Arthur D Little

Viewpoint

The sixth sense of risk

Building foresight to navigate the emerging risk landscape

Today's executives face an increasingly uncertain risk landscape. The business environment exposes organizations to greater vulnerabilities, more complex dependencies and less predictable competition than ever before. At the same time there is intensifying pressure and expectation on the CEO's ability to lead the business to success by measured risk-taking, while avoiding reputational damage. With a relentless stream of emerging risks and increasing ambiguity of "black swan" events, executives must adapt their leadership and transform their approaches to risk management. Executives now require a "sixth sense" of risk, to provide intuition into the emerging risk landscape and enable their organizations to sense and respond to emerging risk before devastating events are realized. This can be achieved through a proactive approach to risk management.

Evolution of the risk landscape

At its core, proactive risk management is identifying emerging risks early, determining how they should be prioritized, and then responding to them quickly and effectively. The integration of this approach is facilitated by a shift in risk management from a reactive "measure and manage" approach to an anticipatory "sense and respond" approach, which utilizes organization-wide engagement to ensure a dynamic response to risk. This need for change follows the evolution of the risk landscape in three fundamental areas: the era of innovation, evolving dependencies and increasing stakeholder expectations.

- **Era of innovation** – As innovation transforms organizations, technology and markets, there are ever-changing paths to accomplishing goals, tools with which to achieve them and developing opportunities for competitive advantage. To ensure value generation in the face of this, organizations must expand into previously unexplored business sectors and technologies, thus exposing themselves to a potentially vast array of unfamiliar risks.
- **Evolving dependencies** – As leading organizations learn to embrace complexity instead of trying to simplify the complicated, they acknowledge increased dependencies: both internal, between business functions, and external, from customers. The consequence of such internal dependencies is that risks which were previously considered immaterial now pose a serious threat across the entire organization. Combining this with increased customer dependencies, wherein society has become accustomed to high quality-on-demand services, loss of function or reputation can swiftly lead to loss of market share.
- **Stakeholder expectations** – Increasing scrutiny, from both internal and external sources, means executives are expected to deliver more successful results than ever before. In addition, society places pressure on organizations to accept accountability for any actions perceived to be related to them, ranging from the personal activities of senior leadership members to scandals involving related third parties. This, combined with the viral nature of modern media, means organizations must be seen to respond immediately following an incident or face reputational backlash.

The result of this evolution is that organizations must accept that they are complex rather than complicated. A complicated system is similar to an intricate machine; although the relationships between cause and effect may be difficult to understand, they can ultimately be explained. A complex system is built on the interconnectivity of multiple contributors, meaning these relationships are no longer as definitive and outcomes are not always certain. Thus, executives should accept that their organizations may struggle to fully rationalize or quantify many of the emerging risks they face. However, these risks can still be managed effectively through a proactive approach.

The CEO can now only afford one significant failure, so they must ensure a leadership style which enables their organization to sense and respond to these emerging risks.

Challenging the traditional

Traditional enterprise risk management (ERM) is well suited to complicated organizations facing determinant risk. This typically features:

- **Optimized risk management strategy** – a "one size fits all" approach based on past experiences.
- **"Measure and manage" risk approach** – reactive response with separation between risk management and organizational strategy.
- **Lengthy internal and public monitoring methods** – risk registers, audit committees and annual reports.

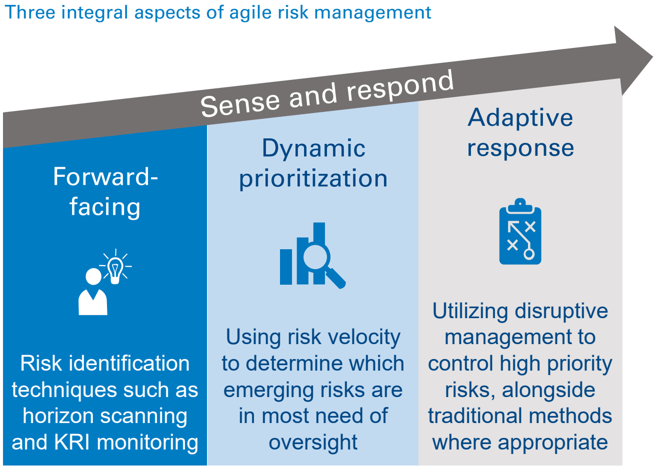
Such risk management approaches can lead to over-reliance on conventional methods and discourage exploration of novel risks and control measures. Even those organizations with exceptional risk management processes may fall foul of emerging risks as they lack the agility to adapt in time. Indeed, the more skilled an organization becomes at managing its known risk profile, the harder it may be to spot weakness or respond quickly to new threats. However, in today's world of rapidly evolving risk, such adaptability is vital. So how do executives equip the complex organization for effective risk response?

