UNIT-12 RISK MANAGEMENT

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Explain what is meant by "Risk Management"
- ✓ Evaluate the objectives of risk management for a business
- ✓ Discuss a risk management process
- ✓ Evaluate the benefits of risk management approach

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Unit 12

Risk Management

Introduction to Risk Management

Risk management emerged from the field of Corporate Insurance Buying and it's now acknowledged as a unique and important element for all businesses and organizations.

Risk management can be either a full-time job for one person or for a whole section within a company. People who are responsible for pure risk management are known as risk managers.

Simply put, risk management is a way to protect one's assets. It can be defined as an organized process used by management to deal with the risks faced by the company.

The History of Risk Management and its Concepts

The current form of risk management emerged in 1956 with an article in the Harvard Business Review. The author suggested that a company employee should be placed in charge of "dealing with" their pure risks. At that time, this was seen as a very progressive approach.

The first insurance managers were employed by the first large companies. Insurance became an important item in company budgets due to the growth of capital investments. Over time, the insurance-buying role was given to in-house specialists.

Although risk management has its roots in corporate insurance buying, the changeover from insurance buying into risk management was not an inevitable evolutionary approach.

The move only occurred when attitudes towards insurance changed and people no longer saw insurance as the only way of dealing with an organisation's risk although this had always been the way insurance managers managed risks.

The insurance manager's job was to buy insurance and they couldn't be blamed for thinking this way. What then really caused the change in thinking from buying insurance to the risk management approach?

In the 1950s two scientific studies, the Gordon & Howells Report and Pierson Report, were done on the curricula of American business colleges. Both these studies strongly criticized the curricula at these colleges saying they were outdated and ineffective in training students for their future role as decision makers.

While some business schools objected to the final conclusions of these reports, they began to change their curricula by introducing new programmes and changing the focus of others.

The most important changes made were to add operations research and management science and to move away from detailed courses to normative decision concepts.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Some business insurance buyers began to understand that maybe there was a more cost-efficient way of managing risk.

They realized that perhaps the most effective option would be to prevent losses in the first place, which would in turn minimize the financial effects of losses they were unable to prevent.

Thus, the idea grew that management could identify and evaluate risks the company faced so they could prepare for and avoid certain losses which would in turn reduce the impact of others. People came to the conclusion that the cost of risk could be managed and kept as low as possible.

This new risk management approach made good sense, and it spread from organization to organization. In its present form, risk management is a combination of three areas, namely; decision theory, risk financing, and risk control.

The Element of Risk

Risk is the possibility that a loss or injury will occur. Avoiding risk in today's world is very difficult. For example, people driving a vehicle, investing in stocks or bonds, or jogging along a country road are in situations that involve some risk.

Risk forms part of every decision made by businesses. The main aspect of making business decisions is the process of evaluating possible risks and gains inherent in different options and choices.

Current Definitions of Risk

Currently there is no universal definition on risk. However, the terms found most commonly in all the definitions are: indeterminacy and loss.

The concept of indeterminacy is present in every definition of risk, i.e.: all risks cannot be anticipated. If we are sure that a loss will occur, then there is no risk involved.

For example, when buying anything, even expensive capital assets, we accept that the item will decrease in value and suffer physical wear and tear. In this situation the loss is both expected and definable, thus there is no risk.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

A risk can occur when one of the possible results is unfavorable. This may be a total loss or it may be a lower profit than what was expected.

For example, if a person makes an investment but doesn't take full advantage of the opportunity, they “lose” the benefit they could have gained.

Uncertainty and Its Relationship to Risk

The word uncertainty is often used together with the word risk.

Uncertainty refers to a doubtful thought. This is dependent on lack of information about what will or will not occur in the future. Certainty is the opposite, which means surety of a particular situation.

A student says “I am certain I will get an A in this course,” which means the same as “I am sure I will get an A in this course.” Both statements replicate a conviction about the outcome.

If one claims “I am unsure what grade I am going to get in this course,” the declaration displays a lack of knowledge regarding the outcome.

Where there is a risk (a situation where there is a possibility for loss), uncertainty exists. It's possible for an individual to feel uncertain in a situation which he or she imagines that there is a chance of loss. It is possible for an individual to feel certain (sure) with regards to a certain risk when the exposure to loss is not known.

