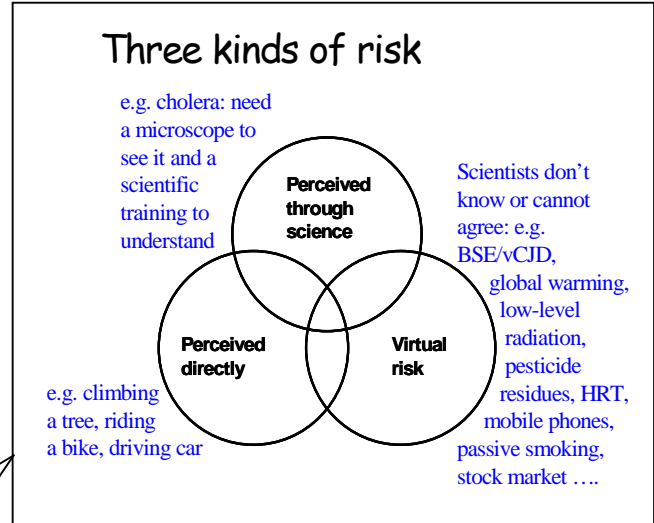


Three Framing Devices for Managing Risk

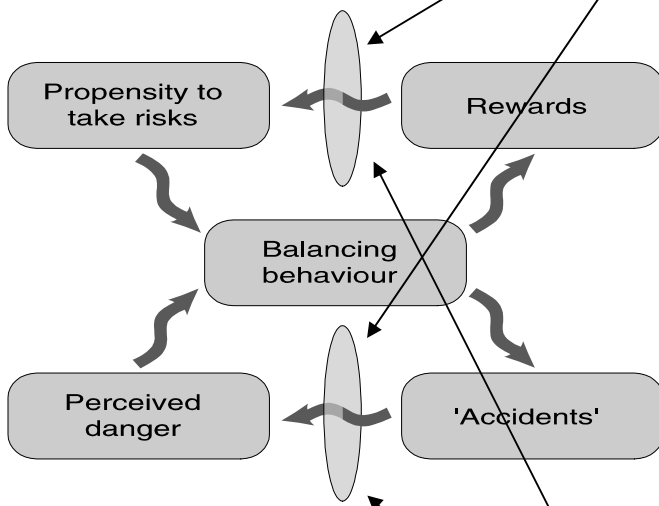
Outline of presentation for CRIMS, Calgary, 17-20 September 2006

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1. It is important to be clear about the type of risk you are dealing with. Directly perceptible risks are dealt with instinctively and intuitively. Virtual risks are culturally constructed – when the science is inconclusive people are liberated to argue from pre-established beliefs, convictions & prejudices. When virtual risks – sometimes called unconfirmed hypotheses – get mistaken for risks about which science has clear and useful advice to offer, much confusion results.



The risk thermostat

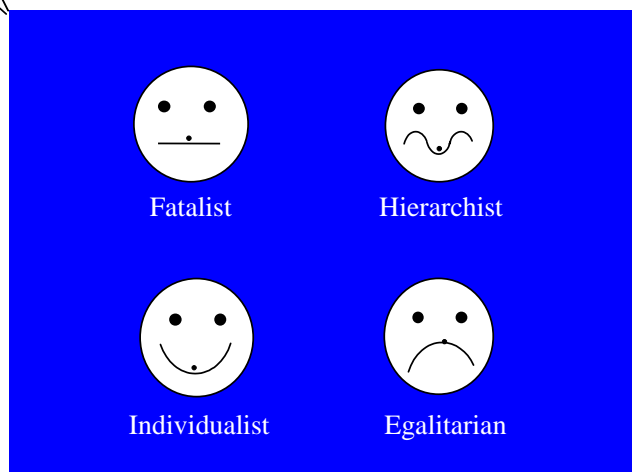


2. Risk management is a balancing act. Institutional risk management commonly ignores this fact. The job specification of most institutional risk managers obliges them to deal only with the bottom loop – judgements about safety ought not, they insist, to be “corrupted” by concerns about rewards. A one-sided concern for reducing accidents without considering the opportunity costs of so doing fosters excessive risk aversion - worthwhile activities with very small risks are inhibited or banned. Occasionally excessive rewards ((mis)selling of pensions; Enron; industries not accountable for externalities etc.) can induce a neglect of the possibility of “accidents”.

