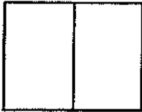



DAVID BACH

# Testing the waters for signs of political risk

As well as investing in practical measures to reduce the risk of political instability and terrorism, companies would do well to engage the communities in which they work

Political risk used to be the concern of only the largest multinationals. But as more and more companies source and sell globally, this exclusivity is quickly becoming a thing of the past. Today, political risk management occupies an increasingly prominent place on the agendas of most senior executives.

Curiously, when talking to managers, one gets the impression that political risk is completely different from other types of risk, such as market risk. For example, managers who might be willing to take a risky bet on a position or product show a surprising aversion to accepting a certain level of political risk.

Historically, one reason has been that political risk is hard to quantify and, therefore, difficult to model. But this is quickly changing, as new technologies facilitate comprehensive real-time data gathering, processing and analysis.

Another explanation has to do with a dynamic similar to many people's fear of flying. In this case, irrespective of how much data exists to prove that the probability of suffering a fatal accident during a taxi ride to the airport is higher than during the actual flight, many people are more afraid of flying than taking a cab. Most people just know a lot more about driving a car than flying a plane and, thus, are more comfortable with the former. Similarly, managers are trained in market dynamics and, thus, are generally more comfortable with managing market risk than the world of politics. Furthermore, the potential consequences of political risk are often more dramatic and visible than instances of mismanaged market risk.

As a result, executives are turning to outside help. Hundreds of consulting companies exist to advise companies on their political risk exposure in particular markets, while others offer monitoring, analysis and early warning services. Using sophisticated risk modelling techniques and a continuous stream of near real-time information, these consultants advise companies on whether to enter or exit a particular country.

But exiting prematurely is often difficult and, in most cases, financially disastrous. Insurance companies, therefore, offer policies that protect against residual political risk. These policies reduce or eliminate exposure in cases of currency inconvertibility, breach of contract by host governments, expropriation, civil unrest or war.

Indeed, concerns about political risk have, in some cases, become serious obstacles to foreign direct investment and development. As a result, the World Bank has created its own political risk insurer, offering similar policies and coverage to those of private providers in order to foster the FDI in specific countries.

## ◆ September 11, 2001

Any doubts that political turmoil in seemingly remote places of the globe could directly impact the world of business were refuted by the terrorist attacks on September 11 2001. In New York, and subsequently in Bali, Istanbul and Sharm el-Sheikh, business installations were direct targets. In Madrid and London, terrorists struck the urban transportation infrastructure that is essential for the business system to function.

In turn, this has had a dramatic effect on the provision of insurance. Not surprisingly, premiums have skyrocketed as insurers recover their losses and pass on expected costs of possible future payouts. In New York alone, insurance premiums for large accounts increased by an average of 73 per cent in the year following the attacks.

At the same time, the number of companies that have not found desired insurance coverage has increased dramatically. In the case of airlines, governments stepped in immediately after September 11 as insurers cancelled existing policies overnight. While many reinsurers returned with policies that limited liability, the prospect of global terrorism lasting decades has led many once again to contemplate withdrawal from airline terrorism insurance because of the "incalculable risk".

GARY BATES

The situation in the insurance market highlights the extent to which the management of terrorism risk has become a business challenge. In a situation like this – with escalating premium and liability costs – smart business policy would obviously entail trying to reduce the underlying risk, not just paying to cover the fallout.

On a practical level, this seems at least partially feasible. The airlines have invested hundreds of millions of dollars in reinforced cockpit doors and other security measures. Meanwhile, thousands of other companies have invested in new security measures, from cameras to metal detectors and security guards all the way to secure ventilation and air conditioning systems. Yet total security does not exist and security consultants tend to protect against the previous attack. As much as they try to catch up, they remain one step behind.

## ◆ The role of business

If protection can only go so far to reduce the risk of terrorism, does business have a role to play in preventing terrorism from arising in the first place?

On a tactical level, active involvement of the business community is essential to dismantling the infrastructure that sustains global terrorism. The fight against money-laundering and the financing of terrorism, for example, must be waged by banks, brokerages and insurance companies. In other words, when it comes to terrorist finance, business stands on the front line.

New transparency requirements and security procedures obviously impose additional costs on financial companies. But all stakeholders should perceive such costs (provided they are reasonable and for policies that actually work) as what they are – investments to reduce the risk of terrorism, rather than no-return costs of regulatory compliance.

