Risk Management

Summer Semester 2023/2024

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CHAPTER TWO: Risk Identification

Textbooks:

- ***Introduction to Risk Management and Insurance, by M. Dorfman and D. Cather, 10th edition, Prentice Hall.***
- ***Lecturer Handouts, Book Chapters***

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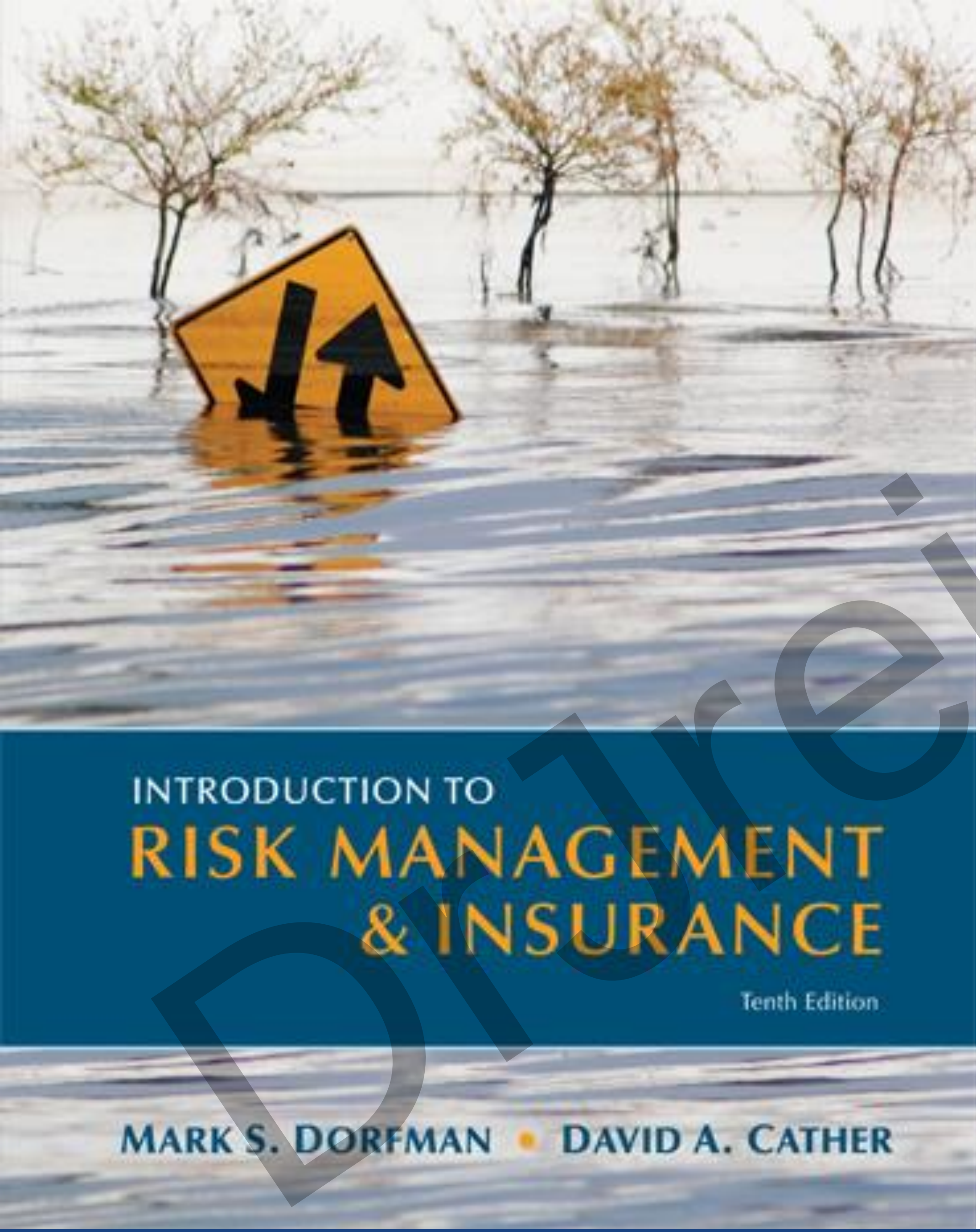

Chapter 2

Risk Identification

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Introduction: Risk Identification

- Risk identification is the most important step in the risk management process.

