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Cooperative risk management: creating opportunities out of uncertainties

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Key points

- There is a general perception in the business world that all risks are bad. Regulatory risks, demand-side risks and revenue risks, for example, typically conjure up visions of significant costs, investments and losses that should simply be avoided. But the reality can be far different.
- With a technique called cooperative risk management, many risks can become essential negotiating points that can be leveraged to provide benefits to all parties in all transactions.
- As this article will discuss, the key to achieving these benefits is the ability to identify, analyse, shape, treat and price risks.

What is cooperative risk management?

To convert what previously were viewed as purely negative risks into powerful benefits that can create cooperative and profitable relationships, sellers and buyers alike need to take a new approach to their contractual environments. At the foundation of this approach is the recognition that the products and/or services that are being bought or sold do not represent the entirety of a transaction.

Take the situation of two companies — Company A and Company B — that sell identical widgets at identical prices to a reseller. Company A recognises that if it is to meet its objective of dominating the market for widgets, it has to differentiate its products in some way. And so it decides to allow resellers to return 50% of their unsold widgets at the end of each quarter. In other words, Company A assumes some of the reseller's risk of excess inventory in exchange for the potential to garner increased market share — in essence, trading a risk for an opportunity. Since it now has the better offer, Company A is able to dominate the market for widgets even though its product is identical to that of its competitor.

This short scenario is illustrative of the concept of cooperative risk management. It is just one example of the opportunities that can accrue by viewing risks as uncertainties which can be controlled to mutual benefit through skillful negotiations.

As another example, consider demand risk. In a conventional relationship, Company A may contract for delivery of an uncertain number of widgets in any given month. But this relationship forces the seller to accept the full risk for the inability of the buyer to clearly define its demand. As a result, the seller has to increase the widget unit price — and the buyer ends up paying for a risk it may well be unaware that it has created.

On the other hand, if the buyer and seller recognise this situation, the buyer could agree to purchase a minimum number of widgets each month — say, 100 — with a set maximum level of 125. This will have the effect of decreasing revenue risk for the seller in exchange for the seller lowering its price. In other words, the buyer addresses its variable demand issue itself rather than forcing the seller to do so for it and, in exchange, both parties benefit.

Identify risks

Identifying the risks that could be used to create opportunities in transactional negotiations requires viewing the transactions through a critical lens. The entire contractual environment needs to be evaluated in a search for areas of uncertainty that could be leveraged to create new opportunities and sustainable profitable relationships. In this search, no area should be left unexamined. Consider factors such as:

- pricing of raw materials;
- service levels;
- order complexity;
- quantities;
- resource utilisation;
- liability exposure;
- subcontracting rights;
- work scope;
- delivery locations and schedules;
- contract duration; and
- intellectual property ownership.

Note that these categories of risk are only meant to be representative, and this should not be considered as a

comprehensive list. Furthermore, risks can be complex, drawing elements from multiple categories.

Analyse risks

Having identified risks, the next step in cooperative risk management is risk analysis, a process that all too often results in either an over- or an under-estimation of both risks and their impacts. Erroneous analyses can be avoided by carefully evaluating the minimum, expected and maximum likelihoods of the risk occurrence, and the impacts should the risk occur.

When analysing risks, both objective and subjective data must be considered. Objective data should include probability assessments based on history and experience, and subjective data should include probability assessments based on expert judgments. By considering the likelihood and impact of the full complement of risks previously identified, over a full range of possibilities, a true risk evaluation can be determined, and negotiations can focus on pricing and trading these risks in a way that benefits both buyer and seller.

Shaping risks

Once risks are identified by either the buyer or the seller, they can be shaped — that is, offers can be made that alter the structure of a transaction in a way that benefits both parties. For example, assume that a buyer has forced a seller to accept a full form indemnity, loading the seller with full responsibility for any claims resulting from a failure relating to the product being sold. This leaves the seller very exposed and perhaps unwilling (or at least unhappy) to do business with the buyer. As a result, the seller raises unit prices.

To get the seller to lower prices, the buyer may offer to accept the first $20 million of loss linked to an event associated with a product failure. For a $100 million claim, this means that the seller will have an $80 million exposure rather than the full amount of the claim. Furthermore, the seller recognises that since most claims fall in the range of $5 million to $30 million, the actual exposure is dramatically reduced, since in these cases its maximum exposure is just $10 million.

By buyer and seller working together to shape the liability risk this way — without either side taking any action — an offer can be structured that meets the real requirements of each party.

Treating risks

It is also important to note that buyers and sellers can also manage risks by treating them with pre-emptive actions that lower the likelihood of a risk occurring, or with planned recovery actions in the event that a risk does occur, to lower its impact. These actions most commonly occur after shaping the risks, but best practice dictates that treating risks is more effective when completed in advance of shaping them, before they are allocated to either the buyer or seller. In so doing, risk shaping can be simplified and residual risks minimised for both parties.

In the scenario above, for example, the parties could have minimised liability exposure by agreeing, in advance, to treat liability risk by re-packaging products with a warning notice to lower the likelihood of liability claims. By doing so, the buyer would presumably incur fewer claims, the seller would reduce its liability exposure, and a more sustainable relationship would be forged.

In shaping and treating risks in new ways, there may be counter-risks. For example, the most economically logical solution may not in fact fit today's standard procedures — so doing it in a non-standard way may have both a cost and a greater risk that it could go wrong. These are considerations that must also be taken into account.

Pricing risk

The key to successful cooperative risk management is accurately pricing the impacts of the various strategies outlined above. If the costs of shaping or treating risk in a certain manner are not clearly defined, it will be difficult for buyers and sellers to fully comprehend their benefits — and residual risks — and to complete successful negotiations.

To price risks in a way that enables both parties to achieve their respective goals is a difficult task, and can only be done with the right mathematical modeling techniques. These can be performed internally or with the assistance of third-party vendors.

Next-generation contracting

The objective of cooperative risk management is to elevate contract negotiations to the point where there is a mutual understanding between all involved parties that success is not a measurement of how much one side benefits at the expense of the other. Rather, the goal is to ensure that transactions, relationships and profitability codified in contractual agreements meet the requirements of all sides.

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