



Risk Management Reports

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Rules versus Principles

Should our business and personal lives be controlled by general principles of behavior or by specific rules and laws that address most areas of activity? While most of us will opt for the former, we live in a world constrained by the latter. Most religions began with simple statements of ethical behavior but, over the centuries, theocratic and self-appointed interpreters enveloped these ideas in reams of rules, rituals and regulations. Libertarians in many countries rail against the regulatory minutiae that, they argue, corrupt our freedoms, while contrarians point out the inherent fallibility of the human species, preferring numerous laws that control almost every aspect of our lives. I believe that the answer is that delicate balance between the two extremes.

In the United States, an accounting system built on specific rules for every transaction led, in part, to the recent financial scandals and the dissolution of trust in reported financial figures. These events were the catalysts for the current international effort to develop global “generally accepted accounting” *principles*, instead of multitudinous and detailed rules, in an attempt to avoid future problems like those experienced in the US. Simplicity over complexity and principles over rules are the new mantras.

Yet we move in the wrong direction almost every day. While lecturing in Canada in May, I read about another example of trying to right presumed wrongs by over-controlling organizational and individual behavior. The Province of Quebec has enacted a new law that took effect on June 1, 2004, one that purports to prevent “hostile behavior and intimidation” in the workplace. This amendment to Quebec’s Labour Standards Act, (*Le harcèlement psychologique au travail*) prohibits “psychological harassment”, defined as “any vexatious behaviour in the form of repeated and hostile or unwanted conduct, verbal

comments, actions or gestures that affect an employee's dignity or psychological or physical integrity and that results in a harmful work environment for the employee.”

The law says that this activity can come from a manager, fellow-employee, customer or supplier. It can manifest itself “in the form of conduct, verbal comments, actions or gestures characterized by the following criteria: they are repetitive; they are hostile and unwanted; they affect the person's dignity or psychological integrity; and they result in a harmful work environment. It includes humiliating or abusive behaviour that lowers a person's self-esteem or causes his torment.”

I support the idea of eliminating reprehensible behavior. In my career I've experienced it several times. But is it so pervasive that we need another law to prohibit it, supported by a fine of C\$10,000 and the threat of damages paid to the victim? And, despite the length of this law, aren't its phrases so vague as to be easily misinterpreted? What is “self-esteem”? What is “psychological integrity”? What is “vexatious behaviour”? Here's a field-day for plaintiffs' lawyers.

Of course, the counter-argument is that real (and imagined) slights have occurred, and will continue to occur. Should we try and alter behavior with new laws and their resulting litigation, or with publicity and transparency? I know of three other countries that have similar legislation or regulations: Sweden (1994), France (2002) and Belgium (2002). A bill is also pending to extend this mandate to all of Canada.

I queried one European risk manager who reported that his firm had already addressed these problems: “As a truly multinational and multicultural company, we pay attention to all kinds of social mores, behavioral codes and employment regulations in different countries around the world.” To me, this is the best response: increasing stakeholder (employee, customer and supplier) awareness of potential problems through clear and explicit policies, supported by an effective complaint procedure and internal enforcement. Yes, harassment is a continuing problem, but, no, I don't think it requires legislation, as Quebec has done, to improve the situation. Let principles, not rules, prevail. (For more detail on this new Quebec law, go to www.cnt.gouv.qc.ca.)

As a last resort, as I suggested to my European correspondent, we could return to the solution of past years: if your “honor” is impugned, simply call out the offender to the dueling fields! It's cleaner, neater and involves no extravagant legal fees!

We have to reject the egotistical human notion that we can, or should, discover and explain everything.

Robertson Davies, *A Merry Heart*, McClelland & Stewart, Toronto 1996

“Stakeholders” and “Opportunities”

In the first six months of this year I’ve listened to numerous speeches and ploughed through many articles on our discipline. I regret to say that most continue to focus on the wrong targets. A large majority still argue that enhancing “shareholder value” is the proper goal for risk management and that risk is only bad, an unexpected downside outcome. I am hoarse trying to correct these grievous misimpressions. Our goal is to build *stakeholder confidence*. Risk combines both *favorable and unfavorable results*. Perhaps I’m on a quixotic quest, tilting at entrenched academic and economic windmills, but, occasionally, I hear a wiser voice than mine, reviving my confidence in my mission.