Classification of Risk

The word “risk” includes all situations wherein there is a chance for undesirable out comes to occur. Risks can be categorised in many ways.

Dynamic Risks

Dynamic risks are those that occur due to a change in the economy. For example changes in prices, consumer expectations, profits, productivity, and technology may lead to financial losses.

Dynamic risks benefit society in the end. Dynamic risks affect a large number of people. However, they are less predictable than static risks.

Static Risks

Unlike dynamic risks, static risks are losses that occur even if there are no specific changes in the economy. If consumer tastes, productivity, income levels, and the level of technology could be maintained, some people would still suffer financial losses.

These losses occur for reasons other than from economic changes; e.g. due to the dishonesty of other people.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

There is no benefit or gain for society as a whole when it comes to static losses. These types of losses are caused by either the physical wear and tear of the asset itself or its loss due to theft or human error.

In the real world, static losses are expected. They are predictable. For that reason, insurance can be bought to cover these types of losses, unlike dynamic risks.

Fundamental and Particular Risks

Fundamental risks are impersonal losses in both the type of loss suffered and the result. The losses will affect a huge group of people or even an entire population; e.g. unemployment, war, inflation, earthquakes, floods, etc.

Particular risks, however, are losses that stem from specific individual events. Normally these losses affect individuals rather than many people.

Particular risks can be either static or dynamic. A building burning down or a bank robbery, are both examples of particular risks.

Fundamental risks are beyond the control of the people involved and are, therefore, not caused by the negligence of any individuals.

While some fundamental risks are covered by private insurance companies, social insurance or government programmes will also take responsibility for fundamental risks.

For example, social insurance would cover fundamental risks like unemployment and work-related disabilities. On the other hand, places affected by flood damage or earthquakes can be declared disaster areas and receive government funding and assistance.

Pure and Speculative Risks

Speculative risk refers to situations where there is potential for loss or gain. Most business decisions are seen as speculative risks, for example, when a decision is made to launch a new product. There is a risk involved. If the new product sells well then the company makes a profit. However, if it fails the company suffers losses.

For example, when buying a car a person is immediately faced with the possibility that the car could be damaged or destroyed. Either a loss will be experienced or no loss will take place. A pure risk is a risk that only involves the possibility of suffering a loss, with no possibility of gain.

So, with pure risk there is no gain. For instance, damage caused by a hurricane, fire or car accident is a pure risk because there is no gain if no damage occurs.

The difference between pure and speculative risk is important, as only pure risks are insurable.

Insurance companies will not insure individuals against speculative risks. Speculative risks are seen as voluntarily entered into and are easily identified because of their two-dimensional nature – the possibility of both loss and gain.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Types of Pure Risk

Pure risks affect individuals and businesses and are categorised as follows:

Personal Risks

Personal risk is the possibility of loss of income or assets due to the loss of the capacity to earn an income. Loss of earning power is attributed to four circumstances, namely:

a. Early death.
b. Dependent old age.
c. Sickness or disability.
d. Lack of employment.

Property Risks

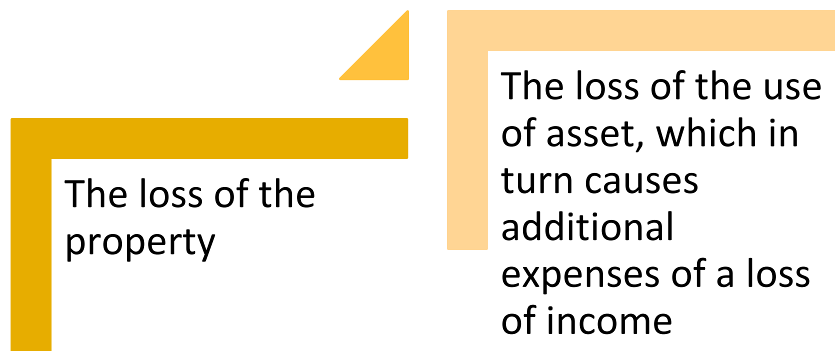
Property risks are faced by anyone who owns an asset, because these belongings can be damaged or stolen. Risks to property encompass two different types of loss; direct loss and indirect or "consequential" loss.

