Q&A

Richard O'Brien

Richard O'Brien is a founding partner of Outsights, a London-based consultancy that specialises in helping organisations think through future business environments, scenarios, opportunities and risks using "insights from the outside world". He has spent much of his career as an international finance economist, with Rothschild Intercontinental Bank and then American Express Bank, where he was chief economist and executive director and editor of The Amex Bank Review. He is the author of the best-selling book *Global Financial Integration: the End of Geography*, and has edited numerous volumes including *Risk Management in Volatile Financial Markets*. In this interview, *ERisk's* Rob Jameson asks him how his work relates to business risk management.

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You began your career as a bank economist and risk analyst, and have ended up as what some might call a "business risk futurologist". Would that be right?

Futurologist is a label I try to avoid. It implies an ability to predict *the* future rather than an ability to anticipate possible *futures*. Risk is a word people use frequently to phrase their business concerns to us, while our scenario-based and other disciplined work is based on identifying opportunity as well as risk.

What sorts of companies and issues do you work with, and on, at Outsights?

We include a broad range of companies from financial through to energy, pharmaceuticals, healthcare etc. The issues vary from the prospects for a country or region, to a specific business turn-round need for a product. We look at the factors driving the external environment as well as the actors. This might include the uncertainty deriving from UK membership (or not) of the euro, from a major change in regulation, or the implications of the growth in consumer power.

How does your work relate to the kind of quantitative "worst-case" scenario analysis that banks and some corporations are now using in their financial risk management?

In the first instance we develop broad environmental scenarios, rather than the "event-driven" scenarios of the kind that are now being used to supplement value-at-risk numbers. Quantitative approaches, such as real options analysis, can be useful when building on these broad perspectives. The organisations we work with develop the quantitative structure, using their specialised knowledge of their industry sector and business.

Is there any way a company can be sure it has considered all its key strategic risks? A lot of these things seem so clear with hindsight, but they still scupper apparently well-managed companies such as Equitable Life.

No, there's no way to be certain. But you can think clearly about possible scenarios, prioritise the main issues and risks, and then devise strategies and actions to cope with them – rather than simply hoping some of the tricky challenges won't come to pass. You can also keep track of the apparently less critical risks, and what you might do about them. And you can make clear why you arrive at a particular decision – an audit trail for decision making, if you like – in a way that allows you to revisit your reasoning and respond better to events as they unfold. This helps avoid the big mistake of trying to deny something difficult is happening when you had been expecting a different outcome.

That won't save a chief executive who takes a wrong turning, will it?

Possibly not – but if you've approached the problem in that way, you're much more likely to have set up a Plan B if the scenario doesn't play out the way you're hoping. You don't have to bet the ranch on most decisions. But if you have, it helps to be explicit about the risk you are taking.

Some strategic decisions are binary, though, aren't they? You either do, or you don't.
Yes. In certain situations, as well as thinking through the options, you have to be clear to yourself and your stakeholders that you are at a crossroads – that is, the business simply has to go one way or another. Business is about taking risks. But if you communicate this kind of "crossroads" decision properly, your career stands a chance of survival – even if the worst happens and you are obliged to fall on your sword. Even the apparently most difficult outcomes will offer risk mitigation options.

I suppose the greatest problem for all risk takers is the 20:20 hindsight of critics when things go wrong.
I used to work in country risk analysis many years ago. I'm talking about the days when the only way of finding out what some countries owed was to clip the tombstones out of *Euromoney* and the *FT* – you certainly couldn't guarantee a sensible answer by ringing their treasury.

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When developing countries' debts were rescheduled, we all took some criticism as to how, as an industry, we had given so much credit to Brazil, and so on, when surely we could see the risks. But if you asked the critic whether they'd lend Brazil any more money at that moment, or whether the discounted debt was now a good buy, they never had a clear answer. Without hindsight, they faced the same uncertainties we had in the beginning.

You seem to be saying that the trick is thinking clearly about the future, in the present. Can you give me an example?
In 1997-8, we conducted a major project for an investment management advisory group in Japan, Nakamae International Economic Research, which involved envisioning long-term scenarios for Japan. After interviewing around 100 individuals in and outside of Japan, and analysing a whole series of issues such as the demographic trends, environmental issues and so on, we developed two scenarios that helped to clarify our thinking.