A proactive approach

Our experience indicates that the following three key aspects are integral to proactive risk management:

- **Forward-facing practices**
- **Dynamic prioritization**
- **Adaptive response**

Three integral aspects of agile risk management



Forward-facing practices

As complexity and uncertainty increase, so do the associated risk and the difficulty of identifying this. Predictive risk identification techniques such as horizon scanning and key risk indicator (KRI) monitoring should be used to detect, predict and monitor emerging risks. Horizon scanning should be undertaken by subject-matter experts, with trends analyzed to determine probable futures using political, societal and organizational data. From this, potential emerging risks can be identified in advance, and effective management strategies put in place.

Once potential risks have been identified, they can be monitored using KRIs, which provide leadership with a real-time health assessment of the organization. KRIs are leading indicators which are calibrated to provide a "red flag" prior to a risk event occurring; the calibration should be directly related to an organization's risk tolerance. These contrast to key performance indicators (KPIs), which are the traditional, well-established lagging indicators that provide situational awareness after a risk event has occurred. Such metrics are useful for preventing known risks and recording the performance of control measures, but they do not provide the whole picture.

The Holy Grail is to have a set of both leading and lagging indicators to support timely intervention to protect the organization and mitigate the risk. KRIs are most effective when detailed understanding of a risk allows informed thresholds to be set. When the threshold is exceeded, an alert can indicate that the probability of a loss has risen considerably and the risk requires immediate attention. There is even potential for effective KRIs, adequately positioned within the business, to prevent risks from materializing even before those risks have been formally defined. This potential can be realized through artificial intelligence techniques such as complex-event processing, which enable combinations of data relating to various smaller events to identify larger threats before they manifest.

Furthermore, organizations may expand their forward-facing practices to adopt an anti-fragile approach. This assumes disruption is the norm; therefore, the organization continuously self-disrupts. This is analogous to the biological concept of muscular development requiring stress – the more a system is disrupted, the more it will improve.

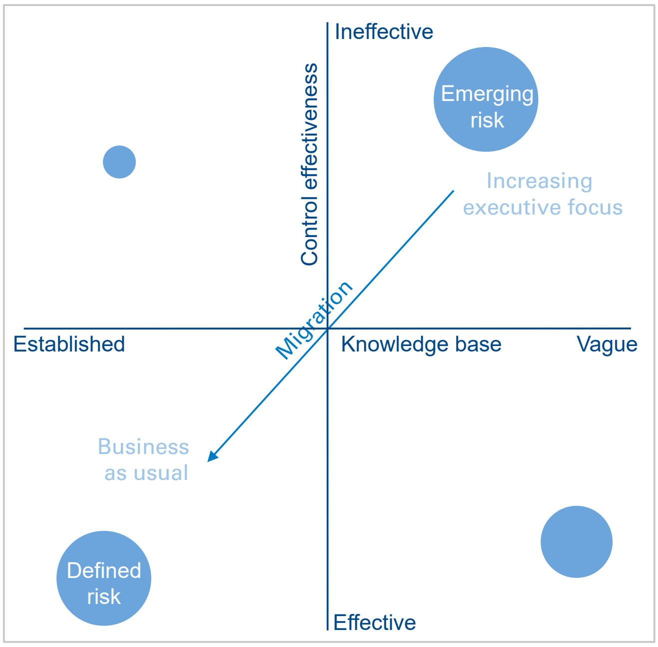
Dynamic prioritization

Emerging risks are particularly difficult for leadership to prioritize when traditional rating methods rely on severity and likelihood – how can these be gauged when there is no supporting data? A helpful metric here is risk velocity, i.e., how quickly an organization will feel the impact of a risk event occurring. For example, reputational damage due to one-off extremely negative media coverage would be high velocity, whereas changing customer needs as they embrace new preferences would be lower velocity. It is the high-velocity emerging risks which should be given high priority and brought to the attention of the executive.

For such risks a knowledge base – control effectiveness map (see later figure) provides an effective reporting tool for executives, as emerging risks can be put in context by relating them to risks with which leadership is familiar. Where velocity is indicated by the size of the marker on the map, it is easy to identify which emerging risks require the highest priority for oversight. Further to this, the dynamic nature of the map, with risk positions changing on a regular basis, is a more engaging way of presenting risks than the traditional risk register, and can be a useful visual tool for executives to use in their working sessions.

Essential to successful risk management today is understanding the varying requirements for different categories or phases of risks. Static risks – which are well understood, have effective control methods, and are unlikely to fluctuate a great deal in the future – are well suited to traditional governance and oversight. Such risks are positioned in the bottom-left quadrant of the map and can be effectively monitored by the risk function.

