proceedings. Second, legislators must provide an accounting of the social costs of shifting pension and healthcare risks to consumers before taking any further legislative action to increase the risk burden, such as privatizing social security. Finally, business ought to be held accountable for risk shifting activities when evaluating (or being evaluated for) socially responsible behavior and in reporting of its socially responsible activities.

REFERENCES

Arbitration Fairness Act of 2009, S. 931, 111th Cong., 1st Sess. (2009).

AT&T Mobility LLC v. Concepcion, No. 09-893 (US Supreme Court April 27, 2011).

Bangeman, E. (2007, November 29). Oregon attorney general criticizes RIAA's conduct in P2P cases. Ars Technica. Retrieved January 18, 2011, from http://arstechnica.com/news.ars/post/20071129-oregon-attorney-general-criticizes-riaas-conduct-in-p2p-cases.html

Baxter, T. C. (2010, July 9). (Letter to the editor). *The New York Times*, p. A22.

Bernstein, P. (1996). *Against the gods: The remarkable story of risk.* New York: John Wiley & Sons, Inc.

Budnitz, M. E. (1992). The revisions of articles three and four: A process which excluded consumer protection requires federal action. *Mercer Law Review, 43*, p. 827-852.

Consumer Credit Protection Act of 1968, 15 U.S.C. § 1601 (2007).

Discover Bank v. Superior Court, 113 P3d 1100 (2005).

Dougherty, C. (2011, August 15). Banks vs. Wal-Mart: Round two. *Bloomberg Businessweek*, p. 46-47.

Federal Arbitration Act of 1925, 9 U.S.C.§§ 1 (2000).

Federal Trade Commission. (n.d.). *Fighting back against identity theft*. Retrieved January 19, 2011, from http://www.ftc.gov/bcp/edu/microsites/idtheft/

Frozen out: A review of bank treatment of social security benefits: Hearing before the *Senate Committee on Finance,* 110th Cong., 1st Sess. (2007) (testimony of the National Consumer Law Center).

Garn-St. Germain Depository Institutions Act of 1982, 12 USC § 226 (2007).

Global Reporting Initiative. (2011). Sustainability Reporting Guidelines. Amsterdam: Global Reporting Initiative.

Global Reporting Initiative. (2008). Financial Services Sector Supplement. Amsterdam: Global Reporting Initiative.

International Standard 31000. (2009). Risk management -- principles and guidelines. Switzerland: International Organization for Standardization.

Lesser, S. B. (2001). The great escape: How to draft exculpatory clauses that limit or extinquish liability. *Florida Bar Journal, 75*, 10-18.

Lewis, M. (1999, January 24). How the eggheads cracked. *The New York Times Magazine*, p. 24.

National Consumer Law Center. (2010). Arbitration and access to justice. Retrieved January 18, 2011, from http://www.nclc.org/index.php?option=com_content&view=article&id=54&Itemid=70

New Jersey Law Revision Commission. (1995). Report and recommendations relating to articles 3 and 4 of the Uniform Commercial Code. Retrieved January 18, 2011, from http://www.lawrev.state.nj.us/rpts/ucc3&4.pdf

Newman, G. R., & McNally, M. M. (2005). Identity theft literature review. National Institute of Justice Focus Group. Retrieved August 7, 2010, from http://www.ojp.usdoj.gov/nij/publications/id-theft/

Nocera, J. (1994). *A piece of the action.* New York: Simon & Schuster.

Peterson, C. (2007). Predatory structured finance. *Cordozo Law Review, 28*, 2185-2282.

Porter, M., Teisberg, E., & Wallace, S. (2008). What should employers do about health care? Retrieved January 18, 2011, from http://hbswk.hbs.edu/item/5979.html.

Rampell, C. (2008, May 16). Recording industry steps up campus-piracy notices. *The Chronicle of Higher Education*, p. IT 1.

Rasmussen, T. G. (1995). New laws governing checks and negotiable instruments under U.C.C. articles 3 and 4: What does it mean to financial institutions in Ohio? *Capital University Law Review, 24,* 507-548.

Reagan, R. (1982, October 15). Remarks on signing the Garn-St Germain Depository Institutions Act of 1982. Archives: Ronald Reagan Presidential Library. Retrieved July 25, 2010, from http://www.reagan.utexas.edu/archives/speeches/1982/101582b.htm

Robertson, D. B. (1995). Report of the commercial code committee of the section of business law of the State Bar of Texas on revised UCC articles 3 and 4. *Baylor Law Review, 4*, 425-511.

Sabbath, M. D. (1994). UCC update: revised articles 3 and 4. *Mercer Law Review, 48*, 83-106.

Schultheis, K. C., & Hroblak, K. G. (1998). Adloo v. H.T. Brown Real Estate, Inc.: Caveat-emptor -- an exculpatory clause may not be effective under Maryland's heightened level of scrutiny. *University of Baltimore Law Review, 27*, 439-474.

Schultz, E. E. (2007, April 28). The debt collector vs. the widow -- Viola Sue Kell thought her social security benefits were safe in the bank. She was wrong. *The Wall Street Journal*, p. A1.

Schultz, E. E. (2010, February 13). New treasury rules to protect benefits. *The Wall Street Journal*, p. A1.

Segal, D. (2012, May 6). A rising tide against class-action suits. *The New York Times, p. BU4.*

Shatz, A. (2012, January 17). Web piracy bill facers fiercer fight. *The Wall Street Journal*, p. B4.

Shiller, R. J. (2003). *The new financial order: Risk in the 21st century.* Princeton: Princeton University Press.

Story, L., & Morgenson, G. (2010, June 30). In U.S. bailout of A.I.G., forgiveness for big banks. *The New York Times*, p. A1.

Uniform Commercial Code, Article 2: Sales, §§ 2-101-725 (2003).

Uniform Commercial Code, Article 3: Negotiable Instruments, §§ 3-101-605 (2003).

Young, J. R. (2010, April 18). New regulations on campus piracy don't mean new antipiracy actions. *The Chronicle of Higher Education,* p. IT1.

Zekan, J. J. (1992). Comparative negligence under the code: Protecting negligent banks against negligent customers. *University of Michigan Journal of Law Reform, 26*, 125-195.

Zelinsky, E. (2004). The defined contribution paradigm. *Yale Law Review, 114,* 451-535.