Napoleon's Invasion of Russia and Risk Management

Today, June 12 is the traditional date given for Napoleon's invasion of Russia. I cannot think of a better anniversary to use to introduce the discussion of risk management. Do you think he made a risk assessment so that he could manage his risks? If he did, what were his risks and how would he go about managing them. While more of a post-mortem than risk assessment, the chart at the right is probably the best statistical graphic ever drawn. It shows a data map drawn by Charles Joseph Minard, showing the losses suffered by Napoleon's army in the Russian campaign of 1812. Beginning at the Polish-Russian border, the thick band shows the size of the army at each position. The path of Napoleon's retreat from Moscow in the bitterly cold winter is depicted by the dark lower band, which is tied to temperature and time scales. Certainly an excellent visual representation.

I thought about risk assessments and risk management when pondering that as companies become more mature in their compliance programs, they can use the information generated in a risk assessment in a variety of ways to facilitate an overall risk management program. In an article in the June issue of the **Harvard Business Review**, entitled "*Managing Risks: A New Framework*", authors Robert Kaplan and Annette Mikes posit that the initial step a company must take to create an effective risk management system is to understand "the qualitative distinctions among the types of risk that an organization faces." The authors have separated business risk into three categories: (1) Preventable Risks; (2) Strategy Risks; and (3) External Risks. They state that companies should design their risk management strategies to each category because what may be an adequate risk management strategy for the management of preventable risks is "wholly inadequate" for the management of strategy or external risks.

Category I: Preventable Risks. These are internal risks, arising from within an organization. The authors believe that "companies should seek to eliminate these risks since they get no strategic benefits for taking them on." The authors specifically mention anti-corruption and anti-bribery risks as falling in this category. This risk category is best managed through active prevention both through operational processes and training employees' behaviors and decisions towards a stated goal. The control model to manage preventable risks is to develop an integrated culture and compliance model. Such a system would typically consist of a Code of Conduct or Business Ethics, standard operating procedures, internal controls to spell out the requirement and internal audit to test efficiencies. The role of the Compliance Department in managing Category I risks is to coordinate and oversee the compliance program and then revise the program's controls as needed on an ongoing basis, all the while acting as independent overseers or the risk management function to the business units.

Category II: Strategy Risks. These risks are those which a company may accept in some form because they are "not inherently undesirable." In other words, a company may be willing to accept some types of risks in this category so that it may increase profits. This category of risk cannot be managed through the rules based system used for preventable risks, instead the authors believe that “you need a risk management system designed to reduce the probability that the assumed risks actually materialize and to improve the company’s ability to manage or contain the risk events should they occur.”

The authors list several specific techniques to use as the control model for strategic risks. These include “interactive discussions about risks to strategic objectives drawing on tools” such as heat maps and key risk indicator scorecards. The Compliance Department’s role here is to run risk management workshops and risk review meetings, usually acting as the “devil’s advocate” to the business units involved. Another key role of the Compliance Department is the marshaling and the delivery of resources allocated to mitigate the strategic risk events identified in this process. Finally, the authors believe that the relationship of the Compliance Department to the business units in managing a Category II strategic risk is to act as “independent facilitators, independent experts or embedded experts.”

Category III: External Risks. These are risks which arise outside the company’s control and may even be beyond its influence. This type of risk would be a natural disaster or economic system shutdown, such as a recession or depression. The authors here note that as companies cannot prevent such risks, their risk management strategy must focus on the identification of the risk beforehand so that the company can mitigate the risk as much as possible. Recognizing the maxim that ‘you don’t know what you don’t know’; the authors see the control model for Category III risks as “envisioning risks through: tail-risk assessments and stress testing; scenario planning; and war-gaming” with the management team. Under this Category III risk, the authors believe that the relationship of the Compliance Department to the business units is to either complement the strategy team or to “serve as independent facilitators of envisioning exercises.”

The authors conclude with a discussion of the leadership challenge in managing risks, which they believe is quite different than managing strategy. The reason is that managers “find it antithetical to their culture to champion processes that identify the risks to strategies they helped to formulate.” Nevertheless without such preparation, the authors believe that companies will not be able to weather risks which turn into serious storms under the right conditions. They believe that the key element is that the risk management team must have a direct reporting line to senior management because “a company’s ability to weather [risk] storms depends very much on how seriously executives take their risk-management function when the sun is shining and there are no clouds on the horizon.” I could not have said it better myself.