More intriguing are innovative business efforts to engage and empower local communities to boost security. At a recent conference on terrorism, the CEO of a leading global security company argued that community outreach and empowerment were often more effective ways of protecting critical infrastructure in unstable political environments than investments in sophisticated technology.

When locals have a stake in foreign installations, they are more likely to be vigilant, and this enables owners to manage security proactively. Perhaps most important, an attack on an installation in which a

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community has a stake is an attack on the community itself, thus depriving potential attackers of the legitimacy they desperately need.

A powerful example of this comes from Venezuela. Ron Santa Teresa, a rum producer, responded innovatively to a 2003 armed gang attack on one of its guards. Once the attackers had been apprehended, Santa Teresa's managers gave them the choice between completing a specially designed training programme and joining the company's workforce, or going to jail.

Following initial success, the ad-hoc programme has since been formalised, offering former gang members three-month intensive training that includes work, attitude management classes, psychological evaluation and team sports. Graduates can then join the company or sign up for another six- to 18-month programme of paid work and more classes that prepare participants for the general labour market.

The programme has lowered crime by 40 per cent and dismantled three gangs entirely. For Ron Santa Teresa, it has been a smart investment that has reduced risk and improved security more effectively than conventional measures.

The key lesson of the Ron Santa Teresa programme points towards a potential strategic role for business in the fight against terrorism: as important as the tactical fight against current terrorists is, that fight should not be waged at the expense of strategic efforts to change the environment in which terrorism flourishes. Business can make tremendous contributions in this respect.

Terrorism enjoys disproportionate support where people lack opportunities and feel that modernity and globalisation work against them. Prospects for community outreach, the provision of economic opportunities and empowerment certainly vary across companies, industries and countries, but it seems clear that no security measure can achieve what could be obtained through delegitimising terrorists by providing real opportunities for those they claim to represent. Business steeped in good governance and social responsibility is a far more powerful ambassador of liberal values than invading armies.

Managing complex political risk will continue to occupy executives, probably increasingly so. Specialised consultants and new tools help evaluate and manage such risk and insurance providers enable companies to hedge potential costs. But ultimately, smart business policy will seek to reduce underlying risk and eliminate some sources of risk altogether. This requires engagement, not withdrawal, and community outreach, not hiding behind walls.

Companies are beginning to realise that our planet's frail environment is a business opportunity and that proactive environmental management can boost competitiveness and welfare. If we can harness the power and innovative capacity of business to similarly engage political instability and the challenges posed by global terrorism, many of the problems that plague this new century could suddenly become a lot more manageable.

**Joel Baum** explains how failure may be a more valuable learning experience than success

# The value of a failing grade

Many have come to view the ability to create a "learning organisation" as a key source of sustainable advantage. However, taking advantage of the benefits of organisational learning is not so straightforward.

Typically, organisational learning efforts emphasise the lessons to be drawn from the success of a company or another high-profile business, with a focus on "best practice" and getting things right. Rarely does management endeavour to learn from failure.

While corporate leaders often participate in task forces to uncover the lessons of highly visible failures – for example, the Enron or Parmalat scandals – they rarely attend to problems at an early stage which, if addressed quickly, could help avoid such crises entirely.

In fact, failure can be a more valuable learning experience than success. A business that experiences only success will be unable to infer the causes responsible for it. In the absence of failure, the learning that follows success can be transformed from a source of further success into a source of failure – as Apple, Boeing, GM, IBM, Kodak, Motorola, Mattel, Polaroid, Quaker, Xerox and many others have shown.

## Why learning from success makes failure inevitable

When management ascribes good results to their own actions, they are inclined to repeat them – and resources are dedicated to refining those strategies at the expense of other activities. Over time, a core strategy emerges and administrative structures and processes are put in place to support it. These are common features of outstanding businesses. Paradoxically, however, these same features can turn into a liability if success persists.

Success not only narrows the focus of management, it also affects its attitudes. The admiration and power that success brings can give corporate leaders the impression that the strategies they developed and promoted are unassailable. The more successful the strategy, the more deeply ingrained it becomes in mutually reinforcing structures and processes, the more ineffectively it is implemented, and the more limited is management's capacity to evaluate its choices.

Consider IBM. Few companies have been as prominent in the computer industry, but strategic and organisational inertia left the business lagging behind in many of the technologies it pioneered. In the 1970s, relational database technology did not fit IBM's hardware-centric corporate vision, delaying its entry into the sector and allowing Oracle to become the leading database provider in the 1980s.