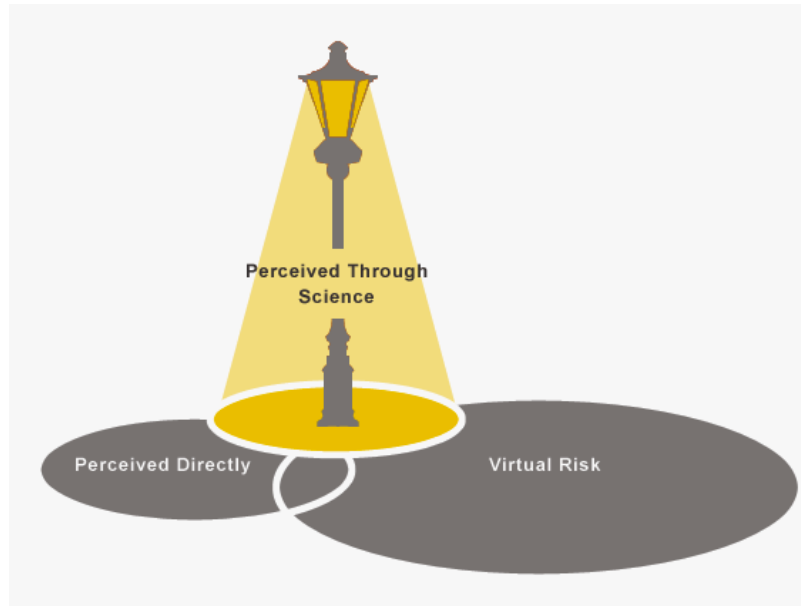
3. The less conclusive the science, the more influential become the filters through which risks and rewards are perceived. This typology captures commonly encountered types.

- the **egalitarian** is fearful and risk averse – if you can't prove it's safe assume it's dangerous & invoke the precautionary principle.
- the **individualist** is an optimist and pragmatist - if you can't prove it's dangerous assume it's safe – tends to focus on the rewards of risk.
- the **fatalist** ducks if he sees something about to hit him – otherwise *que sera sera*.
- institutional risk managers are professional **hierarchists**. They commission more research to find the right answer. Very uncomfortable in the presence of virtual risk.

Perceptual filters



The drunk looks for his keys under the lamppost because that is where it is light



*Some seek to distinguish between “objective” or “actual” risk and “perceived” risk. But risk is a word that refers to a future that exists only in the imagination – **all** risk is perceived.*

Directly perceived risk (much operational risk) is managed using **judgement** – a combination of instinct, intuition and experience. We do not undertake a formal probabilistic risk assessment before crossing the road.

Risk perceived through science. This is the realm of quantified risk assessment – the actuary, the spread better, the programme trader, the financial “rocket scientist”. This is the circle that dominates the risk literature – often, *but not always* – successfully. However objective in appearance, assessments in this circle rest ultimately on subjective assumptions.

Virtual risk. If science cannot settle an argument, people feel liberated to argue from their pre-established convictions, beliefs, prejudices, superstitions. Here we encounter LTCM and Warren Buffet’s “financial weapons of mass destruction”. In this circle, as with directly perceptible risk, we are thrown back on **judgement**.

References

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Risk Management: it’s not rocket science – it’s more complicated”

<http://www.socialaffairsunit.org.uk/blog/archives/000318.php>, awarded the Inaugural Roger Miller Essay Prize by AIRMIC (Association of Insurance and Risk Managers).