



THE MANY COMPONENTS OF RISK

Understand your threats and opportunities

By Professor Didier Cossin. (February, 2008)

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The business landscape has changed. Major risks can take profitability away in a matter of quarters. Whole industries become suddenly obsolete, while new players re-define business models and make former leaders current losers. Effective risk taking is a key component to why companies have flourished while others have floundered.

Often, what separates a successful company from the rest of the pack, is the ability of executives to take smart opportune risks. Conversely, companies often fail because executives either don't seize on risk opportunities or jump at ill-advised chances. Therefore, it is imperative to have a thorough understanding about the many facets of risk. Here are some of those components:

Predictable surprises deal with the elements in an organization that show weakness. A common business mistake is for executives to manage not being cognizant of the ramifications of these weaknesses, thus making it a significant threat. A well-publicized example is the current financial crisis affecting banks, a consequence of the excessive reliance on financial engineering and the lack of transparency where most involved had some awareness of the hubris engaged.

Macroeconomic risks carry implications not directly related to the company sector. The rising prices of oil affect not only auto manufacturers, while the cost of health care has implications for businesses beyond the pharmaceutical industry. Major shifts are coming and understanding these is essential so that they can be exploited to advantage. The newly found power of commodity players and of energy players in today's world is reminiscent of such past shifts.

Information flows can be a risk. How information within an organization flows and the process of information dissemination poses both threats and opportunities. For example, the financial service industry's ability to take advantage of information depends on the culture and compensation system of its organization, either favoring stars or favoring team work.

The idea of **managing innovation** is a complex process. Which technologies are worth the financial costs of investing to improve operations and financial results? How quickly/slowly should a company invest in innovation? These are just two questions that need to be considered when thinking about classical risk-taking. All companies need to innovate, sometimes on processes, sometimes on products and sometimes on client relationships. Innovation can be managed but the lack of such management creates risks in itself.

Private equity carries many lessons on risks, from financial markets to incentivization of management, from leverage to industry shifts, from contract structuring to excessive risk taking.

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We all possess **psychological biases**. How one recognizes and challenges them is key to reducing negative results in personnel decisions. The overarching overconfidence of senior management, while an asset for leadership, can be a serious problem for risk assessment and risk management. Growing an awareness of our biases as well as others thus becomes an asset to steer the business through true risks.

Finally, there are **governance issues** which must be addressed in a proper context within corporations and NGOs. The way in which these two parties organize and structure themselves becomes a source of tension in negotiations. Different goals, cultures and organizations lead to major conflicts in negotiations and lack of awareness is a major risk to corporations.

To best handle the above components of risk, executives should adopt the following four-step process:

- 1) Identify risks
- 2) Assess the risks
- 3) Manage the risks
- 4) Design sharing strategy and structure the risks

Defining these points is the first-step in adopting state-of-the-art risk thinking.

Professor Didier Cossin will present this four-step process in greater depth during the Take Risks, Get Growth program. He also teaches on the following programs: High Performance Boards, Orchestrating Winning Performance, Strategic Finance, and the Breakthrough Program for Senior Executives.

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