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Moving beyond the official future

Unlike traditional risk management tools, which are usually based around tangible and quantifiable issues, scenario thinking encourages executives to step into the unknown and imagine a range of possible futures

When you ask most executives about risk management, they speak earnestly about things like hedging against currency fluctuation, buying insurance or securing options to guarantee future price stability. They respond to what they think is a quantitative question with a bevy of quantitative solutions. They assume you are asking about traditional risk management – the kind most often associated with finance, insurance, law, safety and security; the kind they can model and quantify.

But what if you are really asking about a different type of risk management? And what if you are not asking about the narrow sorts of risk they expect – the kind that can be managed, controlled and avoided – but the broader types of risk they have not yet put on their radar, let alone learned how to think about strategically?

In 1999, one of Enron's strategic partners asked the question: what if Enron were to fail? At the time, the company was a picture of success: it was the seventh largest US corporation, with more than \$100bn in stated revenue. Nevertheless, in order to sharpen its strategy and explore what risks might lie ahead, the company's executive team developed four scenarios. One of its scenarios, called "Starting Over," anticipated Enron's failure. Although they were never heeded, the executive team had identified risks that no one was considering.

In the months following September 11, 2001, at a time when US hegemony was being challenged in new ways around the globe, a number of

leading companies based in the US conducted a rigorous exercise to imagine how they may be perceived outside the country. These companies were concerned about their brands, as well as the security of their plants and personnel in areas where US sentiment was running low, such as the Middle East and even France. Despite the difficulty associated with quantifying brand decay, they built scenarios to understand the brand risks they faced abroad, and the opportunities at home. Had they taken a narrow approach to risk and risk management, they would not have considered brand risk because it is so hard to measure.

Today, many companies are pondering their strategies for China. Should China be viewed as a centre for low-cost manufacturing? A fast-growing consumer market? An emerging threat to US national security? A world leader that could raise the global tide? Right now, in executive suites across the country, scenarios are being used to understand the many potential outcomes for the uncertainty that China faces, without presupposing them as risks or opportunities. Without this approach, what might these companies have missed about what is coming?

While there will always be a need for traditional risk management, none of the strategic learning highlighted by these examples – anticipating the future demise of an industry giant, understanding the impact of September 11 on IBM or Coca-Cola's brands, exploring the range of effects that China might have on Wal-Mart, Philips, or Unocal in ten to 15 years – would be achievable through the traditional tools and perspectives of risk management.

In the past few years, the definition



of risk management for organisations has broadened, expanding beyond the tangible and quantifiable issues for which executives possess well-honed tools to the less tangible and more qualitative forms of risk that few have learned how to anticipate, recognise or respond to proactively. In this new world of risk, the bounded definition to which most executives subscribe is of limited use – not only because it causes them to miss potentially major disruptions, but also because it blinds them to the considerable opportunities that come when risk is well (or even eagerly) anticipated.

Indeed, the classic separation in organisations between "risk managers" and "risk takers" – the investors, entrepreneurs, innovators and strategists – overlooks the fact that these latter opportunity-minded professionals manage risk too, just in a different way. Their job is to look for ways to create value by exploiting uncertainties in the business environment – in other words, to take reasoned risks based on a point of view about where the world is going, despite the uncertainty they face.

In order to better position themselves to see the risks and opportunities ahead of them, executives need to integrate their "risk management" and "risk-taking" sides – both within themselves and within their organisations. This will require them to adopt a new attitude – to take a more

strategic view of risk that incorporates exploring and managing uncertainty.

◆ Scenario thinking: an approach for managing risk

The new mindset for risk management requires a set of approaches that fully embraces complexity and ambiguity, and that allows for a more balanced view of both the risks and opportunities in the business environment. Scenario thinking is a key part of this toolkit because of the unique ways in which it allows leaders to explore and exploit the unknown, and because of its ability to enable action in the face of uncertainty. A quick tour through some of scenario thinking's main components reveals how this can be achieved.

