

# Redefining Risk

By

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Years ago, the word *risk* was rarely used. Recently, it has become ubiquitous. This heightened awareness of life's vicissitudes represents a significant opportunity for those who are involved in the business of risk management, but they need to redefine this word to fully understand the issues that give rise to risk. The current usage of the word *risk* is extremely imprecise and creates troubling implications for anyone who is engaged in risk management.

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## Bad Things

Most people intuitively think of risk as something bad that should be avoided. The American Heritage Dictionary affirms this definition. *Risk* -

1. The possibility of suffering harm or loss; danger.
2. A factor, element, or course involving uncertain danger; hazard.

The first definition makes sense in the traditional insurance context of property or liability risks. These types of risks are known as "pure" or insurable risks because they are defined in a way that can only result in a loss.

The second traditional definition contains two meanings. First, there may be some particular thing that is introduced into a given setting that tends to upset the balance of events. This implies that there is some steady state that would continue if it were not for a particular thing that disturbs the environment in some way.

The second meaning included in this definition implies some personal volition, i.e. that a person might choose to undertake some activity that involves potential danger.

Both of these meanings in the second definition indicate that risk is the result of change. In the first case, some external force thrusts change upon us. In the latter case, we are in the driver's seat and consciously decide to change course. However, why would anyone purposely undertake a risky activity if risk is inherently bad? The human desire to upset the course of events

and seek advantage, forces us to expand our definition to include the possibility that some benefit might come from risk.

## Good and Bad Things

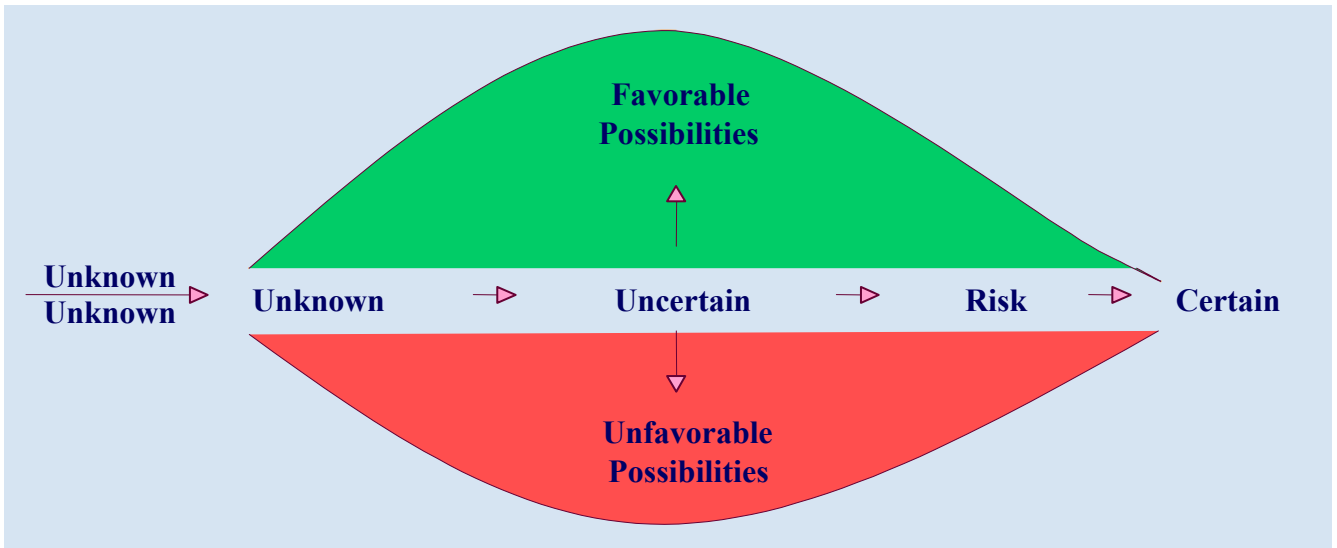
Most people apprehend risk in a bipolar way. In certain circumstances, we instinctively react as if risk were sinister. In other areas of life, we actively seek risk. Thus, we generally feel that that risk has no virtue in some contexts and is highly desirable in others.

In the context of investments, for example, many people are quite comfortable with risk because it is obvious to them that it may bring potential benefits. But can risk ever be *just bad* or is it that we frame it that way?

Historically, risk management activities have been defined in terms of losses and the potential for losses. This definition is highly problematic because it is difficult for most managers to actively support activities that have no beneficial outcomes and that do not fit neatly into their existing compensation systems. Risk management initiatives must be redefined to include gains or they will never be funded appropriately. In addition to identifying and managing new sources of profit, risk management activities should be viewed as a way to free-up finite financial and operational resources.

Traditional insurance definitions make sense from an insurance company's perspective but tend to get in the way of most organizations' true risk management objectives. In reality, even insurable risks have an upside. Managed well, plant and equipment can last longer and produce more value than originally conceived. Similarly, the relationships a company has with its customers, shareholders, employees, regulators, and other interested parties can be negative or positive. Managed poorly, these relationships can bring about many types of liabilities. Managed well, these relationships can produce a tremendous amount of value for a company. Risk management is much more than just loss prevention and mitigation. It is also about identifying and acting on opportunities that may create significant gains.

