

Board Perspectives: Risk Oversight

Preparing for a Black Swan

Issue 12

A black swan is a high-impact, hard-to-predict and rare event that is beyond the realm of normal expectations in history, science, finance and technology.¹ The terrorist attacks on September 11, 2001, were an example. So were aspects of the financial crisis. Simply stated, the premise underlying a black swan is that conventional wisdom can be a loser.

Key Considerations

In a business context, the nature of a black swan is that it represents an event or combination of events that impact the business in a significant manner. Since no one can predict the future, how do we gain an understanding of what we don't know? One approach is to use the most critical assumptions underlying the strategy as a context for understanding how much a black swan might hurt. The approach works as follows:

- **Define your strategic assumptions.** These assumptions are management's "view of the world" for the duration of the strategic planning horizon. They pertain to such attributes as the enterprise's capabilities, competitor capabilities and actions, customer preferences, technological trends, capital availability, availability of reasonably priced raw materials, sustained business operations, and regulatory trends, among other things. In effect, strategic assumptions are management's "white swans" because they reflect management's view of the environment in which the enterprise will operate during the planning horizon.²

¹ The Black Swan, Nassim Nicholas Taleb, 2010.

² Surviving and Thriving in Uncertainty: Creating the Risk Intelligent Enterprise, Frederick Funston and Stephen Wagner, 2010, pages 86-87.

An Illustrative Example

- **Define your strategic assumptions** – As we look at the strategy typical of some financial institutions that had difficulty as a result of the financial crisis, we might sum it up as a strategy of leveraging cheap money to achieve volume and speed in lending to the low-income housing sector. Assumptions underlying that strategy included increasing or stable housing prices, continued availability of cheap money and continued economic growth, among other things.
- **Develop contrarian statements** – To our assumption regarding increasing or stable housing prices, a contrarian statement might be: "The housing market takes a significant dive in all major markets, hitting all segments of the loan portfolio."
- **Recognize that not all contrarian statements are black swans** – Continuing our example, it is obvious that an unusually severe and pervasive decline in housing prices would have a huge impact on a strategy concentrating lending activity in the subprime market.
- **Articulate the implications of high-impact contrarian statements** – Completing our example, we might have stated the following: "The bank needs to monitor housing market indicators in all major markets with significant loan portfolio concentrations as well as test housing prices by selling selected assets from time to time."

- **Develop contrarian statements.** These statements negate the strategic assumptions. If the strategic assumptions are management's "white swans," the ➤

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related contrarian statements are potential “black swans.”³ They frame the impacts that could seriously damage the company’s ability to execute its strategy.

- **Recognize that not all contrarian statements are black swans.** Look for the statements that are likely to have the greatest impact on the company if they were to transpire. These statements should reflect situations that would likely arise from events about which the organization currently lacks sufficient information and that management would likely rationalize after the fact, “Why didn’t we see it coming?”
- **Articulate the implications of high-impact contrarian statements.** An implication statement resolves the conflict between the strategic assumption and the contrarian statement by asking: “What do we do if critical assumptions underlying our strategy are no longer valid?” and “How would we know if our assumptions are no longer valid?” Action plans arising from an implication statement often include implementing new trending and key factor metrics to monitor vital signs germane to the external environment exposures that concern management and the board.

To prepare for a black swan, assume a critical strategic assumption is no longer valid. Then provide the reason(s) why from the perspective of a point in time in the future, and explain what that development might mean and how we might know it has transpired.

³ Ibid.

A company can fall so in love with its business model and strategy that it fails to recognize changing paradigms until it is too late. Strategic assumptions may not remain valid over time; the only certainty is that no one knows for sure what will happen that could invalidate them in the future. The “contrarian thinking” process forces managers to take a big-picture approach to think out of the box, challenge assumptions constructively and develop new ideas that can make the strategy more robust.

Questions for Boards

Following are some suggested questions that boards of directors may consider, in the context of the nature of the entity’s risks inherent in its operations:

- Is there a common understanding between management and the board as to the critical assumptions underlying the enterprise’s strategy?
- Is there a process for challenging underlying assumptions? Are key factors that provide insight regarding the continued validity of the key underlying assumptions monitored over time?

How Protiviti Can Help

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