

CHAPTER TWO

RISK MANAGEMENT

2.1 Concept of Risk Management

Risk management is an important part of planning for businesses. The process of risk management is designed to reduce or eliminate the risk of certain kinds of events happening or having an impact on the business.

Risk management involves identifying, analysing, and taking steps to reduce or eliminate the exposures to loss faced by an organization or individual. The practice of risk management utilizes many tools and techniques, including avoiding, assuming, reducing, transferring or insurance, to manage a wide variety of risks. Every business encounter risk, some of which are predictable and could be controlled by management, and others which are unpredictable and uncontrollable.

The term risk management is a relatively recent (within the last 20 years) evolution of the term "insurance management." The concept of risk management encompasses a much broader scope of activities and responsibilities than is done by insurance management. Risk management is now a widely accepted description of a discipline within most large organizations. Basic risks such as fire, floods, employee injuries, and automobile accidents, as well as more sophisticated exposures such as product liability, environmental impairment/degradation, and employment practices, are in the province of the risk management department in a typical corporation.

Although risk management has usually pertained to property and casualty exposures to loss, it has recently been expanded to include financial risk management, such as interest rates, foreign exchange rates, and derivatives, as well as the unique threats to businesses engaged in e-commerce.

2.2 History of Risk Management

The journey of risk management through history is a narrative of humanity's evolving endeavours to anticipate, lessen, and handle uncertainties. In this concise summary, we highlight pivotal moments in the evolution of risk management practices:

I. Ancient Roots (BC Era): Risk management finds its origins in ancient practices. In the third millennium BC, Chinese traders practiced risk-sharing by spreading their goods across multiple caravans or ships to reduce losses from theft or accidents.

II. Roman Times (BC to AD): Ancient Romans introduced basic forms of insurance, such as "benevolent societies" or "burial clubs," to provide financial support during times of adversity.

III. Medieval Era (5th to 15th Century): The concept of marine insurance began to take shape in Mediterranean trade centers like Venice and Genoa. Contracts like "bottomry" and "respondentia" allowed merchants to secure loans against their cargo.

IV. Lloyd's of London (1688): The establishment of Lloyd's coffeehouse in London marked a significant turning point, evolving into the world's premier insurance marketplace, shaping modern insurance practices.

V. Industrial Revolution (18th and 19th Centuries): The Industrial Revolution brought forth new risks, necessitating the development of insurance for property, liability, and workers' compensation.

VI. Actuarial Science (19th Century): Mathematicians such as Benjamin Gompertz and Augustus De Morgan introduced statistical methods and probability theory into risk assessment, laying the groundwork for actuarial science.

VII. Great Depression (1929): The economic upheaval of the Great Depression resulted in regulatory changes in the United States, including the establishment of the U.S. Securities and Exchange Commission (SEC) in 1934.

VIII. Post-World War II (1940s-1950s): The post-war era witnessed the emergence of modern risk management practices in corporate settings, with a primary focus on insurance and safety protocols.

IX. 1970s and 1980s: The advent of financial derivatives like futures and options necessitated more advanced risk management strategies, particularly in financial markets.

X. Enterprise Risk Management (ERM) (1990s): ERM emerged as a comprehensive approach to managing risks across organizations, incorporating financial, operational, and strategic risk considerations.

XI. Globalization (Late 20th Century): The increasing globalization and interconnectivity of economies led to the recognition of systemic risks, prompting international collaboration and risk management efforts.

XII. Technology and Data (21st Century): Technological advancements, data analytics, and modeling tools have transformed risk assessment and management, allowing for real-time monitoring and proactive risk mitigation.

XIII. Non-Financial Risks (21st Century): Environmental, Social, and Governance (ESG) risks gained prominence as organizations integrated sustainability and ethical considerations into their risk management practices.

XIV. Cybersecurity (21st Century): The digital age elevated cybersecurity as a crucial domain of risk management, with a focus on safeguarding sensitive data and critical infrastructure.

