

Some Notions on the Interpretation of Risk

Insight paper by Harmattan Risk

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Risk can be a tricky concept, and here we suggest a few considerations that might help readers as a reference point in their own interpretations. As a political risk advisory, we tend not to get hung up about the more technical aspect of risk and focus more generally how to sustain operations in complex environments. That being said, we have worked with the concept and have developed some ideas on risk along the way. Providing three points is the modest objective here. These consider: risk as neutral (or the notion of upside risk), risk as “failure to...”, and the interpretation of risk likelihood estimates especially in a political risk context.

Risk as neutral?

Many commentators and theorists say that risk is neutral, in other words it is simply potentiality as opposed to a specific potential downside or problem. If one takes a risk, for example making a bet, one could lose or gain. Taking a risk thus means putting something of value into a position of potentiality.

In political risk, the most obvious comparison to the bet analogy would be deciding to undertake a project in a strategically well positioned country that seems stable and workable now but which might significantly deteriorate while our operation is still in full swing. If it does, we lost the bet. If it does not, we gained from unique market access in a high growth region, and the learning and experience that helps us in future regional operations. Upside risk in this example is continued stability, downside is deterioration.

Our problem with the notion of upside risk is that it seems to be just another expression for opportunity. We have an opportunity in said country if it does not flounder. The “if” is that it does experience deterioration. That “if” is the risk. The notion of taking a risk suggests a potential downside to the intended action. Risk management is about being informed about and planning for the downside. Then even if we still undertake the given course of action, we can at least plan to mitigate the downsides that might occur and be prepared for the deterioration scenario in order to avoid full exposure to it should it manifest. By positing risk as neutral, we start scrambling risk and opportunity. Businesses and other organisations inherently seek opportunities to fulfil their mission,

and risk management is the informed caution which lets us seek opportunities intelligently. Taken to a logical extreme, one would not, for example, see a point in a risk appetite definition phrased as “we would consider this level of opportunity to be excessive” (we might say, however, that we would consider excessive opportunity-seeking to be too risky because it would stretch capacity and focus and likely lead to failure...).

Our sense, though off the cuff, is that “upside” risk got more attention after proponents of enterprise risk management (ERM) realised that a “ball and chain” and compliance-centric image was doing little for the uptake and cultural acceptance of ERM, and a more positive portrayal using “upside” risk would help. Some takes on ERM even seem to posit that “risk-speak” should be the main language of business decision-making. ERM largely came from the regulatory scrutiny and harried business responses that followed major corporate scandals early last decade, and was initially one process by which companies were supposed to prevent such pitfalls from happening again. It certainly did not come from breakthroughs in strategic thinking evinced in stunning corporate successes. From an original intention to help prevent mistakes and liability it has certainly morphed, thanks in part to the inevitable faddishness that accompanies new tools or processes (apparently even the ones we are told to take on by regulators).

Our sense is that risk as a concept is more valuable and coherent when it sticks to the potential downsides. To see risk as all potential things both good and bad becomes a logical tribulation, and we have seen some painful and lengthy convolutions as people have tried to cram all decision factors and problem-solving into the language of risk. Risk considerations need to be a part of nearly every decision about the future and risk intelligence can certainly be applied to opportunity assessment, but risk as a thinking tool starts to fall apart and lose value when it is stretched too far, and it is certainly no substitute for strategic thinking.

Risk as “failure to”?

While ERM theory makes a case for upside risk, risk registries still seem to contain risks in the conventional and common sense of potential bad things. When opportunity is mentioned, it is often as “failure to achieve or capitalise on...[said opportunity]”. And since ERM’s wider adoption, there seems to be some pressure to demonstrate extensive risk registries as at least one indication of ERM performance and a “risk culture”. The result can be trying to read risk into everything, including just being competent in our jobs or intended tasks. “Failure to (e.g. “hire the right talent)” or its equivalents (e.g. “staff rejects change programme...IT systems inadequate to handle projected business volume...”) forms a high proportion of risk registry entries.

