



Risk Management Reports

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Issues for 2002

As *Risk Management Reports* begins its 29th year, I put forward the most significant issues of the year for risk managers, continuing a habit first started in 1988. Most prior years focused on practical and financial concerns. In 2001 I identified governance and the role of risk management in the organization as the most pressing issues: how the discipline should be structured, led, coordinated and communicated. Judging by the numerous papers and conferences that addressed these subjects, it was on target.

In this year dominated by global political and economic turmoil, I submit three broader and more philosophical issues. First, how can organizations, particularly those in the profit-making sector, re-establish their severely eroded credibility with stakeholders? Second, how can all organizations, profit and nonprofit, improve their resilience in the face of increasing contingencies? And third, how can we regain a more balanced perspective of the future? Are these proper issues for risk managers? I submit that they are *essential* to the goal of our discipline, which is to build and maintain the confidence of stakeholders in the future of the organization.

Are we losing it? From Europe and Asia to the Americas, a global recession commands economic headlines. Argentina struggles against default and chaos. Afghanistan cries for relief funds. The World Meteorological Organization in Geneva reports that 2001 was the second warmest year in the past 140 years of record-keeping: global warming continues, even though we are not sure why. Political violence continues, from the Middle East, Sri Lanka, Spain, Nepal, the Balkans, and the Caucasus to Indonesia, the Philippines and many areas of Africa. Disease and famine remain uncontrolled. Malaria kills 3,000 people a day. New antibiotic-resistant strains of tuberculosis threaten millions. AIDS has grown from 225,000 infected people in 1980 to 40 million in 2001, 70% of whom live in sub-Saharan Africa. Of these 3 million will die in 2002. The gap between rich and poor looms over us: almost half the world's population lives on less than \$2 a day. And the events of September 11, 2001 destroyed forever the "innocence" of those living in the United States, who harbored the illusion that "it couldn't happen here." Terrorism is a global problem. And to top it off, doctors tell us that Americans are

submerged in obesity, a major contributing cause to 300,000 deaths a year. Is anything going right?

Yet there is no reason to wallow in pessimism. Jacques Barzun provides the key for 2002:

“To act, enthusiasm must overcome indifference or despair; impulse must be guided by imagination and reason.” (*From Dawn to Decadence*, HarperCollins, New York, 2000)

That’s the goal for risk managers in these unsettled times: to use enthusiasm, imagination *and* reason to help guide our institutions into intelligent action.

Credibility Can we believe what we are told? If confidence in an organization is the goal of risk management, then this is the paramount issue for 2002. The public’s opinion of the words of corporations comes close to scorn. The pabulum pushed out over the airwaves and in print is openly discounted: many of us use the mute button whenever an advertisement appears on television. “Research” reports funded by corporations are dismissed with derision. These beliefs are justified. Consider corporate earnings reports, an “open scandal of misinformation,” according to Peter Bernstein (*Economics and Portfolio Strategy*, October 15, 2001). They are twisted into numerical contortions to satisfy management’s desire to meet the expectations of securities analysts and to avoid the inevitable stock price plunge when they do not. Off-balance sheet guarantees, contributing factors to the Enron melt-down, are grossly misused. For Alstom in Europe they were an astounding 12.8 billion euros in December, according to *The Economist*. They are another example of trying to manipulate financial statements to meet the narrow goal of short-term improvement in earnings per share. Then add the appalling conflicts of interest that further erode our confidence in both organizations and their numbers. Accounting firms grow rich on consulting fees, not on audit fees. People therefore believe that accountants compromise their auditing standards to meet management’s wishes. This is one allegation in the Enron case, and it has been raised in almost every other financial disaster in the past five years. Arthur Levitt, the former head of the US Securities & Exchange Commission, sought to separate the consulting and auditing functions, without success.

