Risk Management In An Hour

Risk Management - Defined

- IRMI - Risk management is the practice of identifying and analyzing loss exposures and taking steps to minimize the financial impact of the risks they impose.

- Dr. Emmett J. Vaughan – Risk Management is scientific approach to the problem of dealing with pure risks faced by individuals and businesses.

- Wikipedia – Risk Management is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or to maximize the realization of opportunities.

THE CONCEPT OF RISK

- Risk involves ***uncertainty*** about the outcome and the possibility that the outcome will be ***unfavorable***
- When risk exists, there must be <u>at least</u> two possible outcomes
- One of the two outcomes must be ***unfavorable***
- ***Without uncertainty – there is no risk***

If we know for certain that a loss will take place, there is no risk

Conceptually in Insurance

- Risk is the chance of loss
- Risk is the possibility of loss
- Risk is uncertainty
- Risk is the dispersion of actual results from expected results
- Risk is the probability of any outcome different from the one expected

THE CONCEPT OF RISK

- When used in insurance, risk can mean
  - The cause of a loss (fire, earthquake, etc.)
  - The chance or possibility of a loss
  - The person or item subject to loss
  - An exposure to loss

For our purposes today…

"Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for"

Emmett J. Vaughan, <u>Fundamentals of Risk and Insurance</u>

- *The notion of an indeterminate outcome is implicit in each of these definitions of "risk" – that is, the outcome is in question*

TYPES OF RISK FACED BY ORGANIZATIONS

- Financial and Non-financial
- Static and Dynamic
- Fundamental and Particular
- Pure and Speculative

Financial & Non-Financial

- Risk = all situations in which there is an exposure to adversity
- Since RISK in its broadest sense includes all situations in which there is an exposure to adversity almost all losses will have some financial impact
- But that financial impact may be considered negligible or incidental by the client and so could be categorized as Non-Financial

Static & Dynamic

- Dynamic Risks = those which result from changes in the economy
- Static Risks = involves those losses that would occur even if there were no changes in the economy

Fundamental & Particular

- Fundamental Risk = losses that are impersonal in origin or consequence
  - IE, group risks, affecting large swaths of the public
- Particular Risks = considered to be an individual’s own responsibility
  - IE, inappropriate subjects for action by society as a whole

Pure & Speculative

- Pure Risk = those situations which involve ONLY the chance of LOSS or no LOSS
- Speculative Risk = situations where there is a chance of LOSS, but also a chance of GAIN

PROBABILITY THEORY

- The body of knowledge concerned with measuring the likelihood that something will happen and making predictions based on that likelihood

- It deals with “random” events based on the premise that while they seem to be merely a matter of chance, they will actually occur with some regularity if observed over a long enough period of time or a large enough number of observations or trials

- PML (largest loss that is likely to happen)
- MPL (largest loss that could happen)
- EPL (amount of loss expected to happen – between 0 and 1)

Probability Theory

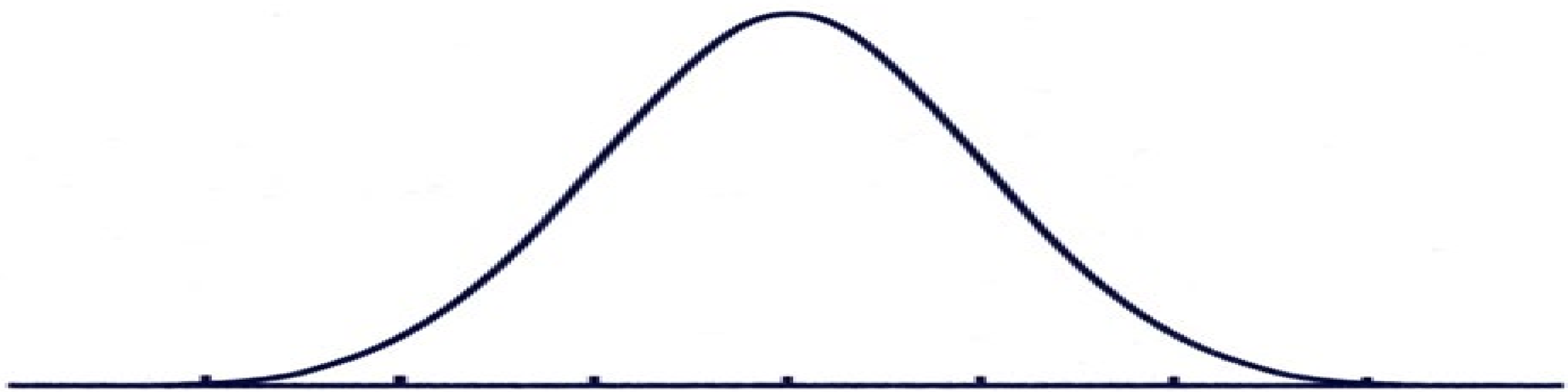
- Likelihood of an event is assigned a numerical value whish is a number between 0 and 1

- Those which are impossible are assigned a **0**
- Those which are inevitable are assigned a **1**

- Those that may or may not happen (neither impossible or inevitable) are assigned a number between 0 and 1

- Those with a higher value (closer to 1) are those estimated to have a greater likelihood (probability) of happening – close to 0 they are estimated to have less likelihood of occurring

PROBABILITY OF FLOOD



5% 15% 60% 15%
5%

Drought Lighter than Normal Normal Heavier than Normal Call Noah

Based Upon The Preceding

Therefore, “risk management” can be defined as an organized approach to identify possible or probable financial harm and take steps to minimize the financial impact to acceptable levels

It Comes Down To Choices

- Risk Control
  - Risk Avoidance
  - Risk Reduction

- Risk Financing
  - Risk Retention
  - Risk Transfer

Risk Control; i.e. Avoidance

- Normally used only in instances where exposure has catastrophic potential and the risk cannot be transferred or reduced

- Essentially the last resort to be used - Otherwise a firm may not be able to attain its primary objectives

- Used when both frequency & severity are determined to be too high & cannot be reduced

Risk Control; i.e. Reduction

- Consists of all techniques used to reduce the likelihood of loss or the severity of those losses that will occur
- Loss Prevention & Loss Control live here
- Two different approaches therein:
  - The engineering approach
  - The human behavior approach

Risk Financing; i.e. Retention

- Most commonly used
- May be conscious or unconscious
  - Passive or active
- If nothing is done, then it is **retained** risk
- May be voluntary or involuntary
  - Voluntary is a decision to retain rather than to avoid or transfer it
  - Involuntary is when it is not possible to avoid, reduce or transfer to another…uninsurable risks

Risk Financing; i.e. Transfer

- Purchase of insurance contracts
- Hedging
- Contractual agreements
  - Hold Harmless
  - Subcontracting

STEPS IN THE RISK MANAGEMENT PROCESS

Determine Objectives

Identify and Analyze

Consider Alternatives

Select and Implement

Monitor Results

RISK MANAGEMENT MATRIX

	High Frequency (probability)	Low Frequency (probability)
High Severity	Avoid	Insure
Low Severity	Reduce or Prevent	Retain

Determined By…

- Those items which are deemed by the customer to be:
  - –ESSENTIAL
  - –Important
  - –Optional

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THANK YOU

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