It is common sense to clarify key assumptions about the success of an initiative or process and then to review these assumptions against the evidence at each relevant phase – if the evidence is weak, then we need to look at the situation and address any gaps before they become problems. A basic but effective tool for this can be the importance-uncertainty matrix, which highlights factors or assumptions that we need to test and monitor. And a risk assessment approach certainly makes sense for more complex initiatives in which a combination of volatile external factors, the relationship between a diversity of stakeholder interests, and new technologies are relevant to success.

It does seem strange to us, however, to have “failure to” as a risk. Potential failure to do something intrinsic to our role is less a risk than a concern about our own competence. It might seem thorough to include such risks, but this can result in huge and disaggregated risk registries that detract from a focus on actual hazards as opposed to potential underperformance in assigned and agreed roles. Risk registries end up looking more like checklists of everything that needs to be done properly.

In political risk management, an organisation needs to take hard look at its own capabilities in dealing with socio-political complexity prior to entering a complex environment, and overall the downside of failing in political risk management is higher vulnerability to socio-political pressures and hazards. But for the most part, the focus is on hazard generated by both exogenous trends and conditions in the environment and our exposure to them, and by direct interactions between the organisation and its socio-political stakeholders. The result informs us of the capabilities that we need to develop and strengthen to manage risks. The implementation of these capabilities constitutes risk management, but spotting gaps in and assuring these capabilities is not risk management, it is routine performance management.

Political risk is inherently about the socio-political environment and therefore an external type of risk, but we think that the question of “failure to” as risk is still worth consideration in even organisational and internal project risk assessment. One significant risk in seeing risk in even routine tasks and competencies is risk fatigue – when risk is everything it becomes nothing special, and meaningful hazard and uncertainty get lost in the trivia.

The meaning of probability or likelihood estimates

This section deals with a question that has arisen several times in client discussions and which is particularly germane to political risk – how to interpret risk likelihood in the face of widely different risk impacts and the historical prevalence of “wild cards” or “black swans” in political evolution, especially in developing countries. Likelihood (along with impact) is one axis of risk severity and logically we should only consider overall severity in defining priorities, but this logic can sometimes seem insufficient to capture what really matters.

We will use three general types of political risk to illustrate the challenge:

- One, we are at risk just by being there – there is a lot going on around us, and we might inadvertently stumble into a hazardous situation or face pressures inherent in the operating environment
- Two, who we are and what we represent matters, for better or worse, and in some cases our identity, even in the general sense of “wealthy foreign organisation”, can be sufficient to inspire predatory interest – when this combines with known threat behaviour in the environment, we need to consider that we could risk becoming a target
- Three, there are dynamics and forces in this environment that are driving it in certain directions, and one or several of these could be towards a significant deterioration in overall operating conditions and this would challenge the sustainability of our presence there

Type One, “the risk of being there”, we should know beforehand, because it is not about change, it is about present factors and our exposure to them. These are reasonably observable and estimable, so matching the confluence of our exposure under present planning with known factors can yield robust likelihood estimates and the straightforward opportunity of tailoring our exposure. This type of risk presents few interpretive dilemmas.

Type Two, the risk of being targeted by a threat actor, is harder. For example, if kidnapping is a risk in an environment, and kidnappers have targeted foreign businesses in the past, it does not mean that we will be kidnapped. It could happen, and if it did it would be terrible for us and our organisation. For this example, with only baseline precautions and deterrence (i.e. no special adaptation yet), likelihood is about a one in four chance over a year given incidence levels, targeting patterns, and our profile and exposure. It is a small-ish chance, but the impact is high, and in common sense terms, a 25 % chance (probably called something like “unlikely / improbable”) of a terrible thing happening seems a lot higher than 25 %. So this becomes a contingency that we feel we should plan for and invest in. At only 25 % likely, we might get away with no investment, but we

balance likelihood with effect. Crisis and contingent risks often could be unmanaged and in most cases we would be fine, but for high-impact risks, on a common sense level likelihood starts to give way to impact. We also have intuitive concerns: Murphy's Law is in the back of our mind, we might feel unlucky, and we also have the bare recognition that if it could happen to anyone, it could happen to us. That 25 % looms large, and indeed even 10 % might seem weighty in this context. Risk tolerance varies of course, but everyone has their limits.