Conflicts of interest are rampant in almost every area of business. Board members are pals of management, often representatives of service providers, such as banks and legal counsel, compromising independence. Securities analysts from banks and investment firms allegedly modify their recommendations based on whether or not their firms are handling lucrative loan, merger, acquisition and initial public offering (IPO) business for their clients. One broker acknowledged that commissions received from insider trades were “. . . a way of saying thank you for the (favorable) research coverage” (*New York Times*). Credit Suisse First Boston stands accused of splitting profits with favored clients allocated shares in IPOs during the dot.com bubble. Insurance brokers, legally

charged with representing their client's interests, regularly accept commissions, overrides, and temporarily invested premium fund income from the insurers with whom they place business. They even invest in their own underwriting facilities. How can we trust counsel from these advisors when these conflicts exist?

Finally, add the growing scandal in pension and 401(k) retirement investment plans, many of which are too heavily invested in company stock. Lucent and Enron are but two recent examples of companies whose employees have been made paupers by the precipitous decline of the stocks they held. In England, soft commissions from favored stock brokers are under attack as ultimately harmful of the interests of clients. Two lessons come out of these disclosures. First, the investment advisors to pension and 401(k) plans should be *completely* independent of corporate management. This includes being separate from firms that do other business with the company. "Undivided allegiance to the plan beneficiaries" must be the rule. Second, employees need independent counsel on their investment selections.

Risk managers will perform an invaluable service in 2002 by working to identify the real and perceived conflicts of interest within their organizations and starting to change the situation. They can also encourage management to report financial and other information quickly and accurately. Re-establishing corporate credibility will take time but a start must be made. It requires a continuing two-day dialogue with stakeholders. I've emphasized the importance of risk communication for some years in these pages. It remains the single most under-recognized aspect of risk management.

Resilience We cannot abolish uncertainty. It continues to dominate our lives and is indeed the relish of life. What we learned from the disasters of September 11 is a fresh appreciation of the innumerable contingencies and interdependencies that make our modern economy work and organizations thrive. While we are increasingly vulnerable to the unexpected, we can construct new responses to improve our resilience. Creating these responses and communicating them to critical stakeholders are key issues for risk managers this year. The crises of the early 21st century are also opportunities. Y2K was an expected event that did not materialize, in large measure because we modified our procedures. September 11 was an unexpected event that did happen. Again we are responding globally. Both have strengthened, not weakened, our institutions.

Paul Slovic suggests that ". . . risk analysis should be supplemented by vulnerability analysis that characterizes the forms of physical, social, political, economic, cultural, and psychological harms to which individuals and modern society are susceptible" (*Risk Newsletter*, Vol. 21, No. 4). I add to those "harms" also the "opportunities" that vulnerabilities create. Don't forget the plus side!

Interdependencies inevitably involve ripple effects. September 11's ripple moved outward from Ground Zero, to the local businesses in downtown Manhattan, throughout

New York City, to the entire US, and then beyond. Airlines were shut down for a week and triggered the ensuing bankruptcies of both Swiss Air and Sabena. The ripples are still being felt. The anthrax mailings crippled portions of the U.S. Postal Service and continue to affect the economy. Three accidents in two years in Switzerland's alpine tunnels rippled throughout Europe. In March 1999, a fire closed the Mt. Blanc Tunnel. It remains closed. In October 2001, a fire shut down the St. Gotthard Tunnel and, two days later, another fire hit the San Bernardino Tunnel. Six tunnels through the Alps throttle trans-European truck and rail transportation. We live in a wired world, dependent on the Internet and the servers that give us access to it. How susceptible to shutdown is this global electronic linkage? We do not really know. Within the next three years we'll probably have a challenge, another crisis that will test our planning and, in its aftermath, that will help us build new safeguards. Another on-going dependency is the reliance of the bulk of the developed world on fossil fuels. The current Middle Eastern unrest accentuates this problem, yet we in North America seem unwilling to trade in our gas-guzzling S.U.V.s for more fuel-efficient vehicles (for example, the gas and electric cars that go 60 to 70 miles per gallon), to price gasoline realistically, or to twist our thermostats down to 60 degrees Fahrenheit (about 15 C.), which doctors say would in any event be better for our health.