XV. Pandemic Preparedness (21st Century): The COVID-19 pandemic emphasized the need for comprehensive pandemic risk management and insurance solutions, prompting a re-evaluation of global risk preparedness.

2.3 Importance of Risk Management

Risk management is a critical and integral part of any organization or individual's decision-making process, and its importance cannot be overstated. Here are several key reasons why risk management is essential:

1. *Minimizing Losses:* Risk management helps organizations identify potential risks and take measures to mitigate or minimize their impact. This proactive approach can significantly reduce financial losses, reputation damage, and operational disruptions.
2. *Enhancing Decision-Making:* By evaluating and quantifying risks, decision-makers can make informed choices. This allows them to allocate resources more effectively and pursue opportunities with a better understanding of potential downsides.
3. *Protecting Reputation:* Reputation is invaluable in today's interconnected world. Effective risk management helps protect an organization's reputation by avoiding or managing crises that could harm public perception.
4. *Compliance and Regulatory Requirements:* Many industries are subject to strict regulations and compliance requirements. Risk management ensures that organizations adhere to these rules, avoiding legal troubles and penalties.
5. *Cost Reduction:* Managing risks can lead to cost savings. For instance, by identifying potential safety hazards in a manufacturing process, an organization can avoid expensive accidents and insurance claims.

6. *Innovation and Growth:* Properly managed risks can lead to innovation and growth. Organizations that are willing to take calculated risks are more likely to seize opportunities and stay competitive in rapidly changing markets.
7. *Resource Allocation:* Limited resources are a reality for most organizations. Risk management helps allocate these resources efficiently by prioritizing actions to address the most significant risks.
8. *Business Continuity:* Effective risk management includes planning for disasters and disruptions. This ensures that an organization can continue its essential functions even in the face of unexpected events.
9. *Long-Term Sustainability:* By identifying and addressing risks that could threaten an organization's long-term viability, risk management contributes to sustainability and resilience.

2.4 Roles of a Risk Manager

The role of a risk manager in an organization is multifaceted and crucial for identifying, assessing, and mitigating risks that could impact the organization's objectives, reputation, and financial stability. Here are the key roles and responsibilities of a risk manager:

1. *Risk Identification:* The risk manager is responsible for identifying potential risks and threats to the organization. This includes conducting risk assessments, reviewing processes and operations, and staying informed about industry-specific risks and emerging trends.
2. *Risk Assessment:* Once risks are identified, the risk manager assesses their potential impact and likelihood. This involves using quantitative and qualitative methods to evaluate the severity of each risk and prioritize them based on their significance.
3. *Risk Mitigation and Management Strategies:* Developing and implementing risk mitigation strategies is a core responsibility. This includes designing risk management plans, policies, and procedures to reduce the impact and likelihood of identified risks.
4. *Compliance and Regulation:* Staying up-to-date with relevant laws and regulations is essential. The risk manager ensures that the organization complies with all relevant legal and regulatory requirements to avoid legal issues and penalties.
5. *Crisis Management and Business Continuity:* Preparing for and responding to crises, disasters, or unexpected events is a critical role. This includes developing and maintaining business continuity plans to ensure the organization can continue essential operations during disruptions.
6. *Risk Communication and Reporting:* Regularly communicating risk information to senior management, the board of directors, and relevant stakeholders is essential. The risk manager prepares reports and presentations that provide insights into the organization's risk profile and the effectiveness of risk management measures.
7. *Monitoring and Review:* Continuous monitoring of the risk landscape and the effectiveness of risk management strategies is necessary. The risk manager regularly reviews and updates risk assessments and mitigation plan to adapt to changing circumstances.
8. *Risk Education and Training:* Promoting a risk-aware culture within the organization involves educating employees about risk management principles and providing training on how to identify and report risks.

2.5 Risk Management Process

The risk management process involves a series of steps to systematically identify, assess, mitigate, and monitor risks within an organization. Here's an explanation of each of the five steps you mentioned:

1. Establishment of risk management objectives
2. Risk Identification
3. Risk Analysis
4. Risk Treatment
5. Risk Monitoring and Evaluation