

## Risky Business

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*"Vision without action is a dream; action without vision is a nightmare"*  
Japanese Proverb

### To what extent is it feasible to run a corporate risk management program without purchasing insurance?

One only has to look as far as the next headline to answer this question. From financial crises to energy catastrophes to earthquakes and threats of terrorism, we hear a lot about events that challenge our ability to identify and manage risk. Running a corporate risk management program without insurance is tantamount to playing "Russian Roulette" with an automatic weapon. Even the largest of companies hedge their risk with some type of insurance.

What this means is that risk managers need to be even more vigilant in their prosecution of enterprise risk management initiatives. Private and Public Sector operations are complex and becoming more complex as more entrants to the global marketplace compete for fewer and fewer available resources at an ever quickening pace.

To quote from David Brooks' article, "Our risk mismanagement," (New York Times, Sunday, May 30, 2010):

If there is one thing we've learned, it is that humans are not great at measuring and responding to risk when placed in situations too complicated to understand.

**First**, people have trouble imagining how small failings can combine to lead to catastrophic disasters.

**Second**, people have a tendency to get acclimated to risk.

**Third**, people have a tendency to place elaborate faith in backup systems and safety devices.

**Fourth**, people have a tendency to match complicated technical systems with complicated governing structures.

**Fifth**, people tend to spread good news and hide bad news.

**Sixth**, people in the same field begin to think alike, whether they are in oversight roles or not.

As Malcolm Gladwell wrote in that 1996 essay, "We have constructed a world in which the potential for high-tech catastrophe is embedded in the fabric of day-to-day life."

So it seems prudent that risk managers not only focus on mechanical ways to reduce risk exposure, but also more broadly on having the right type of insurance to deal with potentially catastrophic complexity.

### Having Insurance does not mean less risk

Risk is complex. When risk is being explained, we often have difficulty listening and comprehending the words used in the explanation. Why? The rather simple explanation is: compelling stories are most often told with dramatic graphics! Molotov Cocktails, RPG-7's and riots are interesting stuff to watch; no matter that the event has occurred elsewhere and may be totally meaningless to you. Is this pure drama or are these events that we should be concerned about? Or are they so unusual and rare that we fail to comprehend the message about the risks that we face?

We live in an era of information explosion and near instantaneous availability to this information. Driven by a media bias for the dramatic we are constantly being informed about some great calamity

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that has befallen mankind somewhere in the world. The BP disaster in the Gulf of Mexico has been eclipsed by flooding in Pakistan, which will get eclipsed by some other catastrophe.

Society is not awash with disasters! There is always another flood, riot, car bomb, murder, financial failure just around the corner. And, there is a compelling reason for this! The societies we live in have a lot of people! Some quick examples – China and India each have over 1 billion people. The U.S. has 300 million people. The European Union has 450 million people. Japan has 127 million people.

These numbers alone ensure that rare events (even very low probability events) will occur regularly; making the wildly improbable perfectly routine. This is true for countries worldwide. Population size is not a factor – Canada has 32 million people, Australia 20 million, the Netherlands 17 million and New Zealand 4 million. Take this to a smaller level – cities; and you find:

- ☐ Tokyo, Japan - 28,025,000
- ☐ Mexico City, Mexico - 18,131,000
- ☐ Mumbai, India - 18,042,000
- ☐ São Paulo, Brazil - 17,711,000
- ☐ New York City, USA - 16,626,000
- ☐ Shanghai, China - 14,173,000
- ☐ Lagos, Nigeria - 13,488,000
- ☐ Los Angeles, USA - 13,129,000
- ☐ Calcutta, India - 12,900,000
- ☐ Buenos Aires, Argentina - 12,431,000