◆ Articulating the official future

Scenario thinking exercises generally begin with a rigorous fact-finding phase, where the "official future" is articulated. Rather than conducting research on how a company is performing, or what the future is likely to be, the research builds a story describing the assumptions that management has about the future, based on their observable actions.

Official future exercises tend to be revealing, as they make explicit



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assumptions that otherwise tend to go unnamed. In creating an official future for the Bush administration today, one might suggest that the US government sees China as a military threat. Recent statements about floating the Chinese currency and attention on the Chinese military expansion point to an underlying belief that the US has about China's ambition to become a Cold War-style peer competitor. Similarly, an official future exercise at BP would suggest a growing business opportunity is emerging from the transition to a diversified fuel economy, integrating hydrogen, solar and wind energy with traditional fossil fuels. By analysing today's actions and commitments, thoughtful analysts infer what management must believe about the future.

This "official future" analysis is a foundation for exploring what is known and what is unknown about the future within an organisation: it provides a snapshot of management's perceptions. Most of the time, executives disagree with the official future when it is presented to them – that is, they reject the underlying assumptions that they themselves are making implicitly as they execute their companies' strategies. When presented systematically with a clear view of their assumptions, they see for themselves where the logic breaks down. What is most startling about this is that they then realise, without quantitative data and without sophisticated risk models, that they are not fully accounting for the risks and opportunities their companies face.

◆ Creating scenarios

Scenarios – plausible future narratives – allow for a thorough exploration of future risks and opportunities. Scenario thinkers begin at the same place as traditional risk managers, by skillfully making an inventory of what is known about the future. After exploring issues such as demographics as well as aspects of industry structure and customer behaviour, scenario thinkers turn to the unknown, the unknowable, and the perceptions that should be challenged based on the official future exercise. Following a rigorous analytical process aimed at articulating the range of uncertainties an organisation could face and all of the relevant outcomes, scenario thinkers design a number of future narratives.

It is important to note that scenario thinkers create multiple futures, rather than just one. This allows for a more complete exploration of the future that is not tied to a specific set of assumptions about how uncertainties will unfold. By demanding something different from a prediction, complemented by a best-case and worst-case scenario, scenario thinking gets leaders to consider alternative worldviews.

The process of developing multiple scenarios helps to increase the possibility that executives will not be surprised, because it allows them to rehearse multiple unique futures. Importantly, it also grounds decision-makers in the reality that, in most circumstances, they cannot accurately predict the future. Rather than falsely assuming one outcome will happen, leaders then understand that they

must make decisions in light of the true uncertainty they face.

For example, one consumer products company used scenarios to test the different environments in which a new health and beauty product would be launched. Since the product was creating a new category for the company, it posed an unusual range of risks and uncertainties. By "test launching" the product in a wide range of future business environments first, the team understood, in a visceral and deeper way, the critical "tipping point" role that would be played by the acceptance or rejection of the product by health professionals. As a result, the company strengthened its education efforts with these professionals prior to launch, which helped the product become a clear success in the market.

◆ Exploring the broader context

In order to explore accurately the range of futures their organisation may face, most executives need to broaden their context. Research conducted by Paul Schoemaker and this article's co-author, Doug Randall, at the Wharton School reveals that executives devote more than 65 per cent of their resources to managing internal uncertainty, leaving only limited resources for the complicated changes that are happening in their industry and in the broader contextual environment.

In a recent scenario thinking exercise, a Fortune 500 technology company discovered that its human resources strategy was not well connected to changes happening in its industry. Most of the high-end technical researchers who were responsible for much of the company's historical success were based in a remote location and becoming removed from the company's future growth plans. Previously, these engineers had focused on driving down costs in a highly profitable product line, because it was so critical to the company's short-term performance. But due to technological change and the falling cost of overseas manufacturing and development, it soon became clear that the product had no further room for innovation or additional cost-reduction inside the US, leaving hundreds of engineers without a clear mission. The company used scenarios to explore and exploit the contextual environment, identifying new options for the engineers and their innovation teams. A scenario thinking process created organisational systems and innovation disciplines that allowed a smooth transition towards longer-term sustainability and product line diversity. Ultimately, the process preserved jobs and avoided a set of risks that would have been quite costly for the company.

