



Article from

Risk Management

January 2016

Issue 34

Black Swans and Risk Management: Prepare Now for the Unthinkable

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Editor's Note: This article was originally published on www.garp.com in September 2015 and is reprinted here with permission from GARP.

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How does a seemingly impossible event become a harsh or startling reality? In business, its occurrence may not be as random, infrequent or unpredictable as one might be led to believe.

At the 2015 MetricStream GRC Summit¹ in Washington, D.C., Nassim Nicholas Taleb,² best-selling author of *The Black Swan* and *Antifragile*, discussed this concept in great detail. According to Taleb, Black Swans are events with very low probability of occurrence, yet come with extreme and often catastrophic impact when they do happen.

In the risk management and compliance space, Taleb argued that our corporations, industries, and economies have become very fragile – a breeding ground for a Black Swan event to occur and to have devastating and lasting impact.

Major historical events – such as the sinking of the Titanic, the 1987 stock market crash, 9/11 and even the 2010 BP oil disaster – all possess the three textbook characteristics of Black Swan events: rarity, widespread impact and retrospective predictability. However, in the last 10 years in particular, it seems that Black Swan events have increased in terms of both their volume and velocity. We have witnessed a crippling financial crisis; several devastating natural disasters; unprecedented accidents and acts of terrorism; and political upheaval and turmoil in nearly all corners of the globe.

At the same time, smaller and more isolated events are beginning to take a bigger toll. Just ask any company that has faced a data breach or found itself involved in a highly publicized or embarrassing corporate scandal. A reputational hit, particularly in today's age of social media, can be just as damaging as a financial one. Consequently, I would argue that Black Swan events are becoming more common than theory would have previously suggested.

I believe this to be true for a few reasons. Firstly, technology innovation has transformed not only the ways that we connect and

consume information but also the way that businesses operate and serve their stakeholders. Despite new opportunities, this has introduced unprecedented points of weakness and vulnerability.

Complacency or comfort with the status quo is another major factor here. In an effort to meet compliance requirements and regulatory obligations, companies have often adopted rigid, structured policies, procedures and controls. While effective to a certain degree in minimizing and protecting against potential losses, Taleb's school of thought would argue that those environments that are too tightly-controlled are in fact more at risk to unpredictable scenarios.

So what does this mean for risk managers, as well as for the risk management function of your organization? In a recent article, *The Next Frontier of Operational Risk Management*,³ I touched briefly on the need for companies to consider and forecast Black Swan events as part of their larger enterprise-wide risk management strategy. Too few companies are doing this effectively today.

Let's now go a layer deeper and discuss the best ways companies can both address the unknown and, at the same time, ensure they are agile enough to react when the seemingly unthinkable occurs.

BROADEN YOUR DEFINITION OF BLACK SWANS

In addition to considering incidents of varying size and scope as described above, there are other factors that companies must also ponder when conducting Black Swan risk assessments.

One important area to evaluate is the way in which businesses operate. Consider the following examples:

- For decades, it was commonplace for many large American corporations to practice inversion. By acquiring or merging with a foreign entity in a lower tax country, organizations could reduce taxes on revenue made in the U.S. However, this practice came under intense scrutiny when the Treasury Department and IRS issued new guidance in September 2014⁴ to curb corporate tax inversions.

This unexpected change to something that had been considered a widely-practiced approach years before sent shockwaves through corporate America. So much so that just one month later, pharmaceutical research and development company AbbVie backed out of a \$55 billion merger (the year's biggest planned deal) with Ireland-based Shire. In the end, AbbVie paid \$1.64 billion to Shire for walking away from the deal, and received a boatload of negative publicity as a result.

- Switzerland was long viewed as an enviable tax haven for the privately wealthy, but all of that changed in the blink of an

eye amid a massive tax scandal in 2009. That year, the country's largest bank, UBS, was ordered to pay \$780 million in fines,⁵ penalties and restitution, as well as to turn over the names of approximately 250 clients suspected of tax evasion to avoid criminal indictment by the U.S. government.

Soon thereafter, the Foreign Account Tax Compliance Act (FATCA)⁶ took effect, requiring both individuals and financial institutions to report their offshore financial accounts and assets. These factors historically changed the way that international banks and individuals manage their assets.

While these two examples may not be of the same massive scale as commonly cited Black Swan events, both caused seismic shifts and new realities for both the companies involved and the industries to which they belonged.

ASSUME NOTHING TO BE TRUE

The saying that “hindsight is 20/20” is especially true when evaluating Black Swan events. One of the biggest challenges associated with the identification of Black Swan events is the lack of historical data to help companies forecast future incidents. Keeping this in mind, how can risk managers overcome this hurdle?

I've previously detailed the importance of identifying, evaluating and assessing emerging risks⁷ as part of a comprehensive risk management strategy. To understand how Black Swan events could manifest in the future, risk managers working within the emerging risks process must be particularly attuned to trends impacting both their own industries and other markets. Essentially, assumptions about your business strategy and current operations must be continuously questioned and evaluated.

Disruptive industry transformations are happening all around us at lightning speeds. For example, a recent story in *The Economist*⁸ detailed how Silicon Valley start-ups are influencing a financial technology revolution, and how these organizations therefore have the potential to disintermediate the financial services industry.

The energy sector in the midst of a similar transformation that has seen consumers become less and less reliant on utilities. In fact, the traditional energy transmission and distribution model is being challenged by the accessibility of alternative energy sources, such as solar panels for commercial properties and residential homes.

