

Economist Conferences

The
Economist



THE RISK SUMMIT

RISK BEYOND THE HORIZON

November 3rd 2011 • The Willis Building, London

SUMMARY PAPER

Gold sponsors:



Willis

INTRODUCTION

These are troubling times for business, government and society. Ongoing problems in the Eurozone, slow growth in the US and political uncertainty across the Middle East and North Africa have given those who manage risk plenty to consider in 2011. In addition to short-term upheaval, companies also need to think about longer-term structural issues, such as demographic change and urbanisation.

Recent events have also shown how companies can easily be sideswiped by a crisis. Although different in nature, crises at BP and News International were severe enough to put the company's entire license to operate at risk.

Navigating this uncertain, dynamic environment is not easy, but there are tools, practices and capabilities that can give companies a much better chance to manage risks and spot opportunities. Risk management has come a long way in recent years, and has evolved from being considered largely a support function to becoming a central part of strategic management.

It is against this backdrop that Economist Conferences hosted The Risk Summit, a one-day event held on November 3rd, 2011 at the Willis Building in London. Invited speakers and high-level attendees from a variety of industries took part in a lively discussion around the challenges and opportunities for companies seeking to identify, assess and mitigate key risks.

SECTION 1: THE RISK ENVIRONMENT

There is a vice of pressure that is bearing down on countries, corporates, banks and individuals. On the one side of the vice is debt, which is leading to a loss of hope. On the other side is the beginning of inflation. We have seen the inflation rate in the UK jump to 5% in one year. This is a painful adjustment for many families – particularly when incomes are also stagnant. The Bank of England appears to have taken the view that inflation must rise in order to manage the debt. That is fine, but we need to recognise that there is a cost associated with that. Many people have never seen the consequences of high inflation, particularly those under the age of 45.

The way in which countries try to escape their debt predicament essentially boils down to two approaches – you are either a liquidationist or an inflationist. The former are those countries – like Japan in the 1990s – that are willing to take the hit and wait patiently until markets reassemble. On the other side are the inflationists, who use inflation to pay down debt. If we take Germany, there is no possibility for it to go down the inflation route because they have seen the painful consequences when they did do previously in the interwar period.

The idea that government can control how defaults happen and can engineer a “managed default” is hubris on the part of politicians. The fact that they think this is possible suggests that mistakes will be made. Neither is this restricted to the Eurozone. The US has an even bigger problem.

One speaker suggested that, ultimately, one country will have to leave the Eurozone. If Greece decides not to leave, this increases the probability that Germany would have to do so instead. One analogy of Europe is that it has been constructed as a building and one of the bricks – the Euro – is not sound. It may be possible to remove this brick and put something else in place. This is not the first time that countries or regions have struggled with currencies. It took several attempts to get the dollar right until the early 20th century.

THE SOCIAL CONTRACT

With many developed economies struggling under crippling debts, we are likely to see a renegotiation of the social contract. According to the old model, people paid taxes in return for services like pensions, rubbish collection and policing. But many European states now recognise that this model is no longer viable. The question is what happens now that the old deal no longer works.

Citizens in Europe now realise that the deal is over. That is why we see protests, such as the encampments at St Paul's and Wall Street and the August riots in London. On the face of it, the Tea Party protests and the protests outside St Paul's may seem very different but at their heart they are quite similar. The key issue for both is that they disagree with how government is spending its scarce resources.

THE RISE OF POLITICAL VOLATILITY

One thing we are likely to see is increased political volatility. Concerns about wealth inequality were a factor behind the Arab Spring and there is a risk that similar demonstrations could occur elsewhere in the world. Some governments are addressing this problem by increasing wages, but that is fuelling inflation.

In the US, it seems highly likely that Obama will be a one-term president, noted one speaker. His successor will probably only last one term too. The problem is not their abilities – but the environment in which they are leading the country. “We have a “stop-go” approach to dealing with economic challenges,” said the speaker. “We deal with inflation but that creates unemployment, then we deal with unemployment but that creates inflation.”

Geopolitical risk is becoming increasingly important. We are seeing conflict on the streets in certain regions of the world and that will probably intensify. We may also see conflict between states as they no longer have the resources to feed their people or build infrastructure.

