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HARVARD BUSINESS REVIEW ON MANAGING EXTERNAL RISK (BOSTON: HARVARD BUSINESS SCHOOL PUBLISHING, 2009), PP. 218, U.S. $ 22.00, (P/B), ISBN 978-1-4221-3844-1

Shiva Kumar Srinivasan

Indian Institute of Management Kozhikode

INTRODUCTION

What are the challenges of 'managing external risk?' This anthology of essays from the Harvard Business Review comprises contributions by a number of business academics, strategy consultants, and representatives of industry who have to deal with the problem of managing risk. It is important to note at the outset that risk is of many types and not all risks are necessarily strategic; many are simply tactical risks. And, again, the risk factors in any given sector are not the same as those that plague different sectors of the economy. It is therefore important to keep in mind that this book does not hope to exhaust the problem of risk in its entirety, but picks up the crucial challenges of managing external risk in a few sectors albeit with a specific focus on the financial sector in the aftermath of the recent economic meltdown. The reader must also differentiate between the approaches advocated by the academics, the consultants, and the executives. These eight essays cover several aspects of risk including not only a typology of risks but the tools and frameworks available to mitigate risk. There is also a discussion on how to anticipate risk through effective forms of forecasting along with advice on how to cope with and make effective decisions in economic conditions marked by uncertainty. The underlying themes in these discussions then is that we must differentiate between 'contingent' and 'structural' forms of risk and the role that regulation plays in designing the playing field. The main management contexts in contention then are finance, strategy, and leadership. All these domains are characterized by risk of both a structural and contingent sort and understanding the differences between these forms of risk is necessary to situate the advice and the attempts at formalization made available in this book. There are also interesting accounts of the origin, development, and evolution of risk management in the context of management theory and practice with a number of examples drawn from financial theory comprising areas such as options, portfolios, hedging, pricing, etc.

Strategic Risk & Hedging

The main focus here is on strategic risk since it brings together the problems that characterize those who work in the areas of strategy, finance, and leadership. Readers are given a lot of advice on what sort of counter-measures are required to mitigate these forms of risk. There is also a 'guide to strategic risk', along with a 'risk map', which provides readers with a cognitive template to think-through and respond to a range of risk factors that cut across a number of sectors. In addition to these guides and maps, there is also a formal framework to manage fluctuations in the value of a range of economic or financial variables. This framework must, needless to say, be integrated into the strategic approach of a firm since the lack of such a framework can lead to a situation

where the firm is overwhelmed by a number of contingencies that will make it difficult to pursue its 'strategic intent' over a period of time. While a number of firms use hedging strategies to mitigate contingent risks, they may not necessarily understand how to optimize these effectively in the pursuit of organizational goals or derive the amount of comparative advantage that is possible. What is needed then is a greater amount of 'coherence' in developing and deploying a risk management strategy rather than a set of contingent responses to contingent challenges since that may not be cost-effective. Hedging is a much more difficult process than is commonly understood and cannot therefore be invoked as a routine response to mitigating risk factors in uncertain business environments. Furthermore, the strategic implications of hedging are far-reaching and may have directional implications on the over-all approach of a firm rather than be reducible to mitigating the risks imposed by rapid fluctuations in the value of specific variables. It is also important to understand the implications of hedging on the competitive dynamics in any given sector or an industry as a whole. There is some interesting advice in this book on who should hedge, how, when, in what contexts, and with what ends in mind rather than merely include hedging in a list of things to do. The guidelines to hedging are therefore as interesting as the strategic and financial frameworks invoked in these discussions. A whole set of financial instruments used in hedging contexts including 'forward-based' and 'options-based' contracts are therefore discussed, but without plunging the reader into more technical details than he may want to grapple with. The underlying strategic thrust however is on increasing 'shareholder value', and the leadership discipline and strategic focus that are necessary to achieve this. The challenges in doing so are complicated by bouts of volatility in the financial markets. The leadership discipline that is envisaged here though is mediated by 'market discipline', which therefore makes it necessary to align the strategic function with the financial function. But since there are limits to discipline, it is important to develop a range of tools that can value options and model risk effectively given the theoretical and practical difficulties inherent in price discovery in a range of businesses and technical contexts.

Forecasting & Decision-Making

An important framework in mitigating risk is to prepare to face it head-on by developing effective forecasting models. The problem with forecasting however is that both the methods used to forecast and the process involved in doing so are not only widely misunderstood, but must also bear the burden of managing the expectations of a varied set of stakeholders effectively. But if done well, forecasting can increase the typical range of options available to a firm or a decision-maker making it thereby possible to generate greater freedom of action when choosing between options. The six rules that will help to develop better forecasts along with the differential factors required to sort out the good forecasts from the bad forecasts are also discussed. What is interesting about this discussion is the effectiveness with which the reader's expectations are managed in the context of thinking through the intellectual and affective dynamics of forecasting along with the problem of when to make or not make a forecast. There is however no technical model of forecasting available that can substitute for strong commonsense that arises out of a rigorous situation analysis, and the learnings that emerge when the reader attempts a forecast himself. So while forecasts are necessary, it is not possible to wish away strategic uncertainty; it is therefore important

to learn to think in interesting new ways about what constitutes strategy in such business environments. A team of McKinsey consultants therefore argue that it is important to differentiate between the four different levels of uncertainty as a way of getting a handle on the situation. How the generic strategies that they advocate are pitched as forms of strategic interventions therefore depends on which of these levels is actually at stake at any point in time. It is therefore important to think through the strategic implications of uncertainty in the context of mitigating risks effectively for a firm.

Managing Complexity Effectively

And, finally, it is important to understand the internal and external conditions in which leaders have to take decisions given the levels of risk to which their analyses and choices are subject to. The challenges are increased in situations where leaders have to simultaneously engage with both strategic and operational aspects of their responsibilities which partake of simple, complicated, complex, chaotic, and disorderly contexts. Needless to say, the notion of risk is not the same in all of these contexts since in most of the decision-making and leadership contexts enumerated above; it is not easy or even possible to subsume the risk factors completely. The affective, intellectual, and political demands of decision-making and risk mitigation are therefore worth a full-fledged study in itself. Developing a framework where such an exercise can be attempted is a way then of formalizing the onerous demands that risk mitigation will make on leaders given the ever increasing range of variables that are beyond their control. What then must leaders do? The answer suggested here again is to invoke the notion of 'levels' since this will help the leader to stop looking for a perfect answer; and instead, learn to pitch according to the internal or external factors in a given situation. The name of the framework that is on offer here is Cynefin, 'which is a Welsh word that signifies the multiple factors in our environment and our experience which influence us'. Amongst those who use this framework include the U.S. Department of Defense and the Risk Assessment and Horizon Scanning Program in Singapore. So what is ultimately at stake in risk mitigation and management, especially when a situation can veer into the disorderly for which there are no pre-set strategies, is to develop a strong understanding of complexity. The typology that is given above comprising the simple, complicated, complex, chaotic, and disorderly is basically about the varying levels of complexity inherent to a situation that needs to be managed effectively. The book ends with a discussion on the theoretical problem of complexity and how incorporating the insights of those who work in complex environments or with theories of complexity can serve as an important theoretical input to managers who may be confronted with complex situations that range from the simple to the disorderly. The tools needed to manage complexity effectively are also introduced for readers who are convinced that the problem in strategic decision-making is not only that of managing risk which stems from uncertainty but that which emerges from complexity as well.

Shiva Kumar Srinivasan, Visiting Assistant Professor, Managerial Communications, IIM Kozhikode, email: shiva@iimk.ac.in