

The Root Causes of Assessment Failures

Governing strategic risk is one of the most important functions a company's board performs. Research shows that companies frequently fail to anticipate, accurately assess, and adequately adapt to existential threats to the success of their strategy and the survival of their organization. Collectively, these failures are often termed, "risk blindness."

In our last two briefing memos, we described the root causes of anticipation failures and steps that directors can take to avoid them. In our next two memos, we'll examine assessment failures.

Once an existential risk to a company's survival has been identified, the assessment process seeks to accurately answer five key questions about it:

1. How large a negative impact could it have?
2. How quickly could this risk develop into a dangerous threat?
3. How much time and resource would be required to prepare a response that would limit the damage to an acceptable level?
4. What is the likelihood this risk will develop into a dangerous threat?
5. What warning indicators should we monitor?

Root causes of assessment failures occur at the individual, group, and organizational level.

At the individual level, we often start with two basic errors, describing risks in terms of discrete events and assuming these events are unrelated to each other. Strategic risks tend to initially appear in the form of adverse trends (e.g., a competitor's gradual mastery of a unique mix of capabilities); only later is the crossing of a dangerous threshold marked by a discrete event (e.g., the competitor's introduction of a highly differentiated product). Moreover, many risks are actually interrelated, and, as we saw in the 2008 global financial crisis, these relationships tend to strengthen as outcomes worsen – cascades and contagions are very real and dangerous phenomena that we too often neglect.

Because many strategic risks are either unique or relatively rare, we are also forced to use subjective estimates rather than traditional frequentist statistics when assessing them, which opens up a Pandora's Box of potential problems.

As Daniel Kahneman has observed, hindsight bias inevitably distorts our subjective assessments: "The illusion that we understand the past fosters overconfidence in our ability to predict the future." Moreover, as Thomas Schelling noted over fifty years ago, "there is a tendency in our planning to confuse the unfamiliar with the improbable. The contingency we have not considered seriously looks strange; what looks strange is thought improbable; what is improbable need not be considered seriously."

Our subjective assessments are usually based on heuristics (rules of thumb that conserve our mental energy) that create biases, including the tendency to focus on information that confirms our existing views makes us overconfident in our conclusions.

When we use quantitative models to help us assess potential threats, we often use deterministic methods (e.g., the classic spreadsheet with a high, low, and most likely scenario), rather than more sophisticated approaches that are better suited to the exploration and quantification of uncertainty (e.g., Monte Carlo methods, and system dynamics and agent based modeling).

Last but not least, at the individual level we often fail to update our assessments as new information becomes available, causing them to increasingly diverge from evolving reality.

At the group level, more errors occur. Too often, subjective risk assessments are made by either one or just a few people who are all exposed to common social pressures towards optimism and overconfidence (the bane of all risk analysts is being derided as the team naysayer). Moreover, people producing risk assessments are frequently not required to make their underlying evidence and logic explicit, much less to have them systematically reviewed. It is also often the case that analysts do not all use the same time horizon when making their assessments, which is guaranteed to distort the aggregated likelihood that different threats will materialize.

A final problem at this level is confusion about the meaning of various words of "estimative probability" used in risk assessments. For example, unless an explicit scale is used, people inevitably attach a

wide range of numerical probabilities to words such as “possible”, “likely”, and “probable.”

The third source of assessment failure occurs at the organizational level. One issue is the “siloeing” of information, and the tendency of different organizational units to only share good news, which results in biased risk assessments. Another critical issue is the widespread use of “risk registers” or “heat maps” to aggregate and convey assessment results. These two-dimensional reports usually focus only on the potential impact and likelihood that a threat will develop, and omit the critical issue of how fast this may occur. Equally dangerous is the substantial information loss due to the use of only three categories to assess both risk impact and likelihood (e.g., low, moderate, and high), multiplying the two ratings to obtain a final “risk index”, and then further aggregating these results by assigning green, yellow, and red colors to them.

Last but not least, too often directors fail to demand that clear early warning indicators are established for strategic risks, and that regular updates on their status are included in all board briefing books.

When you look at all the forces involved, it is easy to see why assessment failures have been so common throughout history. In our next briefing memo, we’ll review what companies and boards can do to improve their chance of avoiding them.

Next up: How to overcome the root causes of assessment failure.

For more information about how Britten Coyne Partners can help your organization manage and govern strategic risk, please contact us:

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