# The Uncertainty Continuum



## Uncertainty Continuum

Rather than think of risk in a bipolar fashion, i.e. good or bad, it is better to think about it as a continuum of different states of knowledge about some issue. This continuum begins with the *Unknown Unknown*, a state of no knowledge; where we do not even know that we do not know something. Next, some catalyst triggers an awareness of our lack of knowledge and propels us into a state of the *Unknown*, where we actively pursue information that will help us understand an issue.

As efforts to gather information intensify, we begin to determine the scope and magnitude of the issue and enter into the state of *Uncertainty*. After we have enough information so that we can understand the full range of outcomes and develop probability estimates, we have entered the state of *Risk*. Over time, this range of possibilities results in one manifestation of risk. Ultimately, we arrive at a state of complete knowledge about the occurrence of a given outcome. After the outcome has occurred, we reach a state of *Certainty*.

Although there is a temporal dimension to the Uncertainty Continuum, the amount of time it takes to move from one state to another is unpredictable and varies based on many different factors. For example, scientists knew of human brain-wasting diseases similar

to Mad Cow Disease as early as the 1950's (the state of *Unknown*). It was not until the early 1990's that a similar type of disease was generally recognized as being present in cows (the state of *Uncertainty*). Approximately ten years later, food and drug companies began taking greater precautions to create safer products and placate their customers. While *Certainty* is still a long way off, scientists around the world are working to unravel this mystery.

Compare this example to our worries about asbestos, which has been known to cause health problems for thousands of years and is of significant concern to many people. In some instances, risk issues are so fundamental that they never completely drop off our radar screens. In other cases, the issue has a definite expiration date due to some sort of action that we take, or as a result of time itself. The Y2K bug, for example, was on everyone's mind during 1999 and was of no concern only a few months later.

These are just a few examples that indicate how inadequate the word *risk* is to articulate the level of knowledge we have about a given subject. Currently, people use the word *risk* to represent every part of the Uncertainty Continuum. This fuzziness gets in the way of any real understanding and obscures the value of various risk management initiatives.

## Rethinking Risk

An in-depth analysis of the Uncertainty Continuum reveals several important aspects of risk. First, when properly defined, there is always an upside to risk. The outcome of any issue can be better or worse than expected. Recognizing that the states of *Uncertainty* and *Risk* contain both positive and negative outcomes implies that a more encompassing view of risk management can actually create value for an organization and should be funded accordingly.

Although the Uncertainty Continuum is set against a temporal dimension, different events will manifest at different speeds based on the unique interplay of environmental factors. The key challenge for companies is to ensure that risk issues are identified quickly and managed. Otherwise, it is quite possible that they will move directly from the *Unknown* into a state of *Risk* or *Certainty* without any opportunities resulting, and fumbling at every step along the way to avert major losses.

Taking action, though, requires that managers understand their ability to influence risk. This is another issue where managers' perceptions of risk can get in the way of effective risk management. In some cases, managers feel that risk is the product of some environmental randomness or some exogenous factor over which they have little or no control. In other cases, they recognize that their efforts do indeed influence outcomes.

## Management's Role

How significant is our role in managing risk? We know that people generally like to take credit when things go well and are equally likely to shun responsibility when things go badly. To what degree can we attribute outcomes to risk rather than to management?

In reviewing the Uncertainty Continuum, it becomes clear that our ability to influence outcomes diminishes over time. Consequently, it is possible to finance *Risk*,

but it is too late to employ operational initiatives because they cannot have much of an impact on the outcome in this state. Put another way, the die has left the hand, and we are powerless to alter its course. Nevertheless, we can arrange our finances so that we are better able to respond to the number that appears and the fate that awaits us.

It is foolish to wait until issues are in the state of *Risk* to manage them. Reacting to the latest bad news or relying on luck is a fool's strategy, but to do otherwise requires organizational foresight and planning. The benefits of managing *Uncertainty* are much greater than for managing *Risk*. Businesses can make or lose billions of dollars if they can understand and adapt to major changes in the environment.

## Delimiting Risk Management

Since risk is not just generated from within the business itself, risk management cannot be an activity that is focused exclusively on the internal workings of the entity. Risk management must also focus on the external business environment. Organizational and operational initiatives are far more important and powerful tools in managing *Uncertainty* than they are for managing risk. Conversely, financial techniques such as insurance and other derivatives, that are so useful for managing issues in the state of *Risk*, are typically unavailable for the same issues in the state of *Uncertainty*.

Ultimately it becomes clear that risk management is a competitive activity that enables businesses to see and respond to change across every state of the Uncertainty Continuum. If managers can see the changes taking place in their internal and external business environments and respond to them by using a combination of operational, financial, and organization initiatives, they can effectively reposition their businesses and capitalize on new opportunities. This is an activity that is worth funding.