

# Risk Management

## *It's not about methodology, but culture and communication*

Ask most businesses to think about risk, and the type of things which come to mind first are either catastrophic risk, or the risk involved in significant projects. Catastrophic risk has an extreme impact, but its likelihood is low. Earthquake, terrorist attack or catastrophic product failure (an aeroplane falling out of the sky) are the stuff of nightmares, but few of us will experience one in our lifetimes.

Risk involved in major projects – a new building, a product launch, a significant acquisition – is difficult to miss, and any competent organization will have a way of identifying and managing it.

This white paper will not say any more about these two types of risk, because they are amply covered elsewhere. Instead, it will focus on two substantial forms of risk which do not force themselves into our consciousness, and are for exactly that reason highly significant and dangerous. There is very little about methodology, and nothing at all about sophisticated mathematical models – it is about psychology, communication and company culture.

Consider some case studies, two from my own experience and one from the public record.

### **CASE STUDY 1 – STAFF REDUCTIONS**

A manufacturing company was looking to make substantial cuts to overhead, in order to respond to falling sales. One proposal was to let go of Steve, the UK Sales Manager, who had been underperforming. He would not be replaced, but his job

shared out between the Sales and Marketing Director and Head of Customer Services. I queried the proposal, and the exchange was revealing. I asked the Sales and Marketing Director, “How much revenue is Steve supposed to generate?”

“It’s not quite like that,” came the reply. “His job isn’t new business, it’s more account management with existing customers.”

“But you said you’d had problems with him,” I continued. “How much have those problems cost us?”

“About two million pounds of revenue [equivalent to £1m of profit] last year.”

“Isn’t that a reason for helping him improve, or replacing him, not eliminating the post?”

Nevertheless, the meeting decided that Steve had to go. Afterwards the Sales and Marketing Director told me that he was “crying” at the decision. He had no confidence in his ability to take on half of Steve’s job on top of his own, but did not feel able to say anything in the meeting. A few weeks later he was in the coronary unit – the added stress couldn’t have helped...

### **CASE STUDY 2 – MISSING THE BIG PICTURE**

I once worked with a marketing consultancy which served the pharmaceutical industry, principally helping it launch new drugs. The company followed a hugely successful model established ten or fifteen years ago: making the scientific case to

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doctors that its clients' products were best clinical choice. All the effort and attention went into selling this case. Life there was always frantic: projects to complete, new customers to win, a constant battle to attract suitably qualified staff.

Behind the constant activity, however, two very significant things were happening, at (relatively) glacial speed:

- The number of new drug introductions, the principal driver of new business, was steadily reducing;
- Healthcare funders were moving their focus from pharmacology to economics; a drug would not be adopted simply on its clinical merits, but had to pass a test of cost-effectiveness.

Month by month these changes were imperceptible, but looking back over several years it was clear that their impact was profound. Nothing was done to address them. The consultancy found itself having to work ever harder to acquire new business to replace projects as they completed, and pay more and more to recruit suitably qualified sales staff. It was sold by its parent company to a group of leveraged investors and within two years had ceased to exist as a separate entity.

#### **CASE STUDY 3 – FATALITIES**

An explosion in March 2005 at BP's Texas City Refinery killed 15 and injured 180, after a mandate from the BP Group Chief Executive to clip operating costs by 25%.

"Cost-cutting in the 1990s by Amoco and later BP left the Texas City refinery vulnerable to disaster," said Don Holmstrom, a supervisory investigator to the Chemical Safety Board's nearly two-year investigation into the incident. In the words of the Chairman of the Chemical Safety Board "the focus of many [safety] initiatives was on improving procedural compliance and reducing occupational injury rates [people falling from ladders slipping on stairs,

spraining their backs or hurting themselves with power tools], while catastrophic safety risks remained. Unsafe and antiquated equipment designs were left in place, and unacceptable deficiencies in preventative maintenance were tolerated."

Two and a half years before the explosion, the company's own safety experts sent a report to London that actually predicted what would happen. It warned that the history of petroleum leaks at Texas City created "...the potential for a major site incident...."

And yet, BP's top refinery executive John Manzoni said under oath that he only learned of serious safety concerns at the refinery on the day of the explosion.

#### **THREE LESSONS**

The three case studies illustrate three very important points about risk:

- Cost reduction is not risk reduction;
- Perception of risk is unreliable – we tend to overestimate the immediate and vivid, and underestimate the slowly evolving and less visible – beware of the "boiled frog";
- It seems to be really hard to communicate about risk.