This time it’s Peter Drucker, the sage of management gurus. In a concise and enlightening article in the June 2004 issue of *Harvard Business Review*, he defines eight practices that make an “effective executive.” What is important to those of us who practice risk management is his acknowledgement of the proper focal points for our discipline.

For his second precept, Drucker suggests that effective executives do “what is right for the enterprise.” This does not mean asking if a course of action is “right for the owners, the stock price, the employees, or the executives.” These are important constituencies, “but they (executives) also know that a decision that isn’t right for the enterprise will not be right for any of the *stakeholders* (my italics).” There’s that lovely word. It acknowledges that a broader, more strategic view is required. Risk managers, take note!

For his sixth precept, Drucker suggests that effective executives “focus on opportunities, rather than problems.” “Problem solving,” he states, “does not produce results. It prevents damage. Exploiting opportunities produces results.” He continues, “effective executives treat change as an opportunity rather than a threat” and that “problems do not overwhelm opportunities.” If risk management practitioners focus solely on the negative results of unexpected events, they cripple their abilities to respond opportunistically to change. Drucker cites seven examples of opportunities lying in wait for those ready to grasp them:

- An unexpected success or failure in their own enterprise, in a competing enterprise, or in the industry;
- A gap between what is and what could be in a market, process, product, or service;
- Innovation in a process, product, or service, whether inside or outside the enterprise or its industry;
- Changes in industry structure and market structure;
- Demographics;
- Changes in mind-set, values, perception, mood, or meaning; and
- New knowledge or a new technology.

So Peter Drucker, a more persuasive and eloquent voice than mine, confirms two tenets of risk management beliefs: the focus must on stakeholders, and risks combine both opportunities and harms.

The other six of his precepts are equally important. Effective executives:

- Ask, “What needs to be done?”
- Develop action plans;
- Take responsibility for decisions;
- Take responsibility for communicating;
- Run productive meetings; and
- Think and say “we” rather than “I.”

For information on this article, go to www.harvardbusinessonline.org.

(Americans have) the habit of thinking in terms of comparison, of perpetual competition; either a thing must be the biggest and the best in the world, or you must blush for it. But only ways and means are good comparatively and on a single scale of values. Anything good intrinsically, anything loved for its own sake, is its own standard, and sufficient as it is. The habit of always comparing it with something else is impertinent and shallow. It betrays a mind that possesses nothing, loves nothing, and is nothing.

Georges Santayana, “Marginal Notes on Civilization in America,” *The Dial*, 1922 (as quoted in *The Wilson Quarterly*, Summer 2001)

Summer Reading

The warm and slothful days are upon us, and what better way to respond than to take several hours to expand our minds with new ideas and challenging perceptions. At the top of this year's list of summer reading is an engineer's approach to tackling the problems of uncertainty. It isn't conventional beach reading but it is worth the effort. It came to me through Mike Murphy, who heads the eclectic Informal Risk Management Association in Toronto, a global group of kindred risk management spirits. The book is Billy Vaughn Koen's *Discussion of the Method* (Oxford University Press, Oxford 2003), a profound agglomeration of philosophy, mathematics, Eastern mysticism and very practical engineering. As he explains, "engineering is a risk-taking activity." Mike wrote his own review for Amazon.com and here is his conclusion:

"This book came recommended to me by a colleague who is a professional engineer. It wasn't the cheapest offering from Amazon, and when I took it out of the shipping box, frankly, I was a little disappointed - seeing a slim, paperbound volume, I thought it might be a thin and expensive read on a penny-per-page basis.

Well, was I ever wrong! As I started turning the pages during a first skim read, it struck me that Koen has brought together a huge amount of experience on engineering with a deep understanding of philosophy (to his credit, both Western and Eastern) plus a range of subjects from classical literature and world religion to the vicissitudes of world languages, and forged them into a brilliant synthesis of remarkable clarity and originality.

His central thesis is 'All is heuristic' (All is rule of thumb). He has surrounded this argument with a phalanx of other heuristics (59 in total) that range from the practical ('at some point in the project, freeze the design') to the metaphysical ('sincerity of belief and the inability to disbelieve are poor justifications for claiming that a belief is true') to the paradoxical ('if a concept produces paradoxes, unexplained complexities or unexpected departures from expected results, better consider it a heuristic').

