Slahadeen university -
college Administration and Economics

Dep: Finance and Banking

Risk management

Stage 2

Chorus I

Chapter 3…. Risk Divisions

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Agenda

- Meaning of Risk
- Objective Risk
- Chance of Loss
- Peril and Hazard
- Basic Categories of Risk
- Types of Risk
- Burden of Risk on Society
- Risk Management Methods

Meaning of Risk

- **Risk: Uncertainty concerning the occurrence of a loss**
- **What does risk mean?**
- Objective Risk vs. Subjective Risk
  - **Objective risk is defined as the relative variation of actual loss from expected loss**
  - **What does Objective risk mean?**
    - It can be statistically calculated using a measure of dispersion, such as the standard deviation
  - **Subjective risk is defined as uncertainty based on a person's mental condition or state of mind**
    - **Two persons in the same situation may have different perceptions of risk**
    - **High subjective risk often results in conservative behavior**

What does Subjective mean?

What kinds of risk

Objective Risk

– **<u>Objective risk is defined as the relative variation of actual loss from expected loss</u>**
– Example: If the company has statistics for a geographical area about the probability of a fire occurring at a rate of 1% in a specific area of 1,000 homes, meaning that it is expected that 100 homes will burn annually. � But 90 houses may burn in one year and 110 in another year means the presence of (+10 houses) and this relative change is called objective risk

Chance of Loss

- <u>Chance of loss</u>: **<u>The probability that an event will occur</u>**
- Objective Probability vs. Subjective Probability
  - **<u>Objective probability refers to the long-run relative frequency of an event assuming an infinite number of observations and no change in the underlying conditions</u>**
    - It can be determined by deductive or inductive reasoning

    what is mean Objective probability ?
  - **<u>Subjective probability is the individual's personal estimate of the chance of loss</u>**
    - A person's perception of the chance of loss may differ from the objective probability

    what is mean Subjective probability ?

    <u>What are the types of loss possibilities?</u>

Peril and Hazard

- **A peril is defined as the cause of the loss**
  - **In an auto accident, the collision is the peri**
- ***What is the meaning of peril?***
- **A hazard is a condition that increases the chance of loss**
- ***What does A hazard mean?***
  - **Physical hazards are physical conditions that increase the chance of loss (icy roads, imperfect electric wiring)**
  - **Moral hazard is dishonesty or character defects in an individual, that increase the chance of loss (faking accidents, inflating claim amounts)**

What are the types of Hazard?

Peril and Hazard

– **Morale Hazard is carelessness or indifference to a loss because of the existence of insurance (leaving keys in an unlocked car)**

– **Legal Hazard refers to characteristics of the legal system or regulatory environment that increase the chance of loss (large damage awards in liability lawsuits)**

What are the types of Hazard?

Basic Categories of Risk
The difference between pure risk and speculation

- Pure and Speculative Risk
  - A pure risk is one in which there are only the possibilities of loss or no loss (earthquake)
  - A speculative risk is one in which both profit or loss are possible (gambling)
- Fundamental and Particular Risk
  - A fundamental risk affects the entire economy or large numbers of persons or groups (hurricane)
  - A particular risk affects only the individual (car theft)

What is the difference between net risk and speculation?

Basic Categories of Risk

- **<u>Enterprise Risk</u>**
  - **<u>Enterprise risk encompasses all major risks faced by a business firm,</u>**

  What does enterprise risk mean?

  - **<u>which include: pure risk, speculative risk, strategic risk, operational risk, and financial risk</u>**

  <u>What does the enterprise risk include?</u>

Types of Risk

General Risk and Special Risks

We can define general risks and special V as follows:

<u>1- General or basic risks:</u>

<u>Those risks that result in losses that are not caused by the human being and its actions.</u>

<u>These risks usually affect large groups of individuals,</u>

what is mean General or basic risks?

General Risk and Special Risks

We can define general risks and special V as follows:

<u>1- General or basic risks:</u>

<u>effect to a specific individual.</u>

- <u>That is, they are those and it is difficult to be traced back in origin or risks that affect a country's economy and a large group of people, as inflation rates and global unemployment rates affect society's economy wholly In addition.</u>

what is mean General or basic risks?

,- natural disasters such as earthquakes, floods and volcanoes are considered a general risks.

- Often insurance companies avoid covering such risks except under certain circumstances and conditions, such as reinsuring them and thus transferring part of the potential risks to reinsurance companies or geographically diversifying these potential risks that the insurance company will be exposed to.

- That is because the occurrence of these risks results in huge losses to the country's economy and to a large group of people.

2- Special risks:

- -which are those risks that affect the individual and not the entire community, such as:
- a house fire or theft,
- noting that these risks may affect society indirectly,

what is mean Special risks risks?

2- Special risks:

- so the burning of a factory will affect the owner of this factory as it will affect society and the economy of the country because that will lead to the exit of this plant from the economic cycle of society.

Risk of static and risks of movement

1- Risks of Static:

- Those risks that arise as a result of fear of the expected irregular change from the forces of nature: such as earthquakes, volcanoes and floods,

- ***What is of Static Risk?***

<u>Third : Risk of static and risks of movement</u>

<u>Risks of Static:</u>

- which result from changes in the social and economic structure,
- this kind of risks causes many material and moral losses and damages, either for specific persons, for a group of them,
- or for society as a whole

What is of Static Risk?