#### **COST REDUCTION IS NOT RISK REDUCTION**

What does it mean when we say that a plan or forecast has been "de-risked"? In my experience, it usually means that the revenue line has been cut back to a level which seems impossible to miss. Often however the risk taken out from the revenue line sneaks back unobserved, into the cost line. The "de-risked" plan makes a whole series of assumptions:

- That you can make the revised revenue with the new lower level of cost;

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- That the cost reduction process will not damage either short term revenues or, worse, long term goodwill with customers, suppliers or employees;
- That the business will remain competitive at the lower level of costs, i.e. will retain its differentiating factors, the things that make customers come to it rather than its competitors;
- That anyone involved in actually delivering on the plan is telling the truth about the risks involved (we will come back to the issue of candour and communication later).

Here's the point: a reduction in cost of x% or £xm involves the same, or greater risk, as an increase of the same amount.

If BP had decided to increase the costs in its refinery by 25% it would have been a major capital project with a high-powered project team, gantt charts all over the walls and a sophisticated risk management plan with constant monitoring. Since it was cost reduction there was none of this, and 15 people died.

If the manufacturing company had been planning to recruit an additional salesperson, not lose one, there would have been a lengthy discussion of who was needed, what revenues they would generate over what timescale, and whether there was a return on investment. Since they were looking at a reduction the whole discussion, including my questions, took about three minutes.

#### **BEWARE OF THE "BOILED FROG"**

It is claimed that if you put a frog in cold water and bring to the boil slowly enough, the frog will not register the change in temperature, not jump out of the pan as it easily could, but allow itself to be boiled to death. The scientific evidence for this claim is very thin, but it is a powerful metaphor for many business situations.

Many organizations today risk ending up as boiled frogs as they battle to preserve themselves through difficult conditions. There is a tendency when dealing with crises to assume that the fundamentals of the environment remain the same. We recognize that revenues are falling because customers have less money as a result of the economic climate, but we can easily miss how customers' requirements and perceptions of value are changing. When the economy recovers the customers will be spending money again, but they will want different things.

The marketing consultancy behaved like a classic boiled frog. The adverse changes in its market – the decline in new drug introductions and the rise of the pharmacoeconomist – were headline news in the industry, but nobody stopped to think what they meant.

The BP refinery incident mentioned earlier also illustrates the insidious power of slowly evolving risks: every month the distillation tower and blowdown drum become more unreliable and obsolete, but there was no single triggering event to force the issue to the attention of management until the final fatal explosion.

#### **WHY WE CAN'T COMMUNICATE ABOUT RISK**

In the BP case, safety experts had highlighted the risk two and a half years previously, but top management knew nothing.

In the case of Steve the Sales Manager, the Sales and Marketing Director knew that sacking him would cause a further drop in sales, but said nothing.

Communication, or lack of it, created the possibility of very bad decisions. How is that possible?

Looking at many organizations, I have been able to make out the unacknowl-

*Unacknowledged,  
but very powerful,  
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communication  
prevent us from  
discussing risk.*

edged rules of communication through the hierarchy, although I have never seen them written down:

- Downward communication consists of objectives and instructions;
- Upward communication consists of responses, which mostly have to be “yes, that is possible”. There is a limited ability to push back, but this reduces in proportion to the amount of stress on the organization.
- Responses such as “I don’t know how to do that” are not permitted.

This is an effective way to drive an organization. The problem is, what happens when you are driving it over a cliff and no one dares tell you?

#### **WHEN DID YOU LAST STOP TO THINK ABOUT RISK?**

Organisations, quite properly, are run with a focus on results, not risks. Time is spent resolving day to day issues and delivering on a predetermined plan. Risks inherent in operations, such as industrial accidents, crashes and product failures, can be managed within this framework, but the subtler, slowly evolving risks discussed above cannot be.

#### **ESTABLISHING EFFECTIVE COMMUNICATION**

This problem was in fact solved in the sixteenth century. Here is Niccolo Machiavelli in *The Prince* (1516):

“Men are so happily absorbed in their own affairs and indulge in such self-deception that it is difficult for them not to fall victim to this plague [of people who tell them only what they want to hear]. The only way to safeguard yourself is by letting people understand that you are not offended by the truth; but if everyone can speak the truth to you then you lose respect. So a

shrewd prince should adopt a middle way, choosing wise men for his government and allowing only those the freedom to speak the truth to him, and then only on matters on which he asks their opinion, and nothing else. His attitude should be such that they will recognize that the more freely they speak out the more acceptable they will be.”