Direct loss is the easiest to understand. If a property is damaged by fire, the owner loses the value of the property. This is a direct loss. However, the house owner no longer has a place to live, so has lost more than just the value of the building.

The owner will need to rent somewhere else to live, while the house is being rebuilt. These additional expenses are known as indirect or consequential losses.

In the case of a company losing their factory, for example, the company not only loses the value of the building and equipment, but also the income that would have been generated through the use of these assets.

Therefore, property risks include the following two losses:



Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Liability Risks

Generally liability risk covers the unintentional injury of other people or damage to their property, due to negligence or carelessness. However, liability can also occur due to deliberate injuries or damage caused.

Therefore, liability risk includes the possibility of loss of owned assets, future income due to damages received, legal liability due to either deliberate or unintentional actions, or even the violation of other people's rights.

Risks Arising from Failure of Other Individuals

Examples of this type of risk include a builder not completing a construction project as scheduled or debtors that fail to make payments as promised.

The swift development of the Internet, the rapid expansion of e-commerce as well as the increased move toward outsourcing by large businesses, has opened up a whole new range of risks relating to the failure of others.

Risk Management

Risk management is the process of evaluating the potential risks that an individual or company may face. Risk management also incorporates minimizing the expenses involved with those risks. Two types of costs are inherent in any risk.

The first type of cost is that which would be incurred if a possible loss becomes a real loss. An example is the cost of rebuilding and re-equipping a factory which has been burned down.

The second type of cost includes the expenses incurred to reduce or to eliminate the risk of probable loss. Costs included here are all the other costs involved like the net income that the factory might have gained. These two types of costs must be off-set against each other, if risk management is to succeed.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Fig: 12.1

Generally people think that simply buying insurance is managing their risk. However, insurance is not the only method of dealing with risk. Other, often cheaper options are available for different circumstances.

Some types of risks are uninsurable which means no insurance company will cover those types of risks. In this section we take a look at the three general techniques of risk management.

Risk Avoidance

One can avoid the risk of a car accident by not driving the car. A company can avoid the risk of having a product fail by simply not launching any new products. With both methods risk is avoided, however, the cost of doing so is very high.

Not driving the car, could result in the person losing their job. A company that does not bring out new products will probably close down, as they are no longer competitive.

On the other hand, there are situations where risk avoidance is a logical approach. People who stop smoking or avoid walking through a park after dark are sensible in avoiding these risks and will benefit by their decisions.

To prevent losses through theft in jewellery shops; the jewellers lock their stock in vaults at the end of the working day. Fuel stations may accept only credit card or exact amounts of cash payments at night, to reduce the risk of staff being held up.

At no point will either individuals or businesses be able to stop all risks. On the other hand, no one should assume that all risks are inevitable.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Risk Reduction

Where risk can't be prevented, the loss can at least be reduced. A passenger in a car can wear their seatbelt to reduce the risk of injury if an accident occurs. A company can reduce the risk of product failure through careful marketing planning and in-depth market evaluations.

In both of these examples, the cost of risk reduction is obviously worth the potential saving. Companies may experience risk due to inappropriate operating strategies or bad decisions made by management. An evaluation of operating procedures by either company staff or perhaps outside experts can usually highlight areas where risk can be reduced.

The strategies which can be used are:

- Launch an employee safety programme to promote safety awareness among employees.
- The purchase and application of ideal safety equipment; i.e. safety shoes for individuals.
- Properties can be protected from robberies by installing alarms, employing security guards, and having guard dogs.
- Installing fire alarms, smoke alarms, and sprinkler systems reduce the risk of losses due to fire.
- Introducing accounting and financial regulations will protect a company’s stock and funds from theft.
- Risks involved in management decisions can be reduced through effective decision making. Every time a decision is made hastily or is based on insufficient information, there are risks involved.
- On the other hand, costs to reduce these risks increase when managers take too long to make decisions. Costs will also increase when managers require far too much information before they are willing to make a decision.

Risk Assumption

Risks are a part of life for people and business. People driving to work understand the potential risk of having an accident; however, they wear a seat belt to reduce the risk of injury if one does occur.