Identifying these interdependencies and their effects (both unfavorable and favorable) is a major responsibility of risk managers. It should go beyond the obvious or primary results to the secondary and tertiary ripples. Small events in another part of the world may be magnified into disasters elsewhere. This is analogous to the famous beat of the Chinese butterfly's wings that ends up as a hurricane in the US. The risk manager's role of identifying potential effects is followed by creating considered responses, planning for *all* contingencies. In a sense, risk management is merging with contingency or business recovery planning. Aren't these two disciplines essentially the same?

Resilience also depends on access to financing following a change of circumstances. The volatility of financial markets over the past decade suggests that risk managers will do well to return to an old idea. A reserve or emergency fund may be more effective than dozens of derivatives and a lockbox full of insurance policies. Southwest Airlines has already proved this point. In the aftermath of September 11, when its sister airlines were scrapping flights, laying off employees, and pleading with Congress for financial aid, Southwest turned to its reputed \$2 billion cash reserve fund. It, in stark contrast to other airlines, continued to fly most of its routes and maintained its employee rolls. Think of the confidence it built with its customers, employees and served communities. Why not return to that old-fashioned idea of a contingency fund? No, contributions to such a fund are not tax deductible, but why not lobby for that status, as corporations are doing in France? Why not re-consider catastrophe bonds? Sure, they cost more than conventional insurance (for the time being), but the cash is in hand! Why not consider new industry pooling arrangements, as the airlines are now doing? These are proven financial tools, witness the successful and financially secure pools of YMCAs, oil companies, and

universities, among others, in North America. Resilience requires secure and quickly available financing.

Unfortunately, public opinion can subvert sound financing decisions. The American Red Cross, more than successful in raising funds for the victims of September 11 in its Liberty Fund, wisely (in my view) decided to set aside half (about \$300 million) of its disaster receipts to help fund potential future disaster victims. A public and Congressional outcry forced the resignation of its President, Dr. Bernadine Healy, (for this and other reasons) and cancellation of the decision. The initial decision was the right one; the communication of the actions of the Red Cross was flawed.

Two potential problems require close attention by risk managers in 2002. The first involves worms, viruses and the plague. It's not medical, it's the Internet. A worm, a self-replicating, self-contained program, could infiltrate the more than half million Internet Information Servers and effectively cripple Internet operations. As computer use expands geometrically throughout the world, the potential repercussions will grow at the same rate. *Scientific American* addressed this problem in an article entitled "Code Red for the Web" in its October 2001 issue. Risk managers should inform themselves on this issue (see www.sciam.com and the National Infrastructure Protection Center at www.nipc.gov). Responses include not only the conventional approaches to backing up, storing and retrieving data, but also new views on how an organization would continue if the entire Internet was shut down for a considerable period.

The second potential problem is that of our heavy dependence on Middle Eastern oil. Heat, transportation and power all rely on fossil fuels. This dependence can distort foreign policy as well as threaten individual organizations. Has your organization considered a worst-case scenario that involves a reduction in the availability of these fuels, combined with a radical rise in cost?

Building resilience is a basic risk management responsibility, as is communicating to stakeholders how the organization plans to proceed in the event of certain contingencies.

Perspective An argument can be made that many of us in the developed world live in self-indulgent cocoons. We foster a Panglossian delusion that we live in the best of all possible worlds, one in which all problems are solved by the operation of the "market" and our ever-expansive technologies. We have, after all, successfully demolished the presumptions of Communism, and we are on a roll. We are more concerned with short-term results. What count are the numbers of this quarter and the next, corporate stock prices, and this year's bonus. Simply stated, we've lost perspective. We fail to see the world as it really is and the necessity for long-term planning. That illusion lies in shards at our feet. We now must re-establish long-term perspectives for governments and corporations alike. Perspective means taking into consideration the desires and needs of all stakeholders, not just those who hold stock. It means considering the effects of

today's decisions ten years on. It means looking at all issues and ranking their relevance. Each year, in the US, we kill each other with cars, cigarettes, drugs, alcohol, and guns, doing little to change habits, even while mounting expensive crusades to eliminate diseases that claim far fewer lives. We litigate equally expensively for other relatively minor injuries and deaths. Let's begin to apply funding more intelligently to the protection of life and limb. That effort can and should begin with corporations taking a broader and more informed perspective on the allocation of funds.