For companies that operate in China, operational risk should be a key consideration. As growth slows and wealth inequality widens, the risk of civil unrest increases. Companies need to think about the consequences of this to their business. The same is true in Europe and North America. As the social contract breaks down, there are risks for business that do not fit into any of their traditional models.

Concerns about regulatory risk were a common theme. One speaker from the financial services industry said that continuing uncertainty in regulation was impeding the ability to plan the business, and limiting lending capacity, particularly with longer-term financing. “You can operate a business model for decades but when you have 75 regulators around the world responding to the financial crisis in different ways, you feel like you are swimming against the tide,” he said.

URBANISATION

Increased levels of urbanisation are creating their own risks and opportunities. In 2007, a tipping point was reached at which 50 per cent of the population lived in towns and cities for the first time. The vast bulk of new urbanisation is taking place in emerging markets, which is largely positive from a growth perspective. The fastest growth of all is taking place in so-called “middleweight” cities.

Urbanisation is increasing for a variety of reasons. There are “pull” factors, including economic opportunities and investment by private sector and the state. But there are negative “push” factors, too, including modernisation of agriculture, environmental degradation, and the effects of war and conflict.

In the absence of sound management, cities can become sinkholes of poverty and inequality. Persistent poverty is strongly associated with crime, ill health and insecurity. There are also environmental risks facing cities in low-lying coastal areas: as sea levels rise due to climate change, they are at increased risk from flooding.

No country has ever achieved economic growth without urbanisation. There is prosperity associated with proximity. Cities can also help to derive economies of scale. High population densities mean lower unit costs for the provision of services.

DEMOGRAPHIC CHANGE

Demographics are often described as being about predictive models playing out over long, stable periods of time. This begs the question of where are the risks – we know, after all, that demographic change is happening. But unless we see what the speaker referred to as “the second bounce of the ball”, there are major risks in demographics.

This year, the world population reached 7bn. Falls in infant mortality and rises in longevity are contributing to this population growth. But populations are ageing dramatically, too. The current rate of growth in the over 65 population is 2.6 per cent a year. The over 85s are growing even more quickly at 4.6 per cent a year. In the UK, 11m people now alive today are expected to live until the age of 100.

The population will only be replaced if each woman gives birth to 2.1 children. Very few countries are hitting that target. Some, such as Singapore, are providing financial incentives to increase birth rates.

Dramatic changes in dependency ratios mean that it will be very difficult for society to pay for its ageing populations. In the early 1900s, there were 22 people in work for every one retiree. Soon there will be just three. We have no map for this scale of demographic change – it is entirely without historical precedent.

In addition, long life does not always mean a healthy life. As populations age, we will face higher medical costs due to afflictions of affluence, such as diabetes and obesity. We may also start to see the contract between young and old break down as younger individuals start to resent paying for care and services for an ageing population.

SECTION 2: MANAGING RISK

Managing risk in a highly adverse economic, political and regulatory environment has become a major challenge. The major strategic problems facing business today have one thing in common – ambiguity. Most large organisations are not good at solving ambiguous problems, such as how to grapple with the future of US healthcare or the potential of disruptive innovation to undermine the business model.

What is the difference between a complex problem and an ambiguous one? Complex problems are like chess – there are many potential moves, but the number of pieces, size of the board, and rules of the game are fixed. Ambiguous problems, on the other hand, would involve entirely new pieces on the chessboard or abrupt changes to the rules.

So how should companies address these challenges? First, they need to recognise that ambiguous problems require a different approach that relies on hybrid thinking. Individuals need to possess a number of different capabilities. Deep knowledge of one area is not enough.

Companies should therefore change the way they recruit by looking for people who have broad capabilities. At Pixar, for example, recruiters look for experience of excellence before knowledge or skills in animation.

We also need to change the way we structure careers. Currently, individuals who move around a lot are looked down upon. Instead, they should be celebrated.

A FUTURE-ORIENTED APPROACH

In addition to developing new capabilities in the workforce, companies need to adopt a more future-oriented approach to risk management. Companies need to spend time thinking ahead and understanding the sensitivities in the business model. Debate needs to take place at board level to understand what major structural changes, such as demographic change or climate change, mean for the business.