(***Remember, you can't treat an exposure you haven't identified***.)

- Risk identification is the key to choosing **correct risk-handling procedures.**
- A key part of the task is to look for "**critical dependencies**."

Critical dependencies refer to key elements, resources, processes, or relationships that are essential for the successful operation or completion of a project, system, or organization. If these dependencies fail or are disrupted, they can significantly impact the overall performance, timelines, or outcomes.

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Introduction: Risk Identification

- The key to risk identification is **a systematic and continuous process**.

- Firms use many means to identify exposures, and the best-managed firms engage their employees in the activity.
- An important issue in **exposure identification**, and one that ties together **pure risk exposures** and **ERM exposures**, is the **critical dependency.**

- A ***critical dependency*** is an element of an entity's operations that has the capacity to interrupt the entire production process.
  - **An example** is a manufacturer that has a single source for supply, or only foreign suppliers, of a critical input, perhaps a raw material.

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Introduction: Risk Identification

So that an **exposure checklist** can be prepared,
there is general agreement that the categories of exposures are **pure risk exposures** and **ERM exposures**.

Pure risk exposures:
property, liability, and human resources exposures.

ERM exposures:
hazard risks (essentially, the pure risk exposures),
financial risks,
operational risks,
and strategic risks.

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Enterprise Risk Management

- Ultimate **Objective** of ERM is to handle risks that is harmonious with the strategic plan.
- Making pre-loss arrangements for post-loss resources.
- Need for *loss identification* and *risk identification*.

Loss Identification:

Focuses on recognizing and documenting actual losses that have occurred. It involves assessing the impact of these losses on the organization, such as financial loss, damage to assets, or other negative outcomes.

Risk Identification:

Focuses on identifying potential risks that might lead to losses in the future. It involves anticipating and evaluating uncertainties and threats that could affect the organization, aiming to mitigate or prevent potential negative impacts.

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Employment

- The staff varies based on size and responsibility.
- All firms and people engage in risk management.
- Career opportunities internally to firms and externally, like consultants and brokers.
- Occupation is professionally recognized – RIMS – Risk and Insurance Management Society.

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Useful Methods

- Useful Methods of Risk Identification (The beginnings of a systematic process)
  1. Distinguish between internal and external exposures
  a. Location
  b. Ability to control
  2. Distinguish between pure and speculative risks

- Identify & Measure (evaluate).
- Choose most efficient tool(s) for Control.
- Implement and review.

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Step 1 - Identify

- **What to identify:**
  - External/Internal
  - Pure/Speculative
  - Direct losses
  - Indirect losses
  - Key personnel
  - Operations
- **How to identify**
  - Balance sheet
  - Income statement
  - Other records
  - Checklists
  - Flow charts
  - Questionnaires

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Direct and Indirect Losses

1. **Direct**

damage, destruction, loss of use, liability claim

2. **Indirect**

inability to generate income, operation of law or ordinance

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Measure (evaluation)

- Maximum possible loss
  - The absolute maximum dollar amount of damage
- Maximum probable loss
  - A conservative estimate of what is likely to occur in a worst case loss
- Relative Frequency
  - An estimate (numerical or verbal) as to the number of times the loss will occur

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Identification of Pure Risks

1. **Property Risks**

a. **Tangible** property

b. **Intangible** property, e.g., *patents, trademarks*

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Property Risks

- Tangible Property:
  - Real Property.
  - Business Property.
- Intangible Property:
  - Patents.
  - Human Capital.
  - R&D.
  - Reputation.
  - Brand Awareness.

