A new perspective on risk

Risk management is non-intuitive; it runs counter to many individual and organizational biases. Rules and compliance can mitigate some critical risks but not all of them. Active and cost-effective risk management requires managers to think systematically about the multiple categories of risks they face so that they can institute appropriate processes for each. These processes will neutralize their managerial bias of seeing the world as they would like it to be, rather than as it actually is or could possibly become.

Despite all the rhetoric and money invested in it, risk management is too often treated as a compliance issue that can be solved by drawing up lots of rules and making sure that all employees follow them.

Rules-based risk management will not diminish either the likelihood or the impact of a disaster such as the 2010 Deepwater Horizon oil rig disaster, just as it did not prevent the failure of many financial institutions during the 2007-2008 credit crisis.

The leadership challenge

Managing risk is very different from managing strategy. Risk management focuses on the negative—threats and failures rather than opportunities and successes. It runs exactly counter to the “can do” culture most leadership teams try to foster when implementing strategy.

Many leaders have a tendency to discount the future; they’re reluctant to spend time and money now to avoid an uncertain future problem that might occur down the road, on someone else’s watch. Moreover, mitigating risk typically involves dispensing resources and diversifying investments, just the opposite of the intense focus of a successful strategy.

Managers often find it antithetical to their culture to champion processes that identify the risks to the strategies they helped to formulate. “Risk mitigation is painful, not a natural act for humans to perform,” says Gentry Lee, the chief systems engineer at Jet Propulsion Laboratory (JPL), a division of the U.S. National Aeronautics and Space Administration. Lee’s biggest challenge in establishing a new risk culture at JPL was to get project teams to feel comfortable thinking and talking about what could go wrong with their excellent designs.

Risks—qualitative distinctions

Preventable risks. These are internal risks, arising from within the organization, that are controllable and ought to be eliminated or avoided.

Examples are the risks from employees’ and managers’ unauthorized, illegal, unethical, incorrect, or inappropriate actions, including the risks from breakdowns in routine operational processes.

This risk category is best managed through active prevention: monitoring operational processes and guiding people’s behaviours and decisions toward desired norms.

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Thus, the first line of defense against preventable risk events is to provide guidelines clarifying the company’s goals and values.

The Mission

A well-crafted mission statement articulates the organization’s fundamental purpose, serving as a “true north” for all employees to follow.

Mission statements should be communicated to and understood by all employees.

The Values

Companies should articulate the values that guide employee behavior toward principal stakeholders, including customers, suppliers, fellow employees, communities, and shareholders.
Clear value statements help employees avoid violating the company’s standards and putting its reputation and assets at risk.

**The Boundaries** A strong corporate culture clarifies what is not allowed. An explicit definition of boundaries is an effective way to control actions. Companies need corporate codes of business conduct that prescribe behaviors relating to conflicts of interest, antitrust issues, trade secrets and confidential information, bribery, discrimination, and harassment. Executive management must serve as role models and demonstrate that they mean what they say. Companies must institute strong internal control systems, such as the segregation of duties and an active whistle-blowing program, to reduce not only misbehavior but also temptation.

A capable and independent internal audit department tasked with continually checking employees’ compliance with internal controls and standard operating processes also will deter employees from violating company procedures and policies and can detect violations when they do occur.

**Managing strategy risks**

Employees should be encouraged to challenge existing assumptions and debate risk information.

**Independent experts.** JPL, for example, has established a risk review board made up of independent technical experts whose role is to challenge project engineers’ design, risk-assessment, and risk-mitigation decisions.

The risk review board meetings are intense, creating what Gentry Lee calls “a culture of intellectual confrontation.” The meetings, both constructive and confrontational, are not intended to inhibit the project team from pursuing highly ambitious missions and designs.

But they force engineers to think in advance about how they will describe and defend their design decisions and whether they have sufficiently considered likely failures and defects.

The board members, acting as devil’s advocates, counterbalance the engineers’ natural overconfidence, helping to avoid escalation of commitment to projects with unacceptable levels of risk.

**Facilitators.** Many organizations, such as traditional energy and water utilities, operate in stable technological and market environments, with relatively predictable customer demand. Since no single staff group has the knowledge to perform operational-level risk management across diverse functions, firms may deploy a relatively small central risk-management group that collects information from operating managers. This increases managers’ awareness of the risks that have been taken on across the organization and provides decision makers with a full picture of the company’s risk profile.

**Embedded experts.** An investment bank’s risk profile can change dramatically with a single deal or major market movement. For such companies, risk management requires embedded experts within the organization to continuously monitor and influence the business’s risk profile, working side by side with the line managers whose activities are generating new ideas, innovation, and risks—and, if all goes well, profits.

**Managing the uncontrollable risks**

External risks lie largely outside the company’s control; companies should focus on identifying them, assessing their potential impact, and figuring out how best to mitigate their effects should they occur. These risk events require a different analytic approach either because their probability of occurrence is very low or because managers find it difficult to envision them during their normal strategy processes.

**Natural and economic disasters with immediate impact.**

These risks are predictable in a general way, although their timing is usually not (a large earthquake will hit someday in California, but there is no telling exactly where or when). They may be anticipated only by relatively weak signals. When these risks occur, their effects are typically drastic and immediate, as we saw in the disruption from the Japanese earthquake and tsunami in 2011.

**Geopolitical and environmental changes with long-term impact.**

These include political shifts such as major policy changes, coups, revolutions, and wars; long-term environmental changes such as global warming; and depletion of critical natural resources such as fresh water.

**Competitive risks with medium-term impact.** These include the emergence of disruptive technologies (such as the internet, smartphones, and bar codes) and radical strategic moves by industry players (such as the entry of Amazon into book retailing and Apple into the mobile phone and consumer electronics industries).

**Understanding the categories of risk**

Managers must be encouraged to develop a company-wide risk perspective by anchoring their discussions in strategic planning, the one integrative process that most well-run companies already have. For each objective on the strategic map, the managers identify the risk events that could cause the company to fall short of that objective. The team then generates a risk event card for each risk on the map, listing the practical effects of the event on operations, the probability of occurrence, leading indicators, and potential actions for mitigation. It also identifies who has primary accountability for managing the risk.

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