STRATEGIC RISK MANAGEMENT.

Checklist 264

» INTRODUCTION

High-profile failures of risk management in recent years have made the subject the topic of every-day conversations and political discussions. The collapses of Bear Stearns and Lehman Brothers investment banks in 2008, and the fatal fire and consequent ecological disaster at BP's Deepwater Horizon oil platform in the Gulf of Mexico in 2010, made headline news around the world and prompted calls for regulatory responses.

Intellectually, there has been a rapid popularisation of some relatively new concepts. A better understanding of how human cognitive biases can skew priorities and distract people from emerging risks, even among the most highly qualified and rationally minded senior teams, has deepened our collective awareness. Also influential has been the 'Black Swan' concept, popularised by Nassim Nicholas Taleb – a former financial markets trader and one of the few individuals who warned of the inherent risk in investment banks' market-modelling before the 2008 crash. He emphasizes that major external threats can arise suddenly without warning, and that, as with many activities which involve human behaviour, it is impossible to create reliable models of markets.

These factors have prompted much rethinking around strategic risk management. There is a movement away from treating risk management as a single specialism, and a realisation that it is unwise to rely exclusively on checklists, regulations or quantitative information to manage organisational risks. Risk must be understood and considered across the management team. Risk management must involve multi-disciplinary, in-depth discussions and scenario planning, and be closely linked to strategy development. Some business leaders adopt a still more radical approach, reconceptualising strategic risk management as a source of competitive advantage, rather than a necessary evil.

Although checklists and procedures should not be the only tools for risk management, they can be useful resources, especially at an operational level. Important examples include procedures for handling hazardous substances, preventing occupational illnesses or minimising the risk of fraud.

It is wise for managers at all levels to have a good level of risk awareness, as this can inform career choices as well as operational and strategic decisions.

This checklist is designed to help managers think about the broader strategic elements of managing risk.

» DEFINITION

Risk management is the discipline of continuously analysing and assessing the internal and external risks, to which an organisation is exposed, both actual and potential, with a view to strengthening strategic decision-making capabilities and planning contingencies.

» ACTION CHECKLIST

1. Develop a behavioural understanding of the business

It is now well understood that excellent recruitment and people management practice provides the best mitigation against internal risks, especially where high-risk posts are concerned. High standards of leadership and communication throughout the business underpin good risk management. Reliance on checklists and regulations is at best limited and at worst counter-productive, partly because rules cannot anticipate every scenario, and also because a climate of fear and unthinking adherence to rules can itself be risky.

2. Distinguish between different types of risk

It is helpful to distinguish between three different categories of risk

- internal, preventable risks relating to performance and conduct
- calculated strategic risks such as investment in new markets
- external risks, including unexpected events, such as the Fukushima earthquake and tsunami in 2011, which had a huge impact on Japanese businesses.

Linked to this analysis, many managers find the four T's: 'Tolerate, Treat, Transfer, or Terminate' useful in deciding how to handle risk.

- A decision to tolerate risk might be made with regard to an uncertain political situation in a target market, for example.
- In the case of a clear internally generated risk, measures to treat the risk would be more appropriate.
- In some cases risk can be transferred by outsourcing a function to a specialist external provider with better back-up and specialist skills.
- In other cases, it would be deemed wise to terminate risk by, for example, exiting a market where the risks have begun to outweigh the anticipated gains.

3. Assess impact as well as likelihood

The collapse of Lehman Brothers, and the explosion of the Deepwater Horizon oil platform, could be categorised as 'low probability/high impact' events. In the case of collateralised debt obligation trading by investment banks, however, it could be argued that the risk was much higher than analysts believed – a case of 'over-confidence' and 'confirmation' biases. Some useful approaches have been developed to help management teams analyse and understand risks according to both their impact and their likelihood. Companies are advised to take a strategic view of their own approach to risk, or 'risk appetite' as it is often called. This should cover matters such as tolerance for debt, strategic approach to acquisitions.

4. Develop a behavioural understanding of markets

Market models based on the probabilities of games of chance where there is a known and finite number of variables have been challenged by Nassim Nicholas Taleb, who has argued that real markets are different in nature. Much of this behavioural understanding has already been used to inform investments on the financial markets, but the same principles apply to other types of markets. They are made up of human beings making economic decisions, sometimes individually, sometimes as a group, and can be influenced by unpredictable social or meteorological events.

5. Distinguish between 'risk' and 'uncertainty'

The difference between 'risk' which is identifiable; and 'uncertainty' which is unforeseen and unpredictable in scale, was usefully defined by the early 20th century economist Frank Knight. Traditional assessment tools such as 'SWOT' (Strengths, Weaknesses, Opportunities, Threats), and 'PESTLE' (Political, Economic, Social, Technological, Legal, Environmental) can also be used. Some managers also define peripheral risk that may grow in likelihood or potential impact as a 'Weak Signal' which should be taken into account. Our checklist on business continuity gives more information on handling uncertainty (See Additional Resources below.)