In writing this book, Koen has both mastered and melded a number of seemingly immiscible disciplines - philosophy, linguistics, theology - with his own professional field of engineering (he is professor of Mechanical Engineering at University of Texas at Austin and a fellow of the American Nuclear Society). It is reminiscent of the way that Thomas Aquinas reconciled Christianity with Philosophy.

This is no mean feat, and Koen's book, unpretentiously entitled 'a discussion', is an intellectual tour of the first order. Of course, his many references mean so much more if you are familiar with them. If you aren't, be sure to try them - your life will be immeasurably enriched. In any event, Koen illuminates a path to greater understanding. His prose is very engaging and the book is well suited for general audiences. It is a book that begs to be read and re-read.

One can only wonder if Koen's book had been available prior to its 2003 publication date, would we have experienced such (fortunately infrequent) disasters as Challenger and Columbia, as the Ford Explorer, Chevy Corvair, Ford Pinto, Bhopal, etc. A little more humility with the inherent uncertainties of engineering life might have made a positive difference. This book strives hard - and I believe succeeds - at doing just that. Bravo, Professor Koen, for shedding new light on old problems. It comes as no surprise that Koen has won high awards for teaching excellence (W. Leighton Collins and Centennial Medallion) - both from the American Society of Engineering Education.”

To the above I add my own acclaim. This is *not* light reading but the rewards for persistence will be significant for those who are truly interested in new ideas for dealing with uncertainty. Koen’s argument is that we “solve problems by successive approximations,” not through fixed rules. Early in this book he suggests several “risk-controlling heuristics” that include “make small changes in your state-of-the art,” “always give yourself a chance to retreat,” and “use feedback to stabilize the design project.” The latter comment applies to general projects as well as engineering.

He summarizes his ideas with the statement that “a specialist’s knowledge is necessary to understand the method of each (discipline), but a generalist’s knowledge of them all is necessary to achieve a synthesis.” It’s a bit like Isaiah Berlin’s use of the Russian adage about the fox and the hedgehog. This is what leads him to a conclusion that “all is heuristic.” “All we require is that errors are possible, that all concepts are potentially fallible” This is a book to be read and reread.

My second summer suggestion is Peter Schwartz’s *Inevitable Surprises: Thinking Ahead in a Time of Turbulence* (Gotham Books, New York 2003). His first book, *The Art of the Long View*, has been a staple on my “ten best risk management book list” since 1991, so it was natural to pick up this new volume. He reviews major world issues including global warming, an aging population, increasing population where we don’t need it, spreading pandemics, revolutions and even the threat of an asteroid hitting the earth. The title is a deliberate oxymoron, a challenge to “contingent thinking,” exactly what risk managers should be doing at the strategic level. Schwartz’s thesis is that we will face more surprises, but that we will be able to deal with and *anticipate* many of them. A long-time advocate of scenario analysis as a risk assessment tool, Schwartz argues that denial and defensiveness in the face of surprise will condemn us to oblivion. The alternatives are rational assessment and resilience. He also argues that the “most powerful weapon” that can be employed by any government or organization is trust. Always a contrarian, Schwartz addresses the current problem of terrorism with the advice: “the best answer to terrorism is to ignore it!” This argument is well worth the entire price of this book!

Yet his summary recommendations are optimistic:

- Build and maintain your sensory and intelligence systems.
- Cultivate a sense of timing.
- Identify in advance the kinds of “early-warning indicators” that would signal that a change is rapidly upon you.
- Put in place mechanisms to engender creative destruction.
- Try and avoid denial.
- Think like a commodity company.
- Be aware of the competence of your judgment . . . and move deliberately and humbly into new situations that stretch your judgment.
- Place a very, very high premium on learning.
- Place a very high premium on environmental and ecological sustainability.
- Place a very high premium on financial infrastructure and support.

