Four tips for managing catastrophic risk

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CNBC.com
Friday, 14 Feb 2014

Companies are increasingly realizing that they need to have proactive plans for dealing with natural and man-made disasters, and not just react to them — or worse, assume that extreme events "won't happen to us."

The Wharton Risk Center has interviewed chief risk officers and other executives from more than 100 firms in the S&P 500 about how they're dealing with catastrophic risks and what they have learned from past mistakes.

For example, after the 2008 financial crisis, the chief risk officer of an investment bank created a formal process to define the firm's risk appetite and made changes in risk governance. And after experiencing flooding that put employees' homes underwater, a firm in the service industry built a contingency office near the airport, housed their workers in a hotel, and provided them with laptops so that they could work remotely.

Some of these examples are highlighted in Global Risks 2014, recently released by the World Economic Forum and discussed at the annual meeting in Davos, Switzerland. Now in its ninth year, the report focused attention on what companies can do to reduce catastrophic risks — the calamities that can create havoc with both their short- and long-term operations.

Here are four tips for firms to reduce the likelihood and consequences of catastrophic risks:

**Recognize interdependencies in designing risk-management strategies.** A weak link in your supply network could significantly impede your production operations. It's important to construct worst-case scenarios so you can determine how interdependencies can severely impact your operations — and make contingency plans.

For example, a health-care services company now relies on two suppliers, so that if one is not functional, they can turn to the other to pick up the slack. And a computer firm maintains an excess inventory of finished products and supplies to hedge against sudden fluctuations in the availability of materials.

**Develop a business-continuity plan.** Clearly define the structure of leadership roles during a crisis for all parts of the company. Examining the consequences of extreme events will improve everyone's performance when a crisis occurs.

Firms in the financial, health-care and informational-technology sectors have developed general crisis plans that create redundancies, enabling them to continue to operate even if they lose mission-critical processes. Financial firms, on the other hand, rely on "can-happen" scenarios and examine how their plans would play out should a catastrophe occur.

**Involve the board of directors prior to the next disaster.** Highlight the consequences of extreme events so that executives and board members will pay attention to them and take action to reduce future losses.

For example, in one consumer-products firm, company executives meet quarterly with the governing board's audit committee to assess the potential impact of its most serious risks.
Does your board play an active role in assessing your firm’s risk-management plan? Boards have only recently become involved in the risk-management activities of firms. Over 30 percent of firms we interviewed reported that this had happened within the past three years; another 35 percent said they’d only done this in the past 4-7 years.

**Interact with leaders from the public sector.** Public-private partnerships are increasingly essential for managing catastrophic risks. So, it’s important for company executives to have good relations with federal, state and local governments, and work with them to develop a realistic risk-management plan. Public-sector agencies have also begun to realize the importance of this to keep businesses and communities running smoothly in a crisis — and to keep a level playing field.

Companies need to shift to more deliberative long-term thinking rather than just short-term thinking (such as quarterly returns). The chief risk officer can facilitate a culture of long-term thinking and risk awareness by working actively with the firm’s top executives and directors.

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