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Property Risks

- Damage to the Property of Others:
  - Supply chains are interconnected through Joint-Ventures or in joint R&D.
  - Disruption or outright failure can occur at a firm. Will affect other firm(s) in supply chain.

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Valuing Property

- Replacement value versus book value versus actual cash value versus market value.
- International operations and exchange rate problems.
- The impact of inflation on values.

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Liability Legal Grounds

- The (English Common Law) American legal system is based on the notion that a person should be responsible for the damage caused to others

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Identification of Pure Risks

2. **Liability Risks**

Tort liability is the legal responsibility for damages caused by wrongful acts or omissions that result in injury or harm to another party.

a. Tort liability (distinguished for crimes and breach of contract)

b. Related to negligence, which has required elements

c. Types of damages
- i. Compensatory (special [economic], general [noneconomic])
- ii. Punitive

d. Defenses in negligence suits
- i. Contributory, or comparative, negligence
- ii. Assumption of risk

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Identification of Pure Risks

3. Human Resources Risks

a. Key employee

b. Workers’ compensation

c. Employee benefits programs

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Enterprise Risk Management Risks

1. **Hazard** risks (essentially pure risks)

2. **Financial** risks, e.g., inflation, currency exchange

3. **Operational** risks, e.g., supply chains, distribution chains

4. **Strategic** risks, e.g., product development

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Liability Risks

- Examples of loss sources:
  - Breach of contract
  - Bodily injury or personal injury
  - Intentional damage to reputation
  - Wrongful hiring, firing, sexual harassment, invasion of privacy, age discrimination
  - Vicarious liability
  - Products, environmental, workers’ compensation

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Torts - An Insurance Categorization

- Deliberate or Intentional Interference
  - Assault, battery, liable, false arrest
  - Can result in civil as well as criminal actions
- Liability Without Fault (Strict and Absolute Liability)
  - Laws or court precedent mandate liability in some circumstances: explosives, dangerous animals
  - Worker’s compensation, pure no-fault

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Torts - An Insurance Categorization

- Negligence
  - Failing to use reasonable care according to a "reasonable man" standard
  - A reasonable person thinks before speaking or acting, and is honest and moderate in all activities
  - Question of fact
  - Other parties can be held liable
    - Vicarious liability
    - Joint-and-several liability

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Establishing Negligence

- Plaintiff must show:
  - Legal duty
  - Failure of the duty
  - Injury
  - Causal connection between the injury and the failure
- Jury must weigh the facts based upon "the preponderance of evidence" not "beyond all or reasonable doubt"

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Types of Damages

- **Compensation for Personal Injuries**
  - Includes medical, lost wages, future wage loss, and pain and suffering
- **Punitive Damages**
  - Compensation to punish a defendant for outrageous acts
- **Punitive damages against insurers**
  - When insurers act in bad faith in resisting an insured's legitimate claim
- **Other Damages**
  - Hedonic damages - loss of life's pleasures
  - Mental anguish

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“Res Ipsa Loquitur”

- Tactic used in court to shift a legal burden to the defendant
- Requires:
  - The defendant has exclusive use of the instrument or process that caused the loss, and the plaintiff did not
  - Use of the instrument or process does not normally cause injury unless **there was negligence**

Res Ipsa Loquitur

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Defenses in a Negligence Suit

- Show there was no injury, duty, or failure
- Contributory negligence - common law
- Comparative negligence - statutory modification
- Last clear chance rule - statutory modification
- Assumption of the risk - common law

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Human Resource Risks

- Loss of Key Person
- Disability – physical (medical) or mental
  - Short or long term
  - Permanent or temporary
- Loss of health
- Unplanned retirement
- Results in loss of income, business continuation problems, replacement and training issues

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Remember: Review and Update

- Regularly review and update the process
  - New assets or disposal of assets
  - Valuation changes
  - New products, processes, and operations
  - New personnel
  - Law changes
  - Currency fluctuations
  - New contractual relationships

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