Knowledge base – Control effectiveness map



Conversely, high-velocity emerging risks, which are poorly understood and have no controls in place, should be proactively managed through executive oversight and a disruptive management team, as discussed below. The result should be that as both understanding and control effectiveness grow, the risk migrates to the bottom-left quadrant. At this point the responsibility of oversight shifts to the risk function.

Adaptive response

Adaptive response is the ability of an organization to manage different phases of risk through the most appropriate approach, balancing traditional and proactive methods. One proactive method is disruptive management, which comprises multi-disciplinary teams that are able to challenge conventional methods, adapt a project as it develops, and foster a "fail early, learn fast" attitude. The output is achieved through breaking a project into numerous small sub-projects known as "sprints", with proof of concept required at each stage. Regular meetings are held for progress updates and to ensure that the optimal approach is used. The result is that the end goal is agreed at the project outset; however, the route to get there is not set in stone and may deviate from initial expectations. Using forward-facing practices enables the team to adapt to changing information as understanding of the risk evolves. A reporting tool such as the knowledge base – control effectiveness map then provides evidence of success, as teams should observe migration towards the bottom-left quadrant if their approach is effective.

Adaptive response provides an opportunity for the executive to swiftly integrate pockets of proactive risk management within the organization and demonstrate its success. This increases the likelihood of stakeholder buy-in and aids setting of the tone for the future risk management strategy. However, it is important to remember that this approach should be used to complement existing practices, not as a replacement. It is through a combination of the two that organizations can most effectively manage their risk portfolios.

Risk management failure

Three notable examples are provided which highlight failures to adopt a proactive risk approach:

Cambridge Analytica data leak

In 2018 an ex-employee of targeted advertising company Cambridge Analytica came forward to whistleblow on the manipulation of Facebook user data. The accusations stated that the data was used to influence the 2014 American mid-term elections and the 2016 presidential campaign. It transpired that Facebook had first learned of the unauthorized access to around 50 million of its users' data in 2015. Many organizations have failed to identify the broader implications of data breaches, and thus no follow-up audit has been undertaken to uncover any uses of the data. Had more foresight been employed, the implications of this breach could have been better understood, a time-sensitive mitigation strategy created, and the breach acknowledged publicly. Any of these actions would have demonstrated Facebook's acceptance of responsibility and attempts to mitigate its error, thus reducing the media and societal outrage at the scandal.

PPI mis-selling scandal

Since 2011, banks and financial creditors have paid out billions in claims due to the mis-selling of personal protection insurance (PPI), with the risk materializing in a relatively short time scale. Since the start of the scandal many banks have even removed PPI as a product, due to the inherent unsuitability for them to supply it. Had proactive risk management been used, the high commission rates and poor customer eligibility checks for the product may have highlighted the risk posed, allowing institutions to handle the risk on their own terms. In 2018 a proactive response continues to be necessary, following the claims deadline being pushed back to 2019 and a UK court ruling that resulted in previously rejected claims now being up for reconsideration. As a result, numerous financial institutions have been forced to allocate further remediation budgets to accommodate these new developments.

Grenfell Tower fire

On June 14th, 2017 Grenfell Tower in London was engulfed in flames, which resulted in 72 fatalities. In the following enquiry it was discovered that the Association of British Insurers had warned London councils in May 2017 about the safety issues posed by outdated regulation around flammable construction materials. Additionally, a fire-safety consultant employed by the council to assess Grenfell prior to the incident identified numerous fire hazards but indicated that their voluntary disclosure would be costly. Following the incident, an expert report highlighted an established culture of non-safety compliance at Grenfell. Had a more vigilant, proactive approach been taken to the early warnings, it is likely that the impact of the fire would have been greatly reduced. As of August 2018, the UK government's pledge to ban these flammable claddings has yet to be implemented.

Insight for the executive

Arthur D. Little understands the challenges faced by the executive in managing risk within the current evolving risk landscape. For organizations to respond effectively, a "sixth sense" must be engaged and a proactive approach employed. We have discussed three key aspects of this:

- **Forward-facing practices** – using horizon scanning and key risk indicators to identify and monitor emerging risks.
- **Dynamic prioritization** – using risk velocity to allocate priorities and understand the differing needs for oversight of different phase risks.
- **Adaptive response** – introducing disruptive management to enable agile project management for emerging risks, while allowing continuation of effective ERM methods for static risks.

Through our experience of risk management at executive level, with a combination of proactive risk practices alongside traditional ERM methods, Arthur D. Little is able to aid executives in preparing their organizations for the unforeseen risks of the future.

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Arthur D. Little

Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients to build innovation capabilities and transform their organizations.

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