Two other aspects of perspective warrant comment. First, in a world dominated by television's talking heads and commentators eager to provoke sensational sound bites, we need to take a bit more time before speaking. Our tolerance for delay has disappeared in a wired world. We want instant comments and answers. Shorter attention spans mean that competing messages interfere with each other. The cautious and considered response is, too often, non-existent. I was therefore pleased to listen to the answers of the US Secretary of Defense, Donald Rumsfeld, in many of his press conferences on the war in Afghanistan. He often pauses, at length, to weigh and consider his answers, deliberating in his own mind as to what he should say. It's a trait that risk managers can productively follow.

Second, we could learn something from the tried academic idea of the "reading period." A week's hiatus from lectures and labs, devoted to reading and re-reading assigned materials before examinations, refreshes perspective. I was reminded of this idea on the arrival of *The Economist's* annual two-week, year-end issue, one crammed with reflection on both past and future. Why not devote the last week of the year to a similar reflective reading period, to restore perspective?

My three issues for 2002 are re-establishing credibility, building resilience, and regaining perspective. Implicit in these is a new understanding of the importance of ongoing, two-way communication with an organization's stakeholders. It's an opportunity for risk managers. Take it! Late last year, the Society for Risk Analysis asked each of its past presidents for their comments on September's disaster. Vince Covello, Director for the Center for Risk Communication, suggested 21 guidelines for effective risk and crisis communications (see *RISK Newsletter*, Vol. 21, No. 4). I cite three of them for risk managers:

- o Listen to, acknowledge, and respect public fears, anxieties, and uncertainties: when people are upset they want to know that you care before they care what you know.
- o Be honest, ethical, frank, and open, recognizing that there are limits on what needs to be disclosed.
- o Provide information on a frequent basis; prevent information vacuums that can be filled by others.

So what to do? Face it, for one thing; ignorance is fear's most durable ally. . . . We could try to think small and large at once about whom we're connected to and separate from, and about what we mean by a community. This kind of puzzling can produce a quiet panic, or it can teach us that the knowledge of what confronts us, worries us, scares the wits out of us and makes us sad is the same knowledge we will need to imagine our strength.

Richard Ford, "The Worry Gap," *The New York Times*, November 11, 2001

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DOES RISK MATTER?

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"Risk management" is cast as the new magic wand that promises greater chances for survival on "life is uncertain voyage," in Shakespeare's apt phrase. Recent financial fiascoes, from Barings to Orange County, are attributed to risk management weaknesses. Bill Ruckelshaus introduced the idea to the Environmental Protection Agency and today we have the Thompson-Levin bill in Congress that mandates rigorous risk-benefit analyses for all government regulations. Natural disasters - floods, windstorms, landslides and earthquakes - are subject to international forecasts and risk management attention, including the just-completed Internet symposium of the United Nations International Decade for Natural Disaster Recover (IDNDR). And author Peter Bernstein describes, in his best-selling *Against the Gods*, how we reached this point where we think that we can not only measure risk, but manage it.

But what is risk management? Is it a replacement for the religious faith of the past that explained the unexplainable? Can it deliver a world in which we can live with uncertainty more prudently and responsibly? I define risk as "the possibility of deviation from the expected." Through education, experience and our genetic engineering, we create our own expectations of the future. The chance that it varies markedly from our expectations, favorably or unfavorably, is risk. In the Middle Ages and before, all divergences were attributable to the will of one god or another, and religious faith was the often so fatalistic that it discouraged change and encouraged the status quo. The growing sophistication of mathematics allowed us to begin a quantitative measurement of risk and fostered a new belief that we could construct a more reliable future, increasing the positive and reducing the negative outcomes.