Scenarios do not help the company to predict the future but to understand how plausible narratives might unfold. “You need to know what the worst-case scenario is and be able to plan accordingly,” noted one speaker.

Prediction may be impossible but companies do need to develop a “house view” of what the future might look like. Plans can then be developed around this so that the board and senior management understand what needs to be done in the event of a major downside outcome. For example, knowing how the business will respond if Greece exits the Eurozone is crucial.

Companies need to learn to live with political volatility, argued one speaker. With governments facing increasingly severe constraints in public finances, companies need to be fleet of foot and have strategies that recognise the ambiguity around them.

They also need to understand how politicians behave and anticipate how policy might affect them. Big investments in public affairs departments are becoming more common to help navigate a fluid policy environment.

The relationship between the risk function and the board is critical. But there are challenges with providing the right type, level and frequency of information. Many companies have made efforts to slim down risk reporting so that it only focuses on the key aspects. But there is a tendency for boards to ask for more information, which inevitably means that the risk information pack gets thicker.

In this environment, business priorities are changing. Five years ago, shareholder value was the main metric of success, but now what stands out is to do the right thing for the customer. In the financial services industry, this has become critical due to the combination of the crisis and problems like PPI and endowment mortgages.

Despite efforts to address these problems, speakers recognised that it would take a long time to rebuild reputations. This could take many years and, in the meantime, there is a major opportunity for new entrants who are not weighed down by baggage of the past.

CHANGING ROLE OF RISK

One delegate wondered whether we might see the title risk manager become obsolete in the future as companies embed risk awareness into their business. Some companies are already doing this – WalMart, for example, has replaced risk management with strategic planning.

An effective risk culture needs to come from the top, argued one speaker. “The number one risk manager in the firm is the CEO and that needs to come all the way through the organisation,” he said.

Having controls frameworks create bureaucracy and can prevent a risk culture from taking hold. If business managers know that there will be assurance people to check their work, then there is no incentive to get it right first time. “You need to embed a risk culture, not just pay lip service to it,” said one speaker.

Ultimately, companies may embed a risk culture, but the role of risk officer will never go away. Risk management will always be needed to make sure that the culture sticks.

SECTION 3: CRISIS MANAGEMENT

A resilient company is one that can withstand shocks and recover from them. Resilient companies predict, prevent and manage shocks to their systems and find opportunities.

In the past 18 months, we have seen two extreme corporate crises: BP and News International. These are quite different in nature. BP was a classic corporate crisis that arose from a sudden incident and tragic deaths. But with News International, there was no sudden incident, yet it was equally damaging. It emerged out of an issue that had been going on for several years that they had failed to manage. The question is whether they could have predicted or prevented the issue.

So what is a crisis? The PAS 200 standard defines it as an inherently abnormal complex situation that represents a threat to an organisation. A crisis is something that forces a company to move beyond its normal business continuity or incident management processes. It is less about the operational response and more about the strategic challenge of protecting the licence to operate, long-term reputation and bottom line.

In a crisis situation, pre-prepared solutions are unlikely to work. Managers will be making major decisions when pressure and external scrutiny are high. Although it is impossible to predict exactly what the response will be, it is essential to get the framework right. A resilient company needs risk management, reputational risk management, strategic issues management, crisis preparedness and a culture that values reputation. The attitudinal and cultural issues are as important, if not more so, than processes.

It is important to distinguish between financial and reputational damage caused by a crisis. Companies can usually take a hit on the P&L, but reputation can be destroyed for good. The customer needs to be prioritised, and senior management should make every effort to exceed expectations.

ROLES AND RESPONSIBILITIES

In a crisis, it is crucial to know who will represent the company. The obvious options are the Chairman and Chief Executive Officer. One speaker argued that the Chairman should be favoured if possible because he or she is there to call the executive to account. Sometimes, though, neither the Chief Executive Officer nor Chairman will be up to the job. Companies need to recognise that this is the case and have an alternative who will come across as authoritative and respectable.

The individual tasked with representing the company in the event of a crisis should be given intensive training in how to present to the media. This should include a dry run that simulates a very tough media interview. “You need to bring the hatchet guy in,” explained one speaker. “The aim of the exercise should be to shock the interviewee and remind them that they will face a very difficult situation under the media spotlight.”

