Low probability disaster scenarios deserve more attention

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Hazards with horrific outcomes — like the disaster at the Fukushima Daiichi nuclear plant in Japan — are not only difficult to contemplate but are also challenging to plan for financially. Especially when the odds of them happening are incredibly low, says Stuart I. Greenbaum, management expert at Olin Business School, Washington University in St. Louis.

Recent natural disasters around the world have focused attention on the methods and processes used by organizations to manage risk known as Enterprise Risk Management (ERM).

Greenbaum recently told a conference in France that low probability disaster scenarios are among the risks that tend to be overlooked by business, but deserve more attention and planning.

Greenbaum was plenary speaker May 17 in Lille, France at Enterprise Risk Management and Corporate Governance for Insurance Firms, a conference sponsored by the International Center for Financial Regulation and EDHEC Business School. Greenbaum is Bank of America Professor Emeritus of Managerial Leadership at Olin Business School.

Obviously, even the most ardent ERM program could not have prevented the earthquake or the resulting tsunami in Japan, says Greenbaum. But businesses must consider all potential disasters and risks inherent to their operations.

“Herein lies the behavioral side of ERM and the most basic motivation for formalizing the management of enterprise risk,” he says. “ERM is a process, and effective ERM is all about process integrity. Thus, we can think of ERM as protection against the inclination to ignore those risks that are most menacing and inchoate. ERM elevates vigilance and thereby reduces the probability of calamitous events. But, it does more, much more.”

“Calamities are inescapable, but their costs are not altogether foreordained,” Greenbaum says. “ERM reduces both direct and indirect costs of untoward events. Typically, for financial institutions, calamities, especially those owing to moral hazards, are accompanied by regulatory sanctions and class-action lawsuits. The best protection against such knock-on effects is a credible ERM program. Well-documented and thoughtfully structured processes for managing existential risks will be the most disarming response to the inevitable question of what was done to protect the organization against enterprise risk.”

ERM is a process, Greenbaum says, but is also a frame of mind. “It is a collective assertion that the organization will bring its best talents to bear upon the challenge of avoiding surprises that threaten sustainability,” he says. “It will consciously and judiciously forego current earnings in order to reduce the probability and severity of existential hazards.

“ERM can never eliminate disastrous outcomes, only those of our own making,” Greenbaum says.

Provided by Washington University in St. Louis