Even after 500 years, this is still pretty radical stuff for most organizations.

It is not easy to achieve the level of candour that Machiavelli recommends, although he tells us clearly how to do it. The problem is that, paradoxically, the bigger the problem you have, the less obvious it is.

It can take a huge effort of self-awareness for a dominant executive to recognize when he or she has created a situation where people only tell them what they think they want to hear, particularly when those people are doing the best to conceal the fact – “I don’t want you to understand that I’m not telling you the truth.” If you do follow Machiavelli’s advice and start telling people that “the more freely they speak the more acceptable they are,” who will believe you?

This is a case when you probably need an external facilitator or consultant, someone who is entirely outside the hierarchy, to help you.

#### **CREATING THE SPACE TO TALK ABOUT RISK**

Proper assessment of risk involves taking into account a great deal of information not usually discussed, and certainly very rarely put together. The good news is that the information needed exists within the organization. The sales force talks to customers, and knows how their world is changing. They know what the competition is planning. Engineers know if equipment is becoming unsafe. Accountants

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know, or can easily find out if asked, if margins on certain lines are slowly declining or marketing costs are rising out of proportion to new business acquired.

What is required is usually not extensive research, but simply some quality time. As one manager put it; "You have to fight for the time to look for the monster coming over the hill."

Getting the right people together and asking the right questions in a carefully structured way can produce everything you need to know... provided, that is, that your organization's rules about communication don't get in the way.

When talking about risk, it can often help to create "safe" space. A risk management workshop, two or three hours taken out of normal activity, possibly with an external facilitator, can greatly increase focus and create an environment where it becomes possible to make the sort of comment like the one made in a top management session that I was facilitating – "there is a risk of not delivering on the strategy because nobody knows what it is."

**WHAT IS YOUR RISK PROFILE?**

Do you permit honest communication? I could suggest some self-diagnostics here, but I won't because, if your problem is severe, they won't help. They would probably lull you into a false sense of security. An outsider could answer the question very quickly.

How often do you take time to talk about risk of the sorts described here? When do you look backwards to identify trends? When you talk to sales people, do you ask them what's happening to their customers, or just whether they are going to make their quotas? When did you last get the management team together for a discussion that didn't cover current performance, current problems or future prospects?

When did you last discuss any of the following:

- **Customers:** What's happening in their world? Are they, like the pharma companies, struggling to come up with new products? Are they facing new competition? Are they struggling financially?
- **Suppliers:** How are they doing? Supermarkets at the moment are worried about the financial viability of some of their suppliers – how are yours doing? Are new customers emerging for your suppliers, offering a better deal than you do?
- **Employees:** How attractive an employer are you, compared to five years ago? Are you still seen as a good place to work, or do you struggle to attract the best and have to pay a salary premium?
- **Substitutes for your product:** What's new? In particular, are there any disruptive competitors, alternative products which are inferior but much cheaper and good enough for many of your customers?

Besides these external factors, there is a whole wealth of insight to be gleaned from internal management information:

- What is your maintenance, product development and marketing spend compared to previous years and industry norms? If they are drifting lower relative to the benchmark or last year, you are probably moving towards a fool's paradise – short term results enhanced, long term prospects compromised;
- What salary inflation are you experiencing? A common sign of problems in an industry is rapid salary inflation for 'rainmakers' as everyone struggles to maintain sales;
- What is happening to the cost of customer acquisition – the cost in market-

ing spend of gaining a new customer? If it is rising, how long is it until the business loses the ability to renew itself, with the cost of a new customer exceeding its value? Even if you are a decade away from that point, something is happening in the market. What is it, and what does it mean?

- What is happening to customer loyalty? What proportion of regular customers stop dealing with you in a year? How is this changing? For every customer lost, many others are probably on the point of leaving. Why is this?
- What is capital expenditure as a percentage of depreciation? Consistently less than 100% means that you are running the business down.

#### **THE ONE THING TO REMEMBER**

Businesses run on assumptions; that we know what's going on in our environment, that we know what customers want, that people know how to do what they are supposed to do, that the direction we have chosen makes sense. It couldn't work any other way; life would be impossible if we had to research and think every decision out from first principles.

What is important is that we remember that we operate on assumptions, not eternal truths. We need to be able to spot the circumstances in which our assumptions can fail us, and take the time out to revalidate them.