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Threats and Opportunities - How to Deal with Uncertainty and Manage in a Changing World

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The Institutes

The future is never known with certainty, "Who knows what tomorrow will bring?" Managing organizations means making decisions, enlightened by information drawn from different methods that shed light on the future.

For a long time, men have tried to improve tomorrow by influencing the forces guiding the future, offering sacrifices to the gods. It is only at the end of the 17th century, that Pascal and Fermat, and their successors started developing ways to open the gates of the future by drawing from past and present experiences. Probability and trend analysis were the first approaches to see through the "cloud of the unknown."

During the last decade of the 20th century, the development of risk management, resting on more elaborate forecasting models, seems to have focused only on the downside aspect of risk, the threats, while putting aside the upside, usually called today "opportunities."

Surely the tragic events of 9/11 and the AZF explosion in France soon after, not to speak of the more recent tsunamis and tropical storms in the U.S., have stressed the need to prepare for the worst. Readiness is essential for survival in a time of a crisis. However, confronted with the uncertainties of the future, organizations are rediscovering that "threats" and "opportunities", the Ying and the Yang of risk, are two sides of the same coin.

It is high time that directors and officers, as well as investors, remember the basics of economic and financial theories. Risk is inherent to undertaking a profitable endeavour. Indeed, it is the acceptance of a significant level of risk that provides the type of return on investment expected by the institutional investors. The theory of finance defines the expected rate of return as the sum of two components:

Basic return, of the risk less investment (usually measured by the U.S. treasury bond rate of similar maturity), and

The risk premium, i.e. an additional return that the investor deserves for having accepted a higher volatility of profit, to enhance some societal goal, like improved technology, a new drug, etc.

Of course, all volatilities are not "equal." Traditionally, scientific authors distinguish between probabilistic future (risk) and non-probabilistic future (hazard).

In practice, deciders are in the first situation when they have enough reliable data to compute law of probability or draw trend lines for future events and can define confidence intervals, i.e. limits between the likely and the unlikely future. For example, in analyzing past economic conditions, it should be possible to have a reasonable idea of the number of cars to be sold in the EU, in the U.S. or in Australia. The boom that the BRIC countries (Brazil, Russia, India and China) have experienced for the last decade may not lend itself easily to this type of reliable trending. Therefore, until the recent chaos in World Economies, an automobile company could predict with a fair degree of precision its sales in mature markets, not so easily in emerging markets.

On the other hand, when launching a new model, especially if some defects are revealed in the first year of sales, it is much more difficult to justify the investments on reliable sales forecast. Banks have experienced a similar situation when they embarked on the management of operational risks to comply with the new Basel 2 requirements. Suffice to say that when no data bank is at hand, experts' opinions will have to be formalized, among others thanks to the Bayesians network approach and the use of scenarios.

As a matter of fact, the above examples might be faulted again by looking only at the negative side of risks. However, operational risks are also a significant opportunity for competitive advantage for the banks who invest more than

others in this endeavour. Not only are they likely to save on internal funds but they may even gain expertise that could benefit their clients in a longer term.

The current trend in risk-management is to break down the risk silos to reach a real global optimization of the management of risk, taking into account for each unit, process and project both threats and opportunities. Any organization is thus analyzed as a portfolio of risks with their upside and downside that must be optimized, much as an investor should optimize his portfolio of shares.

In practice, this integration of all risks is achieved more easily for the financial consequences at the risk financing level. More and more economic actors consider their risk financing exercise as part of their overall long term financial strategy. However, it is also possible to integrate risk assessment and loss control, provided all in command at whatever level, are included in the risk management process. This is now called enterprise risk management (ERM) and the managers become "risk owners." The globalization/integration of risk management is thus efficiently implemented through the principle of subsidiary - the directors and officers should deal only with the exposures which impact the strategy, assured that the risk management process implemented throughout the organization will take care of "minor" threats and size "tactical" opportunities.

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