



About this research

Risk 2018: Planning for an unpredictable decade is an Economist Intelligence Unit report that explores the potential risk environment and the changing roles and responsibilities of the risk management function over the coming decade. The report is sponsored by BT. Rob Mitchell was the author of the report.

The Economist Intelligence Unit bears sole responsibility for the content of this report. The Economist Intelligence Unit's editorial team executed the online survey, conducted the interviews and wrote the report. The findings and views expressed in this report do not necessarily reflect the views of the sponsor.

Our research for this report drew on two main initiatives:

- We conducted a survey of 600 senior executives from around the world. Three-quarters of respondents were C-level, or board-level, and the sample included more than 200 chief executive officers. The survey included companies of a variety of sizes, and from a wide range of industries.
- To supplement the survey results, the Economist Intelligence Unit also conducted a programme of qualitative research, comprising a series of in-depth interviews with risk consultants, futurists and strategic planning advisers.

We would like to thank the many people who helped with this research.



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Introduction

An executive sitting in his office in 1998, trying to imagine what the next ten years might hold, would have had to demonstrate extraordinary prescience to be able to pinpoint the key events of the following decade. From the dotcom boom and bust to the extraordinary rise of China, the past decade has been an extremely eventful one, from both a political and business perspective.

Ten years later, in 2008, the world is more uncertain and unpredictable than ever. A financial crisis arising from poor lending standards in the US retail housing market has spread to the credit markets, causing billions of dollars in writedowns and the forced resignations of the chief executives of Citigroup and Merrill Lynch. An unquantifiable threat from climate change lurks around the corner, and there are rising concerns about energy security and geopolitical instability. If the same executive were to return to his office to ponder the future in 2008, what conclusions might he draw about the next ten years and how accurate would these assumptions be?

The aim of this report is to consider what the next ten years might hold by drawing on the viewpoints of many hundreds of senior professionals. It is based on a survey of more than 600 senior executives from around the world, 75% of whom were board-level or C-level executives. Respondents were questioned about how severe and impactful they expected a wide range of risks to be over the next decade, and how prepared they thought their organisation would be to meet these challenges. Additional questions looked at how respondents expected the risk management function to change over the same period. Key findings from this research include the following:

There is a high level of optimism despite current financial turbulence. Asked about how they perceived their prospects over the next ten years, respondents were extremely upbeat. More than one-half were very confident about the future prospects for their industry, company and the region in which they were based. Less than 10% said they were not confident about the future for the global economy, their industry and their company.

Optimism about the future is tempered by a perception that risks will increase. Despite their bullish view of the future, more than half of respondents agree that the risks that their company will face in ten years' time will be more severe. Respondents to the survey were asked about the severity and likelihood of 46 risk categories over the next decade, along with their levels of preparedness for these risks. The detailed results can be seen in our Long-range Risk Grid on pages 4-5. The survey identified 12 risks as being the most threatening over the next decade owing to their high severity and likelihood, coupled with the relatively low levels of preparedness that companies have in place to deal with them. The 12 risks identified as "Tier One" risks are the following:

- Retrenchment of globalisation/increase in protectionism
- Oil price shock
- Asset price collapse
- Emergence of disruptive business model
- International terrorism
- Unexpected regulatory change
- Global recession
- Instability in the Middle East
- Increased competition from emerging market companies
- Talent shortages
- Climate change
- Increased industrial pollution



Emerging markets are expected to lead the way.

Respondents expect current strong growth in emerging markets to be sustained over the next ten years. Asked to name the countries or regions from where they expected their biggest increase in revenue contribution to come, China was the leading answer by some margin, followed by Europe (including Eastern Europe) and Asia-Pacific (excluding India and China). The mature markets of the US and Australia lagged some way behind.

Risk management will become a more strategic activity. The trend for risk management to be considered a strategic activity is expected to continue in the next decade. Two-thirds of respondents said that they thought risk management would become

more important as a strategic tool, and 58% expected more boardroom attention to be devoted to the function and discipline.

Scenario planning is a widely used tool to consider the future. As companies look to an uncertain and unpredictable future, more and more are using techniques such as scenario planning to help them map out the road ahead. Among our survey respondents, 26% say that they use scenario planning on a regular basis and 40% say that they use it on an ad hoc basis. Out of the remainder, 29% say that they have plans to use the technique in the future. Just under half of those surveyed who currently use scenario planning (42%) say that they apply the lessons they learn from the process to their strategic planning.



The long-range risk grid

About the long-range risk grid

The Economist Intelligence Unit long-range risk grid is a visual representation of the results from a survey of 600 senior executives from around the world. We questioned respondents about their perception of the severity and likelihood of 46 key risks, and then asked them how prepared they believed their organisation is for tackling these risks over the coming decade. The findings are represented on a chart, with

severity and likelihood on the horizontal axis, and preparedness on the vertical axis.

A diagonal line divides the grid into two halves. The risks that appear above and to the right of the diagonal line are those where levels of preparedness lag levels of perceived severity and impact in comparison with other risks. Most of the risks that appear in this half have been selected as Tier One risks—those that, according to our survey, need most attention owing to the perceived gap

between preparedness and severity/likelihood. Several of those above the