When a business launches a new product, they understand the potential risk of product failure. Therefore, they reduce that risk by means of market testing. Risk assumption, then, is the act of taking accountability for the loss or injury which may result from a risk.

It is sensible to surmise a risk when more than one of the following circumstances exists:

1. The possible loss is too small to be of concern.
2. The risk has been reduced through practical risk management.
3. Even if insurance coverage is available, it’s too expensive.
4. There is no alternative option to prevent the loss.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Large companies with many facilities often find a risk control method called self-insurance, to be a practical way to avoid heavy insurance costs. Self-insurance is the process of establishing a monetary fund which can be used to cover the costs of a loss.

For example, assume that approximately 16,000 XYZ grocery stores, each worth £400,000, are spread across the country. A realistic way to self-insure against fire losses would be to collect a specified amount, say £600 annually from each store.

The funds are all placed in an interest-bearing reserve account and used when required to fix any fire damage to any of the individual XYZ stores.

Money which is not used is saved and becomes an asset for the company. As the fund grows, the annual contribution from each store can be reduced. Self-insurance doesn't prevent risks from occurring; it simply offers a less expensive means to cover losses.

However, self-insurance is risky in the beginning. For example, XYZ would suffer a considerable financial loss if perhaps over twenty-four stores were damaged by fire in the first year when the self-insurance programme became operational.

Benefits of Risk Management in a Nutshell

Risk management can be described as a process which offers assurance that:

- Objectives are more likely to be accomplished;
- Destructive situations will be dealt with in a more sensible and practical manner.

The aim of risk management is not to remove risk completely but rather to manage the risks involved in all circumstances, to increase possible gains and significantly reduce negative effects.

Risk Management Tools

There are two approaches towards managing risk; risk financing and risk control.

Risk Financing

Risk financing is focused on creating fund resources to cover losses occurring from the risks that remain, even after risk control methods have been applied.

Risk Control

Risk control reduces the risk of loss by using risk prevention and risk reduction methods. Risk control includes tactics to reduce, at the very least, possible costs. Risk control makes use of risk avoidance and several tactics to reduce risk through loss avoidance and control efforts.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Risk Prevention

Risk prevention should only be used in situations with catastrophic potential loss and where the risk can't be reduced or transferred. Normally, these conditions exist in the event of risks with high frequency and severity. On the other hand, if prevention is utilized extensively, the company may not be able to accomplish its key objectives.

A manufacturer can't stop the risk of product liability by avoiding the risk and continue to stay in business. Hence, prevention is, in a way, the final resort in working with risk. It is used only if no other option can be found.

Risk Reduction

Risk reduction includes all methods used to minimize the probability of loss or the severity of the potential losses. As the term risk reduction indicates, the emphasis of risk reduction is on stopping the likelihood of loss occurring; i.e. controlling the frequency of loss.

Risk reduction processes concentrate on minimizing the seriousness of the losses that do take place, for example, by installing a fire sprinkler system. This is a loss control measure.

Alternate methods of minimizing the seriousness of outcomes include segregation or distribution of assets and salvage efforts. Dispersing assets won't reduce the number of fires or explosions that could happen, however, it will reduce the impact of the loss as assets are not all in one place.

Risk Management as a Business Factor

Risk management can contribute to the fundamental business's goals and objectives in a number of ways. The first one is in guaranteeing that the organization won't be held back from achieving the other business goals and objectives by pure risk losses.

Risk management can impact company profits directly by managing the cost of risk for the organization. Since profits are measured by costs relative to income, the extent to which risk management can minimise costs will directly increase profits.

Costs can also be reduced through risk control programmes. If the costs of loss prevention and control measures are lower than the amount of losses that are prevented, the cost of uninsured loss is obviously reduced.

Not only can risk management limit costs linked to losses, they can also increase income. For example, if the risk manager sees that affordable political risk insurance is available, management may go ahead and in so doing help improve profit margins.

The risk manager responsible for managing all pure risks can select from many different risk management methods and is, thus, in a position to make a large contribution to the operating outcomes of the organization.

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.

Further Reading:

- ✓ ***Introduction to Risk Management and Insurance: 10th Edition (By Mark S. Dorfman)***

Copyrights © CPD (Courses for Professional Development). All Rights Reserved.