

ARE YOU READY TO MEET YOUR 'BLACK SWAN'?

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At a press conference on February 12, 2002, then US Secretary of Defense Donald Rumsfeld, in a discussion of the absence of evidence for WMDs in Iraq, made the now-classic formulation:

"[T]here are known knowns; there are things we know, we know. We also know there are known, unknowns; that is to say we know there are some things we do not know. But there are also unknown, unknowns – the ones we don't know we don't know."

The statement has repeatedly been held up to ridicule in the decade that has passed as an example of Rumsfeld's hubris and intentional obfuscation. It has even been turned into poetry (see, *Pieces of Intelligence: The Existential Poetry of Donald Rumsfeld* by Hart Seely) and music (*The Poetry of Donald Rumsfeld* by Bryant Kong).

And yet, Rumsfeld articulated what is, in fact, a central tenant of contemporary risk analysis, *The Black Swan*. No, we aren't talking about the Oscar-winning psychological thriller about a prima ballerina's mental breakdown, but rather about the *Black Swans* made famous by Nassim Nicholas Taleb in his bestselling 2007 book, *"The Black Swan: The Impact of the Highly Improbable."* Having sold well in excess of a million copies, it would be reasonable to assume that the central lesson of the book – that we are schooled to plan for and avoid past disasters, but we are poor at preparing for new, future catastrophes – would have been absorbed and digested by every risk professional in the world. Events, as they say, prove that supposition wrong.

Since its publication in 2007, the financial world alone has witnessed the subprime lending crisis, the collapse of Bear Stearns, Lehman Brothers, Northern Rock, and HBOS to name a few, the Madoff scandal, rogue traders at Société Générale and UBS, and the European sovereign debt crisis. Clearly, notwithstanding the many copies sold, few were actually read, much less understood.

It was on this theme that Stephen Platt, principal of Stephen Platt Associates LLP addressed this year's Jersey International Business School Annual Leadership Forum on the subject of 'Leading Businesses in an Era of "Black Swan" Events'.

At the heart of his talk, Platt emphasized the key point of the *Black Swan* event: we can't predict them, but we can prepare for them. Too often the compliance and risk management functions within an organization are treated as academic exercises, building bulwarks against yesterday's bad news. After each corporate disaster, a new wave of legislation and regulation breaks, bringing an ever-heavier burden of compliance

to business. And yet disasters still happen. Platt made clear the fault for this state of affairs is inherent in the approach adopted by most organisations. Compliance becomes a box-ticking exercise with the sole goal of getting a clean bill of health from the regulator. Such an attitude begets complacency, and, eventually, disaster.

Platt illustrated this point with a number of key examples. Both 9/11 and the on-going disaster at the Fukushima nuclear power installation were entirely foreseeable, and yet were completely missed by the experts charged with guarding against such low probability, high impact events.

At the heart of this dilemma is our collective inability to learn that we don't learn. Platt argued that it is essential we set out to identify areas of vulnerability in our modelling and understand the value of counterfactual examples. A theoretically perfect risk management strategy is worthless in the face of practical failure.

For the compliance professional, this is hard work and requires turning conventional thinking on its head. Indeed, as Platt illustrated, what we already know can be inconsequential and by definition can't hurt us. The very act of introducing controls to manage risk only lulls us into the false sense of security that somehow *Black Swans* are thereby made more predictable and thus more manageable. Indeed it is human nature to find comfort in routines, even down to the kinds of people we recruit to be board members. The sheer volume of compliance reporting can lead to a sort of hypnosis if not outright institutional blindness. This problem is only compounded when the actual board members charged with monitoring compliance efforts are themselves poorly versed in the subject.

To better prepare our organisations to cope with 'unknown unknowns' requires a philosophical paradigm shift. We must stop viewing compliance as a business cost and rather as a potential profit centre. We reward the trader who enhances the bottom line, but do we similarly reward our compliance and risk managers for saving the company from a potentially business-threatening debacle? Compliance too often is treated like a goalkeeper – important, but at the end of the day, at best only able to show a 'zero' for his efforts.

We must remember that while risk management models treat businesses as mechanical entities, they in fact bear a stronger resemblance to biological counterparts. What are organisations if not aggregations of eminently fallible human beings? Numbers alone can't tell the whole story and at worst provide a false sense of security.

One would be forgiven for despairing at this point. There are, however, actions and more importantly

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attitudes, we can adopt that make Black Swans less potentially catastrophic than they might be.

1. Systems and controls need to be rigorously stress-tested
2. The board should be evaluated regularly as to its fitness for purpose
3. Simulate disasters and learn from the fallout
4. Project your decisions forward and think through their consequences
5. Use extreme examples as your starting point, not as exceptions
6. Encourage maverick, renegade thinking
7. Consider behaviours, not only performance

Implementing such change is not easy. Pilots must train to fight their instincts and correct a stall by flying into it; it takes strong nerves to point the nose of your plane towards the ground when you are already spiralling downward, but do it you must. Likewise risk management professionals must learn to fight the instinct to 'not rock the boat' in an organisation. We value achievement not prevention, and laziness means we don't measure the value of disasters averted; instead we merely measure the 'cost' of controls and business lost.

Platt concluded by asserting that in the complex, interlinked world of global finance, the future will only become less predictable, dominated by extreme events. Extraterritorial application of regulatory regimes and laws is growing. At the same time, scrutiny of the financial services industry is at an all time high, as increasingly it is perceived as the source of most of society's ills. Inevitably the near term will see a reassertion of the state over enterprise in the form of ever more onerous regulation. Compliance and risk managers will have to learn to adapt and, more importantly, anticipate with ever-greater speed.

There are indeed 'unknown unknowns', and the challenge for all compliance and risk management professionals is how we do a better job in preparing for them. The very survival of our businesses depends upon it.

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