The broader context of social, political, economic, environmental and technological domains offers tremendous opportunities and threats to most organisations. Often though, risk management tools do not provide a sufficient connection between immediate decisions impacting an organisation and the external environment. Because this broader context is often less known and less controllable, it is more foreign to executives and, therefore, gets ignored. Most scenario

thinking processes, though, devote substantial resources to exploring the many ways in which the broader context could evolve and the more tactical decisions it imposes on an organisation.

◆ Stories that enable decisions

Scenarios are written as plausible stories – not probable ones. Traditional risk management is based on probabilities, actuarial tables, and other known and measurable quantities. But scenarios are intended to provoke the imagination and provide a more comprehensive view of risk, so that the results can be embedded in critical strategic decisions. If scenario thinkers focused only on what was likely or predictable within some reasonable confidence interval, they would not identify as broad a range of risks or identify as many opportunities as they do. Because scenarios aim to highlight possibilities that could have a meaningful impact on the organisation, plausibility is a more relevant criterion than a specific prediction.

In the past, scenarios were often used primarily to uncover new risks and identify new opportunities; today, scenario thinking frameworks are being integrated into organisational decision-making processes. Companies conduct thorough analysis to isolate scenario-specific actions from robust ones – actions that are relevant in any foreseeable future. By carefully ranking the importance of strategic choices that an organisation faces in various scenarios, analysts can identify which are most likely to be important in all situations, and which are only relevant given specific future conditions. Sophisticated models are then built to track the progression of contextual conditions and a company's corresponding strategy.

◆ The scenario thinking mindset

One of the challenges in implementing scenario thinking effectively is to maintain the new risk management mindset throughout the process. It is sometimes tempting to demand that scenario thinking processes offer the type of outputs that traditional risk management approaches offer, such as predictions, hedging strategies and insurance plans. But scenario thinking has a more ambitious goal: it enables a more complete view of the risks and opportunities a company faces and offers a framework for engaging those findings into the strategic planning process.

The new mindset for risk managers requires rituals and approaches that are deeply embedded in the scenario thinking process: a capacity for learning, an appreciation of uncertainty and ambiguity, an understanding of the value of strategic conversation and a willingness to explore uncharted territory. Increasingly, executives are appreciating that the changing nature of risk requires approaches that may initially be uncomfortable, but over time turn out to be more effective in embracing the unknown.

◆ The future of scenario thinking

The boundaries of risk management are continually being challenged. With faster and more advanced computing power, we can expect improved models for understanding and valuing risks associated with highly complicated processes, such as climate change. As the definition of risk management broadens, we can also expect to see the wider use of approaches, such as scenario thinking, that encompass the many facets of risk.

We can also expect to see wider and more integrated use of scenario thinking within organisations, because managing risk and uncertainty is becoming everyone's busi-

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ness. Consider how many functions in any major company are affected by the emerging importance of the BRIC economies: Brazil, Russia, India and China. Human resources faces new economic and management models; product research and development now have distributed workforces; market research is more complicated and far-reaching; and manufacturing faces new cost models. It is hard to think of a part of the company that is not potentially implicated.

Skilled scenario thinkers take a holistic view of risk, and so too, increasingly, should organisations. Scenarios are indeed a methodology for simplifying the risk and opportunity that a business faces. And scenario planners are quick to warn that not using such a rigorous and progressive risk management approach may be the biggest risk of all.

Your guide to Mastering Risk

Week 1 September 9

- Introduction
- Risk and strategy
- Learning from failure
- Political risk
- Project risk management

Week 2 September 16

- Risk and emerging markets
- IT risk
- Credit risk
- Downside risk
- Risk and the supply chain
- Scenario planning

Week 3 September 23

- Diversification and derivatives
- Risk and performance
- Risk and acquisitions
- Risk management in banking
- Foreign exchange exposure and risk
- Scenario planning: China

Week 4 September 30

- Systemic risk
- Investment decisions
- Strategy and execution
- Enterprise risk management
- Innovation and risk
- Reputational risk

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