**CHAPTER TWO**

**RISK MANAGEMENT**

***2.1 What is risk management?***

It is defined as a systematic process for the identification and evaluation of pure loss exposure faced by an organization or individual, and for the selection and implementation of the most appropriate techniques for treating such exposures.

It is a scientific approach dealing with pure risks by anticipating possible accidental losses and designed and implementing procedures that minimizes the occurrence of loss.

The risk manager is concerned only with the management of pure risks, not speculative risks.

**NB.** Risk management is the identification, measurement, and treatment of property, liability and personal pure risk exposures.

**2.2 Objective of risk management**

Risk management objectives can be classified into two categories:

1. Pre-loss objectives
2. Post-loss objectives
3. **Pre-loss objectives**

A firm or organization has several risk management objectives prior to the occurrence of loss. The most important are:

1. **Preparation for potential losses in the most important economic ways**

This involves an analysis of safety program expense, insurance premiums, and the costs associated with the different techniques for handling losses.

1. **Reduction of anxiety**

Certain loss exposures can cause greater worry and fear for the risk manager, key executives.

1. **Meet external imposed obligations**

The firm must meet certain obligations imposed on it by outsiders.

1. **Post-loss objectives**
2. **Survival of the firm**

After a loss, the firm can at least resume partial operation within some reasonable time period if it chooses to do so.

1. **Continue operation**

The ability to operate after a sever loss is an extremely important objectives

1. **stability of earnings**

The firm wants to maintain its earnings per share after a loss occurs

1. **continued growth**

A firm may grow by developing new products and markets or by acquisition and mergers

1. **social responsibility**

**2.3 Steps in risk management process**

There are four steps in the risk management process:

1. identifying potential losses
2. evaluating potential loss
3. selecting appropriate techniques, or combination of techniques for treating loss exposures
4. implementing and administering the program
	* 1. **Identifying potential losses**

Risk identification is the process by which a business systematically and continuously identifies pure risk (property, personal and liability risk) exposures as soon as or before they occur.

Risk identification is a very difficult process and it is a continuous job for the risk manager because the risk environment is dynamic.

In this step both obvious and hidden risks need to be identified. Most risk managers use some systematic approach to the problem of risk identification. These are:

* insurance check lists
* loss exposure check list
* risk analysis questionnaire
* flow chart
* on-site inspection
* the financial statement method
* interaction with other departments
* contract analysis
* **Which method is the best?**
* No single method or procedures of risk identification is free of weakness.
* The preferred approach to risk identification is a combination approach.
* The choice is a function of:
* The nature of the business
* The size of the business
* The availability of in-house expertise
	+ 1. **Evaluating potential loss**

Evaluating and measuring the impact of losses on the firm involves an estimation of the potential frequency and severity of loss.

**Loss frequency** – it refers to the probable number of losses that may occur during some given time period.

**Loss severity** – it refers to the probable size of the losses that may occur during some given time period.

Loss frequency and severity data is used:

* to identify important loss
* to identify the best way(s) to handle an exposure to loss

**Why we need each dimension?**

Both loss frequency and loss severity data are needed to evaluate the relative importanceof an exposure to potential loss.

Much emphasis should be given to loss severity. The role of loss frequency should not be ignored.

If two exposures are characterized by the same loss severity, the exposure whose frequency is greater should be ranked more important.

In estimating loss severity, it is important to recognize the timing of any losses as well as their total Birr amount.

**Priority ranking based on severity**

The more severe the loss due to a risk, the higher the risk. As the relative severity of losses differs, not all losses warrant equal attention. Some are to be given priority over others.

Risks can have classifications:

1. critical risks – could lead to bankruptcy
2. important risk – would require an individual or firm to barrow in order to continue operations
3. Unimportant risk – it could be met out of the existing assets or current income without imposing financial strain.
	* 1. **Selecting appropriate techniques, or combination of techniques for treating loss exposures**

The major techniques for treating loss exposures are the following:

1. **Risk control techniques** – attempt to reduce the frequency and severity of accidental losses. It includes:
* avoidance
* loss control
* separation/ diversification
* combination
1. **Risk financing techniques** – provides for funding of accidental losses after they occur. It includes:
* Retention/assumption
* Self - insurance
* Non-insurance transfers
* Insurance
1. **Risk control techniques**
2. **Avoidance** – it means that certain loss exposure is never acquired or existing loss exposures is abandoned.

It avoids property, person or activity that could be a source of risk. One way to control a particular risk is to avoid the property, person or activity giving rise to possible loss.

Risk avoidance discontinues the source of risk. There are some characteristics of avoidance. These are:

* Avoidance may be impossible
* It is an impractical approach
* Avoiding a risk may create another risk
1. **Loss control** – it assumes that the firm will retain the property, person or activity creating the risk but the firm will conduct its operation in the safest ways.

It is designed to reduce both the frequency and severity of loss.

Loss control deals with an exposure that the firm doesn’t wish to abandon. It uses both loss prevention and reduction program.

***Loss prevention program*** – seeks to reduce or eliminate the chance of loss.

***Loss reduction program*** – seeks to reduce the potential severity of the loss.

1. **Separation/diversification**

Eg. Don’t put your eggs in one basket

1. **Combination**

Eg. Expand through internal growth, merger and acquisition

1. **Risk financing techniques**
2. **Retention/ assumption**

It is a method of handling risks by the organization and the source of the fund is the organization itself.

Retention may be passive or active, unconscious or conscious, and unplanned or planned.

Retention is passive, unconscious and unplanned when the risk manager is not aware that the exposure exists and doesn’t attempt to handle it.

Retention is active, conscious and planned when the risk manger considers other methods of handling the risk and consciously decides not to transfer the potential loss.

Eg. Self – insurance

Retention can be effectively used in a risk management program when three conditions exist. These are:

* When no other method of treatment available
* When the possible loss is not serious
* When loss are highly predictable
1. **Self – insurance**

It is a special form of planned retention by which part or all a given loss exposure is retained by the firm.

A better name for self-insurance is self-funding. It requires risk retention and there should be adequate financial arrangement in advance to provide funds to pay for losses should they occur.

It is widely used in workers compensation insurance, used by employers to provide group health, prescription of drug benefits to employees.

1. **Non-insurance transfers**

It is a method other than insurance by which a pure risk and its financial consequences are transferred to others.

Eg. Neutralization or hedging, and holding harmless agreements

1. **Insurance**

It represents a contractual transfer of risks. It is appropriate for loss exposures that have low frequency and high severity.

The five key areas that need emphasis are:

* Selection of insurance coverage
* Selection of an insurer
* Negotiation of terms
* Dissemination of information concerning insurance coverage
* Periodic review of the insurance program
* **Which is the best method?**

*Loss frequency*

|  |  |  |
| --- | --- | --- |
|  | Low | High |
| low | retention | Loss control and retention  |
| high | insurance | Avoidance |

*Loss severity*

* + 1. **Implementing and administering the risk management program**

It is the last step in the risk management process. To be effective, the risk management must be periodically reviewed and evaluated to determine if the objectives are being attained.