These two books will keep you awake and thinking this summer. Now I add three more technical documents to consider:

1. *Risk-based Reporting: Delivering Results in a New World of Reporting*, Karen Schoening-Thiessen, Conference Board of Canada, 2004. A useful and thoughtful monograph on internal risk reporting. Website: www.conferenceboard.ca
2. *Risk Management Assessment Framework*, Hugh Pullinger, H.M. Treasury, London, 2004. A practical tool for operating managers to use in a self-assessment of their relative efficiency in risk management. Website: www.strategy.gov.uk
3. *20 Questions Directors Should Ask About Risk*, Hugh Lindsay, Canadian Institute of Chartered Accountants, Toronto, 2004. A 12-page booklet designed for the standard attention span of corporate directors. It describes enterprise risk management succinctly and follows with twenty challenging questions, each with several “recommended practices.” Read it and send copies to your Board members! Website: www.cica.ca

Once you’ve finished these five pieces of reading material, you may cavort on the beach, hike in the mountains, sail the seas, or otherwise indulge in recreation!

. . . La bêtise c’est de vouloir conclure. The conventional ending, with virtue rewarded and loose ends tied up is often sadly chilling; and its platitude and falsity tend to infect what has gone before, however excellent. Many books would be far better without their last chapter: or at least with no more than a brief, cool, unemotional statement of the outcome.

Patrick O’Brian, *The Nutmeg of Consolation*, W. W. Norton & Co., New York 1991

Books I Haven't Read!

One of my editorial perquisites is the willingness of publishers to send me examples of their recent risk management output. While I try and do justice to these volumes, I find one type difficult to finish. It is the lengthy anthology that defeats my best intentions. These monster volumes, often 500+ pages and weighing two to three pounds, are the work of an editor, perhaps someone whose name we recognize, who pulls together articles and chapters intended to describe, in full glory, the complete range of a particular discipline. Too often they descend to a chaotic *mélange* of jargon, without connection or real thought. Many chapters are reprints of earlier published materials. I confess that I have submitted such pieces when asked to contribute to anthologies, undertaking a minimum amount of work and creative thinking.

So it was with apprehension that I addressed two recent submissions. No, I did not read them in full, although I did browse through several articles whose description or authors aroused my interest. I report on each for record purposes so that these publishers will continue to send me materials, from which I can select those infrequent nuggets worth referral.

Risk Analysis and Society (Cambridge University Press, Cambridge 2004), edited by Timothy McDaniels and Mitchell Small, is subtitled “an interdisciplinary characterization of the field.” This is a misnomer: it covers only the public policy sector of risk management: nothing appears about the financial, insurance, security or contingency planning disciplines. The language is often tortuous and the approach heavily academic: one 55-page chapter (there are 12 in all) has a mind-numbing 22 pages of footnotes and references at its end! The authors are in love with their limited and negative view of risk: “risks involve the possibility of damage or loss or injury to individuals and to groups” (Robin Gregory, “Valuing Risk Management Choices”). Yet this book has some value as an overview of ideas from the Society for Risk Analysis. The papers address the “fundamental character of risk” (too narrowly, in my estimation), recent advances in methods for risk assessment and analysis, and approaches and needs for risk management. In their concluding chapter, Rae Zimmerman and Robin Cantor, both past Presidents of the SRA, suggest we “need common frameworks” for risk management. I agree, but these authors must begin to acknowledge the contributions coming from such organizations as IIA, GARP, PRMIA, RIMS and others in the financial world.

Modern Risk Management: A History (Risk Books, London 2003) is edited by Peter Field. It is an even more leaden tome, with 55 chapters and 46 separate authors, almost all from the financial and economic sector of risk management, highly quantitative, as might be expected from this group. It scarcely acknowledges the public policy sector described in the previous book. Another reviewer called it “dense, both physically and

informationally” with “no cohesion at all among the chapters.” As a reference volume to gather dust in a bookcase, it may have some value. I could not find any other.

... if one searches for a statistical correlation between any two random quantities in a population, one will find some statistically significant association.

John Allen Paulos, *Once Upon a Number*, Basic Books, New York 1998

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Editor and Publisher: H. Felix Kloman
Copy Editor: Ann B. Kloman
Graphic Designer: Sarah P. K. Smith
Website Manager: RiskInfo, Larkspur, California, USA
61 Ely's Ferry Road
Lyme, CT 06371-3408 USA
Telephone: 860-434-2917
Telefax: 860-434-3917
Website: www.riskreports.com
Email: fkloman@aol.com