Lastly, consider the impact of companies such as Airbnb and Uber. Both of these start-ups have not only completely disrupted the hospitality and transportation industries, respectively, but they have also begun to take market share away from city and country tourism boards around the world. Indeed, recognizing this trend, the French government has exerted pressure on Airb-

nb, which will collect tourist taxes⁹ (as of October 1, 2015) from all Paris stays, passing the revenue directly to the city.

This brings me to an important point: organizations can no longer assume that the core things they know about their businesses are true. For example, people no longer have to go to a bank to take out a mortgage on a home. Moreover, college students can now buy digital textbooks (instead of going to the campus bookstore), and the medical community is seeing the rise of telemedicine, reducing the need for traditional office or hospital visits.

Nearly every industry, in fact, is experiencing a disruptive transformation that would have been viewed as an impossibility just years ago. It is therefore essential for risk managers to watch mega trends inside and outside of their organizations and industries, enabling them to both learn from others' experiences and to provide the context needed to identify the next big potential events that will make an extreme impact on theirs.

RECOGNIZE THE IMPACT OF EMERGING RISKS AND CONTROLS

Most organizations today are in the early stages of evaluating potential Black Swan events as part of their emerging risk capture and classification processes.

However, in order for this effort to be truly effective, the risk management function must have an active process in place to identify, monitor and manage emerging risks. It cannot be a one-time or once-per-year review; it must be continuous.

Controls put in place to safeguard against emerging risks must also be evaluated and refined frequently, based on new trends, market projections and the evolving risk appetite of the business.

This topic is particularly concerning for large organizations. Typically, these are the companies that face intense regulation and have therefore put in place as many controls as possible to make them less susceptible to crisis. In doing so, however, many have been inadvertently lulled into believing that the controls themselves will protect the business and prevent harm.

When this happens, it is easy for managers to become set in their ways: i.e., they become too reliant on the controls themselves as protection, and, as a result, are unable to respond and react in an agile manner when unforeseen crises occur. Consequently, companies – as well as the markets they serve – in fact become more fragile.¹⁰

While seemingly contradictory, consider how this dynamic has impacted the financial services sector. At an economic level, the reaction to the 2008 financial crisis was to introduce more regulations; to reduce the number of entities that could transact; and to require most derivatives to clear through a central clearing

house (among other changes). At the time, these were deemed as necessary and appropriate responses; however, many now argue that these limitations have actually made the financial system more fragile to unforeseen risks than it ever was before.

PUT BLACK SWANS INTO PRACTICE

There are several impactful things that risk managers can do to advance their efforts around identifying and planning for potential Black Swan events — both on a large scale and a smaller scale.

In addition to putting continuous focus on the identification and classification of emerging risks, companies are advised to go a step further and apply scenario analysis against a list of potential events to determine their impact on the business, customers, stakeholders and industry at large.

Companies also need to recognize that there is inherent risk in the comfort of complacency. To reduce this, organizations should gain an independent view of the events that may cause extreme impact to their company or industry. This can be done in a variety of ways: e.g., by bringing in external experts or consulting teams; by chartering and/or evaluating market research; and by analyzing third-party data to help identify hidden or under-considered areas of future weakness or vulnerability.

Furthermore, controls is another area that requires serious consideration and careful refinement. While most companies would agree that it's cost-prohibitive to be perfectly controlled, the level of optimal residual risk companies are willing to assume varies vastly.

In the same vein, some experience in smaller, lower-impact crisis events may actually prove beneficial for the organization long-term. The more practice risk managers and employees have when things go wrong, the more agile they can be when a Black Swan event presents itself.

What's more, companies must insist on innovation in their risk management program: what proved successful three to five years ago certainly cannot be expected to perform in the same way in 2015 and beyond.

Here are three suggestions for achieving innovation in risk management:

1. Acknowledge that controls are not perfect and that events will occur. People understand how to deal with unexpected events because they have practiced. Reactions to small disruptions can help train people to react to the larger events.
2. Question and test the old tried and true markers for risk. This requires embracing new sources and inputs for risk identification — from employees, customers, systems, big data and much more.

3. Use a somewhat pessimistic lens. This is necessary for companies to picture worst-case scenarios; to imagine how they would react to such events; and to determine the actions they would take as a result. An effective risk manager should mirror the approach of an adept business leader who expands to new markets, takes on new hires and sells new product - all without knowing the perfect outcome.

Expect the unexpected and challenge the expected.

PARTING THOUGHTS

Despite what movies or popular fiction might tell us, an overwhelming majority of Black Swan events are in fact within the realm of our control. For risk managers, this means that increased attention must be paid to efforts that aid in the identification of events that may lead to widespread - and seemingly abrupt - change or disruption.

This effectively requires (1) an expanded definition for Black Swan events; (2) the knowledge of mega trends impacting your industry and those around you; (3) active identification and evaluation of emerging risks and controls; and (4) continuous innovation in risk management programs to diverge from the status quo.

While no company can predict the future, those who shore up their efforts now will be better able to anticipate the unexpected; have the opportunity to create and practice contingency plans; and potentially be in a position to thrive (not just survive) in the face of the next Black Swan event. ■

ENDNOTE

- 1 <https://www.grc-summit.com/>
- 2 <http://www.fooledbyrandomness.com/>
- 3 http://www.garp.org/#!/risk_intelligence_detail/a1Z4000002vwX6EAI
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