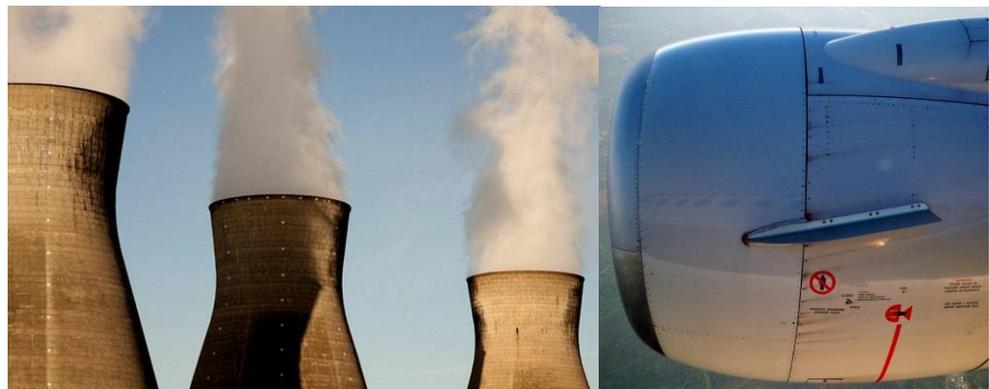
The above may be the ten largest cities in the world; but, consider this – India has 192 cities with populations of over 200,000 people and China has 40 cities with populations of over 2,000,000. New York City with 8 million, London with 7.5 million, Toronto with 4.6 million and Chicago with 2.8 million barely would be of significance in China.

With this many people around, there would appear to be a bottomless supply of rare, but dramatic events to choose from. Does this seemingly endless parade of tragedy reflect an ever dangerous world? Or, are the risks overestimated due to the influence of skewed images?

Nassim Taleb tells us that the effect of a single observation, event or element plays a disproportionate role in decision-making creating estimation errors when projecting the severity of the consequences of the event. The depth of consequence and the breadth of consequence are underestimated resulting in surprise at the impact of the event. Theories fail most in the tails; some domains are more vulnerable to tail events.

### Risk, Risk Perception, Risk Reality

When we see cooling towers, our frame of reference generally will go to nuclear power plants. More specifically, to Three Mile Island, where America experienced its closest scare as a result of a series of errors and misjudgments. As you can see a cooling tower is nothing



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more than a large vent that is designed to remove heat from water (what is termed “non-contact water) used to generate steam.

We worry about cooling towers spewing forth radioactive plumes that will cause us death – when, in fact, this cannot happen. Yet we regularly board commercial airliners and entrust our lives to some of the most complex machinery man has created!

Our perceptions of risk are influenced by several factors. Peter Sandman, Paul Slovic and others have identified many factors that influence how we perceive risk. For example:

<b>Risk Perception Factors</b>	
<b>Acceptable</b>	<b>Unacceptable</b>
Risks perceived as:  Voluntary Under an individual’s control Have clear benefits Distributed fairly Natural Statistical Generated by a trusted source Familiar Affect adults	Risks perceived as:  Being imposed Controlled by others Having little benefit Unfairly distributed Manmade Catastrophic Generated by an untrusted source Exotic Affect children

People perceive risks differently; people do not believe that all risks are of the same type, size or importance. These influencing factors affect how we identify, analyze and communicate risk. Why is it so important to effectively communicate risk information? Here are a few vivid examples of how poor communication/no communication turned risk realization into brand disasters:

- Firestone Tire Recall – Destroys a 100 year relationship with Ford
- Exxon Valdez Oil Spill – Still getting press coverage after 20 years
- Coke Belgium Contamination – Loss of trust
- BP Deepwater Horizon – Enterprise Risk Management (ERM) restructured?

Many years ago, I attended a conference on risk and risk communication in Chicago in the aftermath of the Bhopol disaster in India. Peter Sandman was one of the speakers and he left an indelible imprint on my brain that has stood the test of time and the test of validation. He drew the following equation:

$$\text{RISK} = \text{HAZARD} + \text{OUTRAGE}$$

Sandman, explained his equation as follows:

“Public perception of risk may not bear much resemblance to Risk Assessment. However, when it comes to their accepting risk one thing is certain; perception is reality.”

Sandman concluded his presentation with the following advice regarding the six interrogatories:

- WHO: Identify internal/external audiences
- WHAT: Determine the degree of complexity
- WHY: Work on solutions - not on finger pointing
- WHEN: Timing is critical
- WHERE: Choose your ground - know your turf

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□ HOW: Manner, method, effectiveness

In the 20+ years since that speech in Chicago much has changed. Social Media has, will, might; transform our lives – take your choice. While I agree that the Internet has transformed the lives of millions; I am not convinced that it has yet displaced the traditional media sources for our news.