6. Understand cognitive biases

It is well understood that humans as individuals and groups can be prone to major errors of judgement explained by ingrained cognitive biases. One example is 'over-confidence bias', which probably explains why so many corporate mergers fail to achieve their expected gains. Another is ‘confirmation bias’, in which people tend to pay more attention to evidence that supports their view than to that which contradicts it.

7. Build meetings structures that interrogate ideas

Given the nature of cognitive biases, it is generally risky to allow an individual or a small group to make major decisions without their ideas being tested. Many companies have established effective approaches to discuss and assess risks and to debate these thoroughly, with inquirers given licence to play ‘Devil’s advocate’. The principle of individual accountability is important here.

8. Integrate analysis and decision-making, without risk managers ‘going native’

Experience shows that while the principles of risk management can be set out quite clearly, it is very difficult to maintain operational discipline. Risk assessment needs to be sufficiently close to the business to ensure a good understanding, but not so close that individual risk managers are ‘captured’ by a local team that is too risk-hungry or, conversely, too risk-averse.

The best organisational approach may depend on the business context. The three major approaches involve the use of: independent experts, facilitators, or embedded experts

9. Build capacity in scenario planning

Scenario planning was developed by the Shell oil company in the 1960s. It was one of the few major companies to have envisaged a transition from the old Soviet Union to a more democratic group of countries and freer markets. Prior to 1989, this was seen by many as less likely than either nuclear war or an expansion of the Soviet empire. As a result, Shell was better placed than many companies for the opening of markets in Eastern Europe in the 1990s. Scenario planning has been used to great effect by many strategic teams, often in conjunction with models to assess likelihood and impact of likely or potential events.

10. Use good risk management as a source of competitive advantage

Businesses have varying levels of risk appetite with regard to strategic decisions, but all organisations can improve their adaptability and resilience by following the principles outlined above. This can lead to risk management becoming a source of competitive advantage, as it helps organisations to respond to emerging threats and opportunities at a strategic level. Being a resilient organisation can result in enhanced brand image, stronger negotiating positions, and multiple other business advantages.

» POTENTIAL PITFALLS

Managers should avoid:

- **Over-reliance on procedures or checklists to prevent accidents**: strong leadership and clear communication are typically the best preventative measures, particularly for internal, avoidable risks such as fraud and operational errors. However, procedures based on proven methods can play a supporting role
- **Reliance on legislation relating to risk management**: Regulation cannot cover every scenario. Many practices that are tolerated by regulators carry significant operational or strategic risk
- **Striving to control everything**: Managers cannot control external events. Hence the importance of distinguishing clearly between internal and external risks
- **Neglecting low probability/high impact events**: a particular type of event may be considered unlikely, but scenario planning for a major impact event can still be useful
- **Managing for the most easily envisaged risk, rather than the most likely**. Experience and the dominant narratives can strongly influence our perception of likely events. It is helpful to consider different or unlikely scenarios.

» ADDITIONAL RESOURCES

BOOKS

Fundamentals of enterprise risk management: how top companies assess risk, manage exposure, and seize opportunity, 2nd ed., John J Hampton
New York NY: AMACOM, 2015

The risk doctor's cures for common risk ailments, David Hillson
London: Berrett-Koehler, 2014

Managing business risk: a practical guide to protecting your business, 8th ed, Jonathan Reuvid
London: Kogan Page, 2012

A short guide to operational risk, David Tattam
Farnham: Gower, 2011

Fundamentals of risk management: understanding, evaluating and implementing effective risk management, Paul Hopkin
London: Kogan Page, 2010

Risk strategies: dialling up optimum firm risk, Les Coleman
Farnham: Gower, 2009

The black swan: the impact of the highly improbable, Nassim Nicholas Taleb
London: Penguin Books, 2007

JOURNAL ARTICLES

Managing change and building a positive risk culture, Philip Atkinson
Management Services, Summer vol 57 no 2, 2013, pp 9-13

Managing risks: a new framework, Robert Kaplan and Anette Mikes
Harvard Business Review, June vol 90 no 6, 2012, pp 48-58, 60

Making better risk management decisions, Julian Birkinshaw and Huw Jenkins,
Business Strategy Review, Winter vol 20 no 4, 2010, pp 41-45

RELATED CHECKLISTS

255 Business continuity: planning for major disruptions
196 Carrying out a PEST analysis
049 Internal audit
005 Performing a SWOT analysis
050 Spotting fraud
230 Using scenarios

INTERNET RESOURCES

IRM Publications http://www.theirm.org/publications/PUpublications.html
A range of guidance papers is available.

ORGANISATIONS

The Institute of Risk Management
6 Lloyd's Avenue, London EC3N 3AX
Tel: 020 7709 9808 Web: http://www.theirm.org

» CMI PROFESSIONAL STANDARDS

This checklist has relevance for the following standards:

- OP2.4 Managing risk
- OP1.1 Being aware of the external environment
- PE2.2 Analysing data
- PE2.4 Responsible decision making

» MORE INFORMATION

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