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What is Risk?

As I deal with a variety of industries, professionals, investors and even risk managers, it has become obvious that the first issue that needs to be addressed from a risk management context is to define the term “risk”. I generally get pushback on this, but what I find is that everyone has a strong definition in their own mind that varies from person to person. How you define risk drives both risk appetite and risk culture. One of the keys in many of the management classes I have attended over the years has been to recognize that others tend to not think like I do. This is important here too. Before reading further, how do you define risk? Let me know if you don’t see your personal high level definition below.

Knightian Risk

Probably the most interesting risk definition I have seen, and the one I had never considered in its extreme, was put forth by Frank Knight in his 1921 book Risk, Uncertainty and Profit. Risk is defined as uncertainty. It is best explained by an example. If you were to launch yourself into space with no protection against the cold and lack of oxygen that defines space, you know you would die. By this definition there is no risk. If there is no uncertainty, in any direction, there is no risk. Sure to fail, no risk. Sure to win, no risk. Most people consider this definition in moderation when managing risk, although most would override it with one of the definitions we will consider next.

Downside Risk

When managing a business or portfolio, many managers consider risk only with respect to something bad that could happen. Outcomes can be defined numerically as more of something is either good or bad, and less of something is the opposite. An additional nuance is needed, and it has been mentioned by others. I like to look at “good” outcomes and “bad” outcomes. To follow an example earlier in this thread, higher sales might initially be called a good outcome, but often it eventually becomes a bad outcome as it outstrips capital availability or flags a pricing issue. Keep in mind that what is important is the overall impact on the entity, so a good overall outcome should be encouraged even if some lines of business would call it a bad outcome for their silo. High mortality is an example of this, with a life insurance line saying it is a bad outcome and a payout annuity considering it a good outcome. This is an example of a natural hedge, provided by two lines with offsetting risks in their portfolio.

Most companies today are looking at risk from a one sided perspective to meet their regulatory compliance needs. Risk management is viewed as a fixed cost under this paradigm. This approach is useful and helps the company avoid bankruptcy. It also provides a base from which you can leverage your ERM efforts.

Volatility Risk

I often think of traders when considering a volatility driven definition of risk. Opportunities abound if prices move, no matter which direction. Those who look at risk from a two sided perspective, and are good at it, can provide an organization with a competitive advantage as enterprise risk management becomes a major part of the strategic planning process. Everything is on the table. This helps an organization grow and prosper, in addition to lowering the probability of ruin. Incorporating risk into decision making provides a competitive advantage in all environments. The downside of this approach is that many who think of volatility as risk also believe that risk can be modeled accurately. They are more prone to model risk.

Not everyone is capable of the two sided risk approach. Risk culture can get in the way, but you also need the right people in place to drive risk management opportunities to senior team members. A risk manager should try to nudge their firm in this direction, but trying to leap there all at once is not likely to work.

Which risk definition is the best one?

It will depend on firm culture and risk appetite to know which definition is most consistent within an entity, and employing people with each definition can help a firm avoid overfocusing on one of the definitions. This will allow the firm to make better decisions. Risk is Opportunity!

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