

RISK MANAGEMENT IN TIMES OF UNCERTAINTY

Lessons from the battlefield

Global recession, tumbling stock markets, banks dropping like flies, continuing instability in Iraq, possible threat of cold war over Georgia... It would appear that the further we move into the 21st century, the more uncertainty we encounter. What we need is to review the way we manage risk, whether in politics, business strategy or corporate management. It's time to lever risk management to the strategy level and integrate the unknown into our approach.

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The fundamental principles of modern risk management emerged in the 1970s, as more and more industries – including banking – began facing change on an unprecedented scale. Deregulation, global competition, new product development and technological change all contributed to increasing risk in the business world. It was a period of growing uncertainty, with the end of stable exchange rates under Bretton Woods, a double helping of oil shocks, and rising inflationary pressure, making interest rates more volatile. To survive in this new paradigm, firms turned to the principles of risk management as a source of competitive advantage, whatever their field.

Meanwhile, advances in business theory made it possible to isolate specific risk categories and study their behaviour. IT developments facilitated the processing of risk data, paving the way for further research. Correspondingly, the body of literature and seminal work now available on the subject of risk management has grown extensively.

Traditional Risk Methods Under Pressure

Now, in the early years of the third millennium, the business world is again undergoing enormous change. Deregulation has continued apace, technology is advancing at breakneck speed, and globalization has taken on the added dimension of the virtual world, sharply intensifying competition for most businesses. On top of that, issues related to compliance, corporate governance and litigiousness have only added to

the complexity of doing business in the modern world.

Recent world events – political and financial – show that what really hurts companies is the events that have not been planned for, or even identified as a potential risk. From the invasion of Georgia to the bankruptcy of 150-year-old Lehman Brothers, we are forced to realize that risk analysts did not see these events on the horizon and, even worse, could not have even planned for the aftermath using traditional risk management.

Traditional risk management is linear and tends to deal only with known risks. One of the main problems with traditional risk management is the definition of the scope of risk, which often refers solely to future foreseen problems.

The second problem is that managers are very often reluctant to look beyond the scope of what has already been analysed as risk.

According to Anil Gaba, INSEAD Dean of Faculty and Professor of Decision Sciences, another problem lies in the fact that executives learn complex methods in renowned business schools for assessing risks but, most of the time, they rely on their intuition. “You take young people, you train them very hard in these theories—public policy makers, investment bankers, and general managers,” Gaba says, “but when they go out into the real world, they still tend to rely a lot on their gut feeling.”

Fig. 1 shows five stages of the classical risk management process and some possible reasons why the traditional approach can fail along the way. Lack of information, unclear objectives, overconfidence, and lack of overview are among the most common reasons for failure. In our opinion, however, “groupthink”, whereby decision-makers tend to avoid promoting or sharing



Fig. 1

▶ viewpoints out of the zone of consensus thinking, is the one most frequently encountered. It's the old "emperor's new clothes" syndrome, where no-one wants to rock the boat with a new or different approach. The man who coined the term, Irving Janis¹, identified several symptoms of "group-think", among which an *illusion of invulnerability, unquestioned beliefs and direct pressure* seem to be the ones most dominant in the corporate world today.

It's A Battlefield Out There!

The parallels between business in general and the battlefield have already been well documented in the past². Recent world events only reinforce this notion. More than ever, fighting the competition has become more a matter of eliminating the enemy than merely competing on an economic level. In a 1997 interview, Larry Ellison, founder of Oracle, is very clear about the parallel between business and military leaders:

"It is Bill Gates' job to make Microsoft the biggest company on earth, that's what he's paid for. It's my job for Oracle – the number two software in the company in the world – to become the number one software company in the world. That's my job, that's what I'm paid for. If I'm not aggressive enough in the pursuit of that, if I'm not successful in the pursuit of that, I should be gotten rid of. If the general running Desert Storm is not aggressive enough and successful enough in the pursuit of that goal, he should be fired."

What's more, military terms are commonplace in today's business world: companies "invade" new markets, management consultants take on "engagements", and marketers conduct fierce competition in "red oceans". Even business schools are creating successful exchange programmes with military schools (e.g. Wharton-Westpoint Exchange Programme).

But the biggest similarity between the business world and war is probably the daunting task of having to deal with uncertainty. The greater the uncertainty, the more difficult it becomes to rely solely on traditional methods. This applies across the business spectrum, such as in project management³, and most especially in risk management. The immediate problem with uncertainty is that it is a major driver of complexity. Prussian General Carl von Clausewitz studied and closely analysed the issue of

uncertainty in war in his treatise "On War"⁴. We believe that the lessons from Clausewitz could be applied to risk management, given that he described uncertainty as a major reason for failure in war.

Here, we draw on the specific elements of this parallel to develop additional key points to be taken on board when attempting to manage risk in times of uncertainty.

The 4 Pillars Of Risk Management Today

In addition to the traditional risk management process, as outlined above, we have identified four pillars that have become crucial for efficient risk management in today's world, as outlined here.

A. *Corporate Culture:*
Consciousness of the symptoms of a battlefield at both the individual and organizational level

The first step towards managing risk in an uncertain world is a conscious acknowledgment that we are operating in an unpredictable business environment and that traditional risk management may not be sufficient. Without such recognition, which must be collective, there can be no "état d'esprit" to develop leaders' skills and make systematic use of the tools described below. This initial step is more easily said than done. There is bound to be resistance throughout the organization, for various reasons. Senior managers tend to be overconfident when it comes to identifying risks, as the mere acknowledgment of being in a state of uncertainty may be perceived as a weakness and a loss of control over their teams and domain of expertise. Meanwhile, the lower echelons of the organization are likely to be troubled by the concept of uncertainty, which they may associate with anxiety and instability of their current position.