Companies also need to put in place a unit that is tasked with processing all media information as the crisis unfolds. This should be run by someone who is highly valued in the company. As well as monitoring media information, this team should also be responsible for vetting any information that goes out to the media. The aim should be to put out information, not avoid doing so.

DEALING WITH THE MEDIA

In the event of a crisis, companies should be prepared for an amazing velocity and volume of interest in every aspect of the case. This will not only be in the mainstream media but online and across social media. Companies may find that rumours spread across social media are untrue. They should be careful about how they engage with these channels, however. Only if a story is wholly inaccurate should they consider wading into the argument.

One speaker advocated sticking the same story and repeating the same message to ensure consistency. But a delegate thought that this might backfire because the public would tire of this robotic approach. A phased approach to communication might be better, whereby the company repeats a message until it is sure that it is understood, then moves on to the next stage in the communication.

Should business leaders admit their mistake? Most speakers thought they should, arguing that an immediate apology is essential, followed by a pledge to conduct a thorough investigation into the causes of the crisis.

An objective, third-party perspective can help to restore confidence. For example, in the case of a corruption scandal, the company may decide to bring in an organisation like Transparency International to give their verdict. This approach has its risks, of course, but it does help to take the heat off the organisation.

There was universal agreement that sticking to the facts in a crisis is vital. This is one of the reasons why a specialist unit to filter out-bound information is so necessary. It may be that information being received from lower down the organisation is not accurate. Companies need to be aware of that and be able to filter it out or await confirmation.

One delegate expressed surprise that chief executive officers find it difficult to stick to the facts during a crisis. One explanation for this may be that they are terrified of the consequences of telling the truth. They may also be insulated from the real story by layers of bureaucracy. “Some CEOs don’t like people telling them hard truths so they pull the duvet over their heads and try to muddle through,” noted a speaker.

CONCLUSION: GROUNDS FOR OPTIMISM

The downbeat assessment of some sessions at the Risk Summit made one speaker want to “hide under a stone”. These are undoubtedly challenging times, but there are grounds for optimism, too. “The world is changing faster than ever,” said another speaker. “We need to envision new futures and not dwell on the past.”

Crisis always brings with it opportunity. One example is that manufacturing is moving back to the Mid-West in the US and the Midlands in the UK. Why? Because wages are rising in Asia and unemployment is pushing down wages in Europe and North America, reducing the difference between the two. In addition, oil prices are still high, so that encourages companies to manufacture closer to home. These trends create the possibility for new business models and ways of creating value.

We should also bear in mind the principles of creative destruction. The end of the social welfare state in southern Europe is a massive dislocation but also an opportunity for new models, ideas, and businesses. This kind of change is like a breath of oxygen for entrepreneurship.

Focusing on the status quo and being reluctant to embrace change is dangerous, suggested one speaker. But there are various ways in which we try to protect the past, even if it is no longer relevant. The political system has not changed in 200 years. French is still taught in schools when a language like Mandarin would be far more valuable. Conservatism is enshrined in business, with the average age of a FTSE100 director hovering at around 58.

Openness to new ideas can be a valuable tool for identifying new risks and opportunities. “One of the problems with managing risk is that people want to build walls around themselves,” said the speaker. “But to respond to the world, you have to bring the walls down and interact with the world. If you don’t, you will never smell what’s on the breeze.”

Economist Conferences

Economist Conferences is a part of The Economist Group, publisher of *The Economist* newspaper. Sharing *The Economist's* commitment to informed, impartial and independent debate, we are recognised the world over as a leading provider of highly interactive meetings—including industry conferences, private gatherings and government roundtables—for senior executives seeking new insights into important strategic issues.

Economist Conferences

26 Red Lion Square
London
WC1R 4HQ
Telephone +44 (0) 207 576 8000
Fax +44 (0) 207 576 8472
www.economistconferences.co.uk

Copyright

© 2011 The Economist Group. All rights reserved. Neither this publication nor any part of it may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior permission of The Economist Group. Whilst every effort has been taken to verify the accuracy of information presented at this conference, neither The Economist Group nor its affiliates can accept any responsibility or liability for reliance by any person on this information.