- It is also defined as: the risks that include losses that occur even when the economy is completely stable.
- These losses result from other causes that have nothing to do with stability in the economy or not such as natural accidents, accidents of deviation of individuals,

- and these accidents usually occur and affect an individual or group of individuals and their impact may extend to society as a whole,
- and these risks can be predicted and quantified, therefore they are insurable.

Movement risks:

- are the risks that result from changes that accompany fluctuations or economic instability,
- such as changes in price levels,
- changes in consumption patterns and consumer tastes,
- and the modernization of production methods and means.

What is Movement risks?

Movement risks:

- These risks usually affect an individual or a large group of individuals, whether negatively or positively,
- but their influence does not reach the point of causing losses at the level of society as a whole. It is noted that these risks are difficult to be predicted or quantified because they are in the field of speculative risks.

What is Movement risks?

Major types of personal Risk

- Earning Risk (Death , Disability , Aging , Unemployment)
- Medical Expenses
- Liability (Auto Accident , Home firing)
- Physical Assets (Auto , Home. Boat ,other)
- Financial Assets (Stock , Bonds)
- Long life.

What are the main types of personal risk? only write the types

Types of risk Facing Business

- **<u>Business Risk concerned with possible reduction in business value from any sources.</u>** The market value of stocks depends fundamentally on the expected size of risk associated with future net cash flow (cash inflow less cash out flow).

- What is Business risk?

- What types of risks face the business risk that؟,only write the types.

Types of risk Facing Business

- **Price risk : refers to uncertainty over the magnitude of cash flow due to possible changes in output and input price.**

- ***What is price risk?***

- What types of risks face the business described that؟ ,only write the types.

Cont. Business Risk

- **<u>Credit risk : commercial banks face credit risk due to default by the borrower .</u>** If the borrower will be unable to pay its debt and thus be forced into bankruptcy.

- ***What is credit risk?***

- What types of risks face the business described that؟ ,only write the types.

Major types of Business Risk

1- Price Risk (input price risk-Output price Risk)

Commodity price Risk

Exchange Rate Risk

Interest Rate Risk

2- Credit Risk

3-Pure Risk (damage of asset, Legal Liability , Worker injury , Employee benefits)

What are the types of of Business Risk ?

Types of Pure Risks

- Direct loss vs. indirect loss
  - **A direct loss is a financial loss that results from the physical damage, destruction, or theft of the property, such as fire damage to a restaurant or a hotel.**
  - **An indirect loss results indirectly from the occurrence of a direct physical damage or theft loss, such as lost profits due to inability to operate after a fire**

- ***What are the types of pure risks?***
- ***What are the types of direct and indirect risks?***

Types of Pure Risks

- **Liability risks involve the possibility of being held liable for bodily injury or property damage to someone else**
  - **There is no maximum upper limit with respect to the amount of the loss**
  - **A lien can be placed on your income and financial assets**
  - **Defense costs can be enormous (huge).**

What are the types of pure risks? only write the types.
What are the risks of liability?

Burden of Risk on Society

- **The presence of risk results in three major burdens on society:**
  - **In the absence of insurance, individuals would have to maintain large emergency funds**
  - **The risk of a liability claim may discourage innovation, cheap society of certain goods and services**
  - **Risk causes worry and fear**

There is a burden of risk on society what is this burden?

Methods of Handling Risk

- **Avoidance**
- **Loss control**
  - **Loss prevention refers to activities to reduce the frequency of losses**
  - **Loss reduction refers to activities to reduce the severity of losses**
- **Retention**
  - **An individual or firm retains all or part of a loss**
  - **Loss retention may be active or passive**
- **Noninsurance transfers**
  - **A risk may be transferred to another party through contracts, hedging, or incorporation**
- **Insurance**

What are the Methods of Handling Risk?

Risk Management Methods

- **First : Loss control (Loss control are actions that reduce the expected cost of losses by reducing the frequency of losses or size of losses that occur**

Example : a routine inspection of air craft for mechanical problems . It will reduce mechanical problems while airplane in the sky .

What are the ways to deal with risks? only write the types

Risk Management Methods

- Second **: loss reductions (consists of actions that primary affect the frequency of losses).**
- **Diversification : Firms can reduce risk internally by diversification .**

By dealing with risk, what does loss reduction mean?
What are the ways to deal with risks? only write the types

-

Diversification of Risk

- **Diversification means don't put all activities in one place. Firms can reduce risk internally by diversifying their activities** (not putting all their eggs in one basket) . **Stock holder can reduce its risk through portfolio diversification. It means dividing stock into different (Economic sectors / Geographical and Terms) .**

- ***What does diversification mean to reduce risk?***
- ***What are the ways to deal with risks? only write the types***

Major risk management Methods

- Loss Control
  - Reduced level of risky
  - Increased precautions
- Loss financing
  - Retention and self insurance
  - Insurance
  - Hedging
  - Other contractual risk transfer
- Internal Risk reduction
  - Diversification
  - Investment in information