Today, risk management, defined as "a discipline for living with uncertainty," is practiced to some degree in public policy, in major corporations, by the insurance industry, by safety, security and quality assurance adherents, and by contingency planners. It attempts to reduce to manageable limits the uncertainty that still circumscribes life despite our best efforts at forecasting and control. It holds promise for more effective use and protection of resources. I offer, however, three cautions.

The first is excessive risk aversion. Too often we define risk in its negative or pejorative sense. What can go wrong? How much can we lose? We become almost obsessive trying to eliminate any chance of loss. In so doing we overlook the positive side of every risk decision. We accept risk because we believe that the potential for a reward will more than offset any potential harm. Denying the existence of reward leads to a life-stultifying response of avoiding every risk. It is the ostrich approach. Risk aversion may well be the riskiest behavior of all. It's time to re-create the relish of risk, even as we try to measure its parameters using all the modern available tools of technology and communication.

The second caution is that of confidence and perception, two factors that are more subjective than quantitative. Statistics tell us that risk is measured by multiplying the potential likelihood of an event or decision outcome by its potential consequence. It is relatively easy to assign numbers to these factors. This, however, is a mathematical over-simplification. It omits any evaluation of our confidence in our estimate. How sound are the data on which the assessment is made? What critical assumptions underlie it? Do we have some gut reservations about it? We must modify the assessment by our level of confidence. The "likelihood" times "consequence" equation also omits the power of the perception of others in the risk assessment. Experts and medical studies, for example, may tell us that the

mathematical risk of health injury from the use of silicon breast implants is negligible, but if enormous numbers of women believe otherwise, for whatever reason, the risk, and its purported effects, are very real indeed. What is the real risk of a meltdown or other disaster from a nuclear power station? After the catastrophe of Chernobyl, and the near-miss at Three Mile Island, the public in the United States has grown so wary of nuclear power that new facilities are at a standstill and older facilities are being decommissioned. Public fear, rational or irrational, drives the risk response. And it is such a perception to which organizations must respond if they are to survive. The softer estimates of overall confidence and public perception must become part of the overall risk assessment.

The third caution is the most serious. It is possible that unintended adverse consequences may follow the best intentioned risk responses. Overcome by the supposed enormity of some problem, we rush to protect and preserve, ignoring secondary and tertiary effects that could be more serious than the original situation. A manufacturing facility is plagued by employee pilferage. The pressured security director padlocks all exits except the front entry, now supervised by a guard and inspections. The pilferage ceases, but at what cost? If a fire occurs, how many employees will die or be injured in their panic attempt to evacuate through a single door? We build dams and levees to control floodwaters and provide new recreational areas. This inadvertently exacerbates the flood risk elsewhere. It may also eliminate spawning grounds for fish, causing ripple effects throughout an ecostructure. We are just beginning to learn about the global effects of El Niño and La Niña. Chaos theory predicts that the beat of a single butterfly's wings in China could create storms in North America. For some scientists, the elimination of the use of DDT has created environmental and health problems far more serious than those resulting from its use. In the United States we have panicked over asbestos, removing it from schools and buildings, at greater cost to owners and risk of injury to employees and contractors than if it had been encapsulated. Repercussions from decisions reverberate throughout systems. Too often risk managers allow the enormity of the problem at hand to obscure their broader, long-term vision. The rule for physicians is "do no harm." The rule for risk managers should be "do the least harm." Risk management needs to take a longer and harder view of possible consequences before recommending remedial action

Wise and responsible risk management requires a broader view of all risks, their effects, both positive and negative, the probable reaction of other stakeholders, fair or unfair, and the possible down-line consequences, however remote. Only in this way will this discipline contribute beneficially to our future.

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