One was the "long hollowing" scenario in which Japan sinks steadily, the brightest and the best begin to leave, and no difficult reform decisions are taken. The other was a much more radical "crash and rebirth" scenario, in which banks were allowed to go bust or nationalised and real reform was effected – this was well before any such action was taken. At the moment, elements of both scenarios seem to be coming to pass. It's too early to tell which will dominate in the longer term, but the scenario analysis is helping to point up the consequences of events in Japan as they unfold.

You have a banking background, but you've worked extensively with non-financial companies over the past few years. Is there a big divide in how these two groups think about risk?
Banks will often focus on quantitative risk modelling techniques, which are often theoretically based and focused on specific kinds of risks. In financial markets the portfolio of assets, often tradeable and transferable between assets classes in the shorter term, lends itself to the quantitative work. This is less easy in other sectors. Businesses outside the financial sector are more likely to stress broader, qualitative strategic thinking, and then quantify risks only where it helps and is possible. In finance it can be tempting to quantify things even when the numbers are not reliable. I call it the mythical side of "safety in numbers".

You're an economist, but you seem concerned mainly with the qualitative side of risky decision making.
You can put numbers on projected revenues, and dates against timetables and maturities, but putting a number on risks is difficult. Even in the currency markets people might complain that the forward cover "seems expensive". They're really saying: "We have a different view from the forward markets but we aren't prepared to be explicit about it." Much of our work is about making explicit this kind of implicit thinking. You have to try to make transparent the assumptions, and avoid

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the “dismissed knowledge” problem. We all have a tendency to ignore things that don’t fit in with our present view of the world. I’ll use numbers when they give more clarity; I’ll avoid them when they offer false security.

Is there a common trap that companies fall into when they are thinking through strategic risk issues?

Companies can easily define the issue too narrowly at the outset of their thinking. We begin our enquiries openly and try to avoid the pre-set questions. For example, a bank might be considering which Internet strategy it should adopt. But has it convinced its managers there should be an Internet strategy at all? If half the managers think it’s a bad idea in principle, the idea is unlikely to go far or receive the support it needs. The way questions about strategy are framed is important.

Are there any general rules that might help firms avoid making bad decisions?

As many rules as bad decisions – but if there is poor communication within the firm, and in this instance fuzzy language about risk, then it will be tough.

A lot of the big strategy risks for businesses today seem to depend on regulatory uncertainties of some kind. Is this because of some failing in the way regulators communicate?

Regulators are not infallible but people tend to forget that the climate within which regulators work also is constantly changing. Regulators also have to choose their priorities. For example, after a utility has been privatised, the Year One priority may be to make sure consumers get a fair deal. For Year Two it’s to bring prices down. For Year Three, it’s to make sure the infrastructure remains safe and functioning. Meanwhile, businesses have their own responsibilities for these issues too.

Isn’t it the job of regulators to make clear where those responsibilities lie?

In finance this is the tack regulators are taking today: but markets and regulators – and customers too – carry joint responsibilities. Regulators can’t be too prescriptive because of the risk of “moral hazard”, that is, the risk that the market assumes the problem is taken care of. So the responsibilities tend to migrate and evolve over time in a way that is not transparent. ■

Other resources

If you are viewing this in Acrobat, you can click through the hyperlinks

ERisk’s analysis on Equitable Life
http://www.erisk.com/news/weekly/news_weekly2000-12-16_04.asp

How Shell has tried to make future planning a part of its corporate culture
http://www.plausiblefutures.com/text/shell.html

More on Shell’s use of scenarios
http://www.wholeearthmag.com/ArticleBin/224.html

Website of the Decision Analysis Society
http://faculty.fuqua.duke.edu/daweb/

Decision analysis at Arizona State University’s College of Business
http://www.public.asu.edu/~kirkwood/

Planning for high risk, low probability events at the Wharton Risk Management and Decision Processes Centre
http://grace.wharton.upenn.edu/risk/

Rene Stulz and Rohan G Williamson, “Identifying and Quantifying Exposures”, *Financial Risk and the Corporate Treasury: New Developments in Strategy and Control*, Risk Books, London 1997, pp. 34-73.

R Jameson, ed, *The New Power Markets: Corporate Strategies for Risk and Reward*, Risk Books, London 1999; includes extensive discussion of the use of real options theory in investment decisions.

Forthcoming this Spring: Later this Spring, ERisk will add Business Risk to our series of Internet essays on key risks, The Risk Jigsaw.