Information, especially information found via social networking, social media, etc., requires significant insight and analysis. Beyond that, confirmation of the source is critical. Can you imagine the above story making its way into the legal proceedings under discovery?

Risk perception will influence your ERM program. Management simply must devote sufficient resources to recognizing and understanding how operations are being viewed from a risk perspective. With routine incidents being treated as front-page news by the media, you must be prepared to deal with public perception, as well as reality.

### **Disruptive (Unsettling) by Design (with Purpose, Plan, Intent)**

How can you get better at anticipating what will happen? That is the million dollar question. What do you need to do to create an ERM program that leverages forward and creates global awareness within your organization? You must learn to create a mosaic from diverse sources of information and diverse elements within your enterprise. You must learn how to respond to change, disruption and uncertainty; and how to use disruption and uncertainty to your advantage to create a business continuity plan that is truly resilient. Disruption is transforming the way smart organizations make decisions, keeping their business in business when faced with disruptive events. For example, here might be a typical sequence of events:

A risk materializes or is realized (event occurs). Someone, who is perceived to have good information and/or insight into the event or problem, makes a decision. Others observing the first person's decision avoid further analysis/discovery and copy the earlier decision. The more people that copy the earlier decision, the less likely any new discovery or analysis will occur. If the earliest decision was correct, everything works out. If it was not, the error is compounded, literally cascading throughout the organization.

Modern communications systems allow information to cascade rapidly; exacerbating the effect of a wrong or inadequate decision. Disruption happens. Natural disasters, technology disasters, manmade disasters happen. How would a technology breakthrough, a shift in consumer demand or a rise, or fall, in a critical market affect the continuity of your business? Any of these can rewrite the future of a company – or a whole industry. If you haven't faced this moment, you may soon. It's time to change the way you think about continuity and the way you run your business.

### **Dealing with Certainty – Insuring Against the Repercussions**

Michael J. Kami author of the book, 'Trigger Points: how to make decisions three times faster,' wrote that an increased rate of knowledge creates increased unpredictability. Stanley Davis and Christopher Meyer, authors of the book 'Blur: The Speed of Change in the Connected Economy,' cite 'speed – connectivity – intangibles' as key driving forces. If we take these points in the context of the black swan as defined by Taleb we see that our increasingly complex systems (globalized economy, etc.) are at risk.

Understanding the complexity of the event can facilitate the ability of the organization to adapt if it can broaden its strategic approach. Within the context of complexity, touchpoints that are not recognized create potential chaos for an enterprise and for complex systems. Positive and negative feedback systems need to be observed/acted on promptly. The biggest single threat to an enterprise will be staying with a previously successful business model too long and not being able to adapt to the fluidity of situations (i.e., black swans). The failure to recognize weak cause-and-effect linkages, small

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and isolated changes can have huge impacts. Complexity (ever growing) will make the strategic challenge more urgent for strategists, planners and CEOs.

Figure 1, entitled, “But that’s what you were supposed to have before!” provides five definitions that risk managers should be aware of when considering to insure or not.

### *But that’s what you were supposed to have before!*

#### Constructive Knowledge

If one by the exercise of reasonable care would have known a fact, he is deemed to have constructive knowledge of such fact; e.g. matters of public record

#### Foreseeability

Reasonable anticipation of the possible results of an action, such as what may happen if one is negligent or consequential damages resulting a from breach of a contract.

#### Constructive Notice

“Such notice as implied or imputed by law, as in the case of notice of documents which have been recorded with the appropriate registry of deeds or probate. Notice with which a person is charged by reason of the notorious nature of thing to be noticed, as contrasted with the actual notice of such thing.”

#### Foreseeable Risk

A danger which a reasonable person should anticipate as the result from his/her actions. Foreseeable risk is a common affirmative defense put up as a response by defendants in lawsuits for negligence.

#### Negligence

“The omission to do something which a reasonable man, guided by those ordinary considerations which ordinarily regulate human affairs, would do, or the doing of something which a reasonable and prudent man would not do.”

Risk must be viewed as an interactive combination of elements that are linked, not solely to probability or vulnerability, but to factors that may be seemingly unrelated. Addressing risk does not necessarily mean mitigating risk; it means that risk is assessed, quantified, valued (what does it mean to the organization) and monitored. Mitigating risk does not mean that risk is eliminated. It means that the enterprise is buffered against the risk exposure. This is not a one off or onetime process; buffering risk must be monitored constantly to ensure that you have adequate protection based on the current situation.