Type Three, country deterioration, is the hardest one. It is long-term and there are many variables at play. The average instability rating given by a reporting organisation will posit some countries as at high risk of major negative change based on their tracked indicators (indicators are usually linked to a propensity for violent change by reference to global historical patterns). But many of the "high risk" countries will not have shifted one bit from the political model or regime that has been in place for years, or if they did, they flop right back into being fragile and tenuous with just a few changes at the top. Is instability a condition or state of being on the precipice, or is it the chaos of a transition, or is it the far less workable aftermath of a chaotic transition? Egypt for example fit the model of a pre-revolutionary or disruptive transformation situation for decades, but it only happened once (change from Nasser to Sadat was extensive but not revolutionary, and Sadat's death hardly changed anything). And now? It recently fell from a precipice of potentiality and one would expect that it is now more stable just by having gone through this change, but if we look at the indicators it seems even less stable than Egypt under Mubarak. Type 3 has huge implications, most likely making a country a "no go zone" for a while or much harder to work in, but is far less predictable than other types.

Even more than Type 2, the impact element of a Type 3 risk takes precedence over likelihood estimation, partly because we know how hard it is predict such transitions (and the poor track record of prediction bears this out). Major country events are "black swans" and are at the limits of estimation capability. We can define how fragile a situation is, but we can seldom say when or even if this fragility will lead to major change. There are too many variables and potential triggers. Political risk assessments often give a low likelihood to major transformation risks, partly because of the infrequency of such changes in a specific country, and sometimes because analysts erroneously equate a low probability with uncertainty (uncertainty and risk are different, but if one had to rate an uncertain potential event in risk terms, the best reflection is 50 %). Yet such events happen, and they can be ruinous if a company is not prepared.

In practice, major deterioration risk is often addressed through scenarios as opposed to risk assessment, and indicators of the emergence of a scenario are supposed to provide warning to

enable staged preparation. But in many cases of major deterioration, the time from trigger to emergence to manifestation does not leave much room for playing catch up with events.

Clients have been justifiably concerned about Type 3 risks and how to interpret likelihood in this context. There are no easy answers, but it is probably a good idea for analysts to rely less on past frequency for such risks and more on the prevalence of instability indicators, and not be shy about assigning higher likelihood ratings when this seems appropriate. And as with Type 2 risks, users would be entirely justified in giving more psychological and decision weight to impact than likelihood when the impact would be extreme. Spending budgeted time and money on something bad that does not happen is usually absorbable and quickly forgotten; hasty extrication from a chaotic situation can entail very real harm, and leave lasting scars and inhibitions.

In light of the above, intelligence users and planners can accept that the psychological and intuitive weighting of impact for higher-impact risks is not irrational, and indeed this extra layer of interpretation helps to put raw assessment into a human and organisational context. People are ultimately the ones at risk or dealing with manifested risk, and our own tolerances matter. A gambler might win more often than not by retaining perfect objectivity, but in political risk there often is more at stake than just money, and manifested risk can have reverberations far beyond just a bad bet.

Conclusions

We are certainly not risk experts in technical or mathematical terms. Nonetheless we have encountered the above three interpretive problems in our work, and as noted we have developed a particular perspective on each. We think risk as a conceptual tool is more valuable when it focuses on the downsides and hazard; we do not think it is useful to see risk as failing to do something intrinsic to our roles because this trivialises risk and distracts from meaningful hazard; and we feel that it is appropriate to give weight to impact for higher-impact risks. Particularly in the section on risk as “failure to”, we seem to give ERM a rough time. However, we welcome the trend as long as ERM sticks to providing warning and prudence in business decisions and initiatives. It gets scrambled when it is seen as a way to address routine quality assurance or when the ERM lens is applied to strategy formulation. Political risk is a unique domain and we have our own biases, but hopefully readers will be able to use some of the above as a reference point in their own ongoing consideration of what risk means in their context and organisation.

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