B. *Organization:*
Integration of risk management into strategy and execution, centralization and direct reporting structure to the CEO and Board of Directors

As a second pillar, it is necessary to implement the right organization and relevant processes. Recent business turmoil shows that, although risk analyses are clearly conducted, the information is not always in the hands of the decision-makers. McKinsey consultants K. Buehler, A. Freeman, and

R. Hulme⁵ identify the problem of risk management being spread among executives for political or organizational reasons:

"In most organizations, the identification and management of risks is highly fragmented, so the board and the CEO find it hard to engage in a meaningful and informed analysis: the CEO ends up relying on his or her gut feeling." Risk management should thus be centralized, together with a direct report to the CEO and the Board of Directors so as to streamline information channels and processes.

C. *Methodology:*
Application of a new methodology for dipping into the unknown

Many elements that cannot be predicted in the preparatory stages using traditional methods may emerge in real life, on the battlefield so to speak. These risks that were not previously identified tend to be the ones that create the most casualties. What is needed is a means of diminishing the surprise effect in such cases. Here, we use the Known/Unknown Risk Matrix (Fig. 2).

The theory behind this was explained in 2003 by US Secretary of Defense Donald Rumsfeld:

"Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know."

At the time, Rumsfeld was met with a fair amount of derision for this remark but, in fact, the thinking behind this is fundamental to identifying risk management in uncertain times.

¹ Irving Janus: formerly a research psychologist at Yale University and professor emeritus at the University of California, Berkeley

² For example: "Clausewitz on Strategy: Inspiration and Insight from a Master Strategist" by Tiha von Ghyczy, Christopher Bassford, and Bolko von Oetinger, 2001

³ Cf. Rémi Chadel & Avril Wright. "Reforming Project Management: Using leadership skills to manage IT projects" in: Banque & Finance Banking Solutions, Sept. 2005

⁴ "Vom Kriege". Cf. www.clausewitz.com

⁵ "Owning the right risks", in: Harvard Business Review, September 2008



Section 1 represents all the facts we deal with every day. There are the things we consciously know that we know. For example, after conducting a strategic analysis, we usually know a large part of our strengths, weaknesses, opportunities and threats.

Section 2 represents the set of information that we don't actually know that we know. For instance, some information may be available within the organization, on a database for instance, but because we have not taken the time to analyse or use it, we are not aware of its existence. Similarly, some useful information may be in the hands of a particular employee, but because this person has not been invited to a certain committee meeting, the group that could make use of such information is not even aware that it exists within the organization.

Section 3 represents the set of information that we consciously know we do not have access to, perhaps because of lack of resources or integrated IT systems. Examples of such information are customer preferences or market statistics, which we know we do not know. As shown by the arrows, the object of the exercise is to try and take elements from sections 2 and 3 into section 1. For instance, the risk of a company losing a large share of its most profitable clients may be identified as a "known unknown" risk. As long as customer profitability has not been determined, it is impossible to assess this risk. Thus, to make this a "known known" risk, customer

profitability will have to be determined, so as to evaluate the risk, as well as its severity and probability.

Section 4 of the matrix represents the infamous "unknown unknowns", i.e. the risks that are inevitably out there but which we cannot even imagine. The risks in this section are akin to what Clausewitz terms the "fog of war" (*Nebel des Krieges*: uncertainty) and "friction" (*Friktion*: the factors that distinguish real war from war on paper). Of course, one could argue that the mere fact of recognizing the existence of such "unknown unknowns" draws them a step closer to being "known unknowns". But awareness of such risks is not sufficient to control them. And even if we did manage to control some of these risks, there would always be more of them to contend with. Dealing with such risks means trying to think the unthinkable, to expect the unexpected. Here, given the extreme complexity of the strategy involved, we believe it is more important to rely on the qualities of the leader, as explained in the next section.

D. Leadership Skills: *Development of a new set of skills*

The final step in our approach to risk management concerns the leaders and their skills and behaviours. Here, Clausewitz speaks of the qualities of warriors/leaders (*Eigenschaften des Feldherrn*) as key differentiating characteristics. According to Clausewitz, the first quality of a leader in war is, as one might expect, courage (*Mut*). However,

he goes on to say that, to deal with the perpetual conflict with the unexpected, the leader needs two specific characteristics. The first of these is "an intellect that, even in the darkest hour, retains some glimmerings of the inner light which leads to truth". The second quality is "the courage to follow this faint light wherever it may lead". In other words, intuition (*"coup d'oeil"*) and determination (*"Entschlossenheit"*) are the characteristics to be sought in the effective leader in times of uncertainty. Taken together, these two qualities give the leader the "presence of mind" he needs to deal with the unexpected that is so much a part of the atmosphere of war. We believe that these are all qualities necessary in a business leader to drive and supervise the risk management process.

Conclusion

Recent events in the business and financial world have shown that these are nothing if not uncertain times. Uncertainty draws decision-makers out of their comfort zone and into an environment more closely resembling a war zone. In such a context, traditional risk management tactics will necessarily have to make way for new concepts and approaches that go more towards addressing the issue of uncertainty. In this article, we have drawn on some of the parallels between business and the battlefield to draw up a 4-pillar framework to help risk managers cope with uncertainty. This entails reviewing (A) Corporate Culture, (B) Organization, (C) Methodologies, and (D) Leadership skills. The objective is to create a risk management function that is less inclined to look to the past for future risks and more prepared to think the unthinkable and expect the unexpected. ■

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