Companies can optimize their supplier portfolio risks using sophisticated solvency analysis. Most business units in large organizations neglect the counterparty risk in their supplier partnerships. Service degradation risks run high when the supplier’s financial health erodes and there are potentially huge risks and replacement costs if the supplier defaults. Insurance is one measure that companies can take to ensure that they are insulated or compensated for those risks.

There are six basic time element coverages that all companies, regardless of size, should consider:

- Business Interruption
- Contingent Business Interruption
- Extra Expense
- Civil Authority
- Service Interruption
- Ingress/Egress

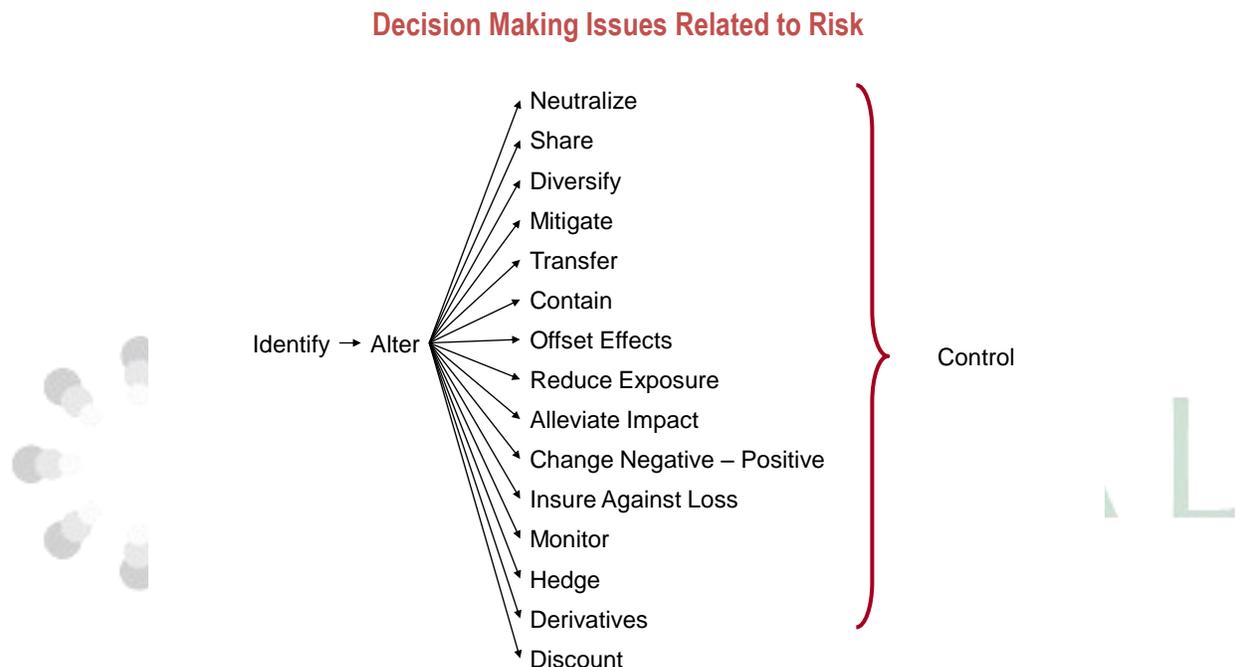
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Business interruption coverage “Protects the cash flow of an insured when it cannot operate as normal due to material damage to its own property.” There are several court rulings that support this point. For example:

“The purpose of a business interruption policy is to indemnify the insured for loss caused by the interruption of a going business due to the destruction of a building, plant or parts thereof”  
- Quality Oilfield Prods., Inc. v. Michigan Mut. Ins Co., 971 S.W.2d 636, 638 (Tex. App – Houston [14<sup>th</sup> Dist.] 1998, no pet.)

Figure 2, entitled, “Decision Making Issues Related to Risk;” provides examples of typical measures that can be taken by risk managers to control risk exposures. Each is a form of insurance.



### Summary Points

I will offer the following summary points:

- ❑ Clearly defined rules for the world do not exist, therefore computing future risks can only be accomplished if one knows future uncertainty
- ❑ Enterprise Risk Management needs to expand to effectively identify and monitor potential threats, hazards, risks, vulnerabilities, contingencies and their consequences
- ❑ The biggest single threat to business is staying with a previously successful business model too long and not being able to adapt to the fluidity of the situation
- ❑ Current risk management techniques are asking the wrong questions precisely; and we are getting the wrong answers precisely; the result is the creation of false positives
- ❑ Risk must be viewed as an interactive combination of elements that are linked, not solely to probability or vulnerability, but to factors that may be seemingly unrelated.
- ❑ This requires that you create a risk mosaic that can be viewed and evaluated by disciplines within the organization in order to create a product that is meaningful to the entire organization, not just to specific disciplines with limited or narrow value.

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- ❑ The resulting convergence assessment allows the organization to categorize risk with greater clarity allowing decision makers to consider multiple risk factors with potential for convergence in the overall decision making process.
- ❑ Mitigating (addressing) risk does not necessarily mean that the risk is gone; it means that risk is assessed, quantified, valued, transformed (what does it mean to the organization) and constantly monitored.
- ❑ Purchasing insurance against risk makes good business sense.

Unpredictability is fast becoming our new normal. Addressing unpredictability requires that we change how Enterprise Risk Management programs operate. Recognize too, that unpredictability can be positive or negative. For example; our increasing rate of knowledge creates increased unpredictability due to the speed at which knowledge can create change.

The degree of risk is based on the perception of the person regarding their vulnerability to the consequences of the risk that is being posited materializing. Risk is, therefore, never absolute. Risk is set by the receiver of the consequences.



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### About the Author



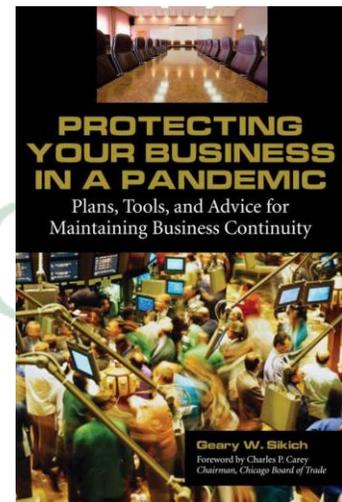
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Geary Sikich is a Principal with Logical Management Systems, Corp., a consulting and executive education firm with a focus on enterprise risk management and issues analysis; the firm's web site is [www.logicalmanagement.com](http://www.logicalmanagement.com). Geary is also engaged in the development and financing of private placement offerings in the alternative energy sector (biofuels, etc.), multi-media entertainment and advertising technology and food products. Geary developed *LMSCARVER*<sup>™</sup> the "Active Analysis" framework, which directly links key value drivers to operating processes and activities. *LMSCARVER*<sup>™</sup> provides a framework that enables a progressive approach to business planning, scenario planning, performance assessment and goal setting.

Prior to founding Logical Management Systems, Corp. in 1985 Geary held a number of senior operational management positions in a variety of industry sectors. Geary served as an intelligence officer in the U.S. Army; responsible for the initial concept design and testing of the U.S. Army's National Training Center and other intelligence related activities. Geary holds a M.Ed. in Counseling and Guidance from the University of Texas at El Paso and a B.S. in Criminology from Indiana State University.

Geary is also an Adjunct Professor at Norwich University, where he teaches Enterprise Risk Management (ERM) and contingency planning electives in the MSBC program, including "Value Chain" Continuity, Pandemic Planning and Strategic Risk Management. He is presently active in Executive Education, where he has developed and delivered courses in enterprise risk management, contingency planning, performance management and analytics. Geary is a frequent speaker on business continuity issues business performance management. He is the author of over 200 published articles and four books, his latest being "*Protecting Your Business in Pandemic*," published in June 2008 (available on Amazon.com).

Geary is a frequent speaker on high profile continuity issues, having developed and validated over 2,000 plans and conducted over 250 seminars and workshops worldwide for over 100 clients in energy, chemical, transportation, government, healthcare, technology, manufacturing, heavy industry, utilities, legal & insurance, banking & finance, security services, institutions and management advisory specialty firms. Geary consults on a regular basis with companies worldwide on business-continuity and crisis management issues.



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