

Black swans and silver linings

Here we look at what business can learn from 'black swans': why the decision-making process should incorporate risk analysis

Few people would deny that 2010 has seen its fair share of 'catastrophes'. The volcanic ash cloud earlier this year caused major disruption to travel plans and wiped £millions off the revenues of many companies. And the ramifications of the Gulf of Mexico oil spill, from lost livelihoods to strained political alliances, seem likely to be felt for many years.

These are 'black swan' events. They have severe consequences but are highly unlikely to occur. They are also difficult to predict accurately - even with the best practices and software tools used by experienced risk analysis professionals. However, they serve a useful purpose in raising public awareness of 'risk' - and potentially offer useful lessons in when and how it can be mitigated.

This is particularly valuable in light of the current state of the global economy, the catalyst of which is widely accepted to be the unacceptable risks taken by fund managers that led to the collapse of major financial institutions. However, despite this acknowledgment, day-to-day risk analysis, which focuses on events that have a high probability of occurrence, is still rarely given the prominence it deserves.

According to Craig Ferri, Managing Director at Palisade Europe: "In the commercial environment, all businesses make decisions every day, irrespective of whether they are operating in a boom or a recession, and regardless of their sector. Each one of these has an associated level of risk: - where to invest, what product to produce in what quantity, which vendor to use, what price to charge, what marketing activity to pursue - the list is endless."

These decisions have potentially business-critical consequences. However, many organisations do not take a strategic approach to decision-making, for example by increased use of risk analysis in the form of quantitative risk management (QRM) and decision-making under uncertainty (DMU).

Today's risk managers and decision-makers have a useful - but limited - window of opportunity to illustrate the benefits of their role. Craig Ferri has compiled the following guidelines on maximising the benefits of QRM and DMU programmes:

Embrace risk management - Risk management is not an optional extra. It is a business critical tool that is an asset and an integral part of the project. Company culture must be developed to embrace QRM and DMU in order that everyone understands their benefits

and the need for them.

Invest budget - Business tools cost money, but managing risk is an investment - not an overhead. Allocating resource and making it a formal business process should be seen as an insurance policy but, by identifying potential risks, it can protect the organisation against unexpected costs in the future.

Communicate clearly - As with any organisational change, it is essential that everyone is clear on the new processes. Create a common risk language - or 'glossary' - that everyone can understand to avoid misunderstanding and ensure a consistent approach to risk and decision analysis.

Illustrate with numbers - Qualitative assessment is essential, but numbers are more powerful - for example the percentage chance of meeting a deadline or budget. Monte Carlo random sampling provides the margin of error for a venture and is a good way to illustrate the consequences of different courses of action.

Create structure - Create the right organisational structure. Individuals and groups need clearly defined roles, and must take responsibility for their own area of expertise.

Think laterally - No enterprise operates in isolation, so other external variables must be included in the decision-making model and process. For example, even a small rise in fuel costs could have a major effect on revenues if raw materials need transporting long distances.

View the complete picture - Political, cultural and social risk factors can be explored by involving all stakeholders. Investing time and money in consultation and research ensures that businesses have a clear idea of the complete environment in which they operate, and therefore minimise the chances of products and services failing.

Report and review - Risks, and their management, must be reviewed regularly - and the programme amended if necessary. Instigate a reporting process in which risks are clearly identified and prioritised.

Learn new tricks - Being risk aware does not mean being risk averse. Businesses should guard against rigidly adhering to 'the way we've always done it' approach, instead keeping up-to-date, learning new tricks and being prepared to be bold.

Supply evidence - Back up the commitment to a thorough QRM and DMU programme with documentation. This validates the budget and buy-in requested at the start. And it's good for business - organisations this thorough are guaranteed a competitive edge.

"Risk managers are currently in an ideal position to progress a cultural change towards making risk analysis an integral part of corporate operations," says Craig Ferri. "They have sophisticated technology at their fingertips that enables the creation of accurate assessment models, combined with the public attitude for risk still being low."

Whilst risk analysis does not help to avoid catastrophic meltdowns, it does enable informed decision-making by taking into account what might happen on an everyday basis - thereby saving time, money and stress in the future.

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