Similarly, in the PC market, IBM's hardware-centric view meant it misjudged the significance of software, leaving Microsoft to establish its Dos standard and, eventually, dominate the sector.

## Failing to learn from failure

While it seems obvious that business should learn from failure, successful companies are strikingly resistant to doing so. More often, evidence in support of management strategies is overvalued while evidence against it is undervalued. For example, preferred performance indicators may be altered, so that a failure is redefined as a success. Internal scapegoats or outside forces are blamed, relieving management of the need to question their assumptions. Thus, early failures may be interpreted as proof that management's strategies and activities were poorly executed, rather than recognising that the policies are potentially flawed.

Under threat, management becomes hyper-resistant to change. To protect their reputations and positions, they openly champion what they view to be the company's most essential activities in an effort to deny failure and to reaffirm their own strategic priorities. Quality leaders become quality fanatics, acquirers become hyperacquisitive and innovators become hyperinnovative.

Indeed, some of the most innovative companies have also yielded some of the most notable business failures. For example, Apple opened the PC market and introduced many features that PC users now take for granted, including the graphic user interface, the mouse, laser printers and colour monitors. But its founders' obsession with crafting the perfect PC led them to do everything in-house, regardless of cost, and opt for an easier-to-control closed operating system on early Macintosh computers. This opened the way for the "Wintel" PC, for which anyone could obtain the licenses and components to build. Now, Apple represents less than 4 per cent of the PC market.

Today, Apple could be making the same mistake in digital music with the iPod. Once again, the design and software are impeccable, but the system is closed: only music downloaded through the iTunes software (and open-source MP3 files) plays on iPods. How long until digital music products from other companies are good enough to eat into Apple's pie?

Simply put, a run of success can be dangerous. Outstanding companies often succumb to crises because their leaders were innovative years ago but continue to favour strategies and activities based on past success, which do not always translate well after changes in the business and consumer environment.

## Learning to succeed from failure

Learning from failure is one way that management can avoid the crises that are often the downfall of a business. There are no simple prescriptions to ensure the lessons of failure are learned, but the following ideas may help companies overcome their resistance and avoid losing their edge.

**■ Focus on small and moderate failures**
Management reacts differently to failures that require incremental modifications to strategy than to issues that call for a major strategic reorganisation. Small and moderate failures draw attention to potential problems, stimulate the search for possible solutions and motivate improvement.

It is important that problems that seem insignificant or minor be studied. While such failures are often met with scepticism or dismissed as one-time events, ignoring small failures – particularly early on – makes it difficult to deduce the basis of success.

**■ Risk failure deliberately**
Failures must not be viewed as anomalies but as inevitable. Learning from failure can be facilitated by planning modest-scale trials of strategies and actions to gain diagnostic feedback quickly, so that what happens can be discussed, analysed and put into practice.

Limiting the costs of failure so that people will be willing to experience and learn from them is crucial. By basing pay rises, bonuses and promotions on success, management can explicitly or implicitly discourage this kind of experimentation and analysis. Instead, incentives and policies to fund experiments and encourage analysis and discussion of the results should be implemented.

Of course, management keen on maintaining their core strategies can choose experiments that do not challenge or are likely to sustain them. But the value of experimentation depends on a willingness to deviate temporarily from favoured strategies to check their validity.

**■ Falsify rather than justify**
Management often disregards evidence that is inconsistent with its choices. This reliance on positive justification tends to prevent managers from rigorously evaluating the validity of their strategies. Such justifications are incompatible with efforts to learn from failure.

Management must be willing to design tests of its strategies and actions aimed at disproving or falsifying rather than confirming them. This requires that they are willing to alter or replace their strategies based on available evidence.

**■ Benchmark "worst practices"**
Typically, benchmarking is used to compare one company's performance and practices with those of other high-performing businesses to find ways to refine current practices and improve performance. But if only successful companies are scrutinised, it is impossible to determine whether or not "best practices" are indeed best.

More relevant are the differences between thriving and failing businesses. It is often surprising how similar the "best" and "worst" performers are – they may differ only by a small degree. Benchmarking "worst practices" is also advantageous because people find it easier to learn from the failures of others.

Given the tendency of management to take credit for success and to dismiss failure as the result of people or events beyond their control, management may be more objective regarding the failures of external players. Thus, they may usefully attend to them for clues about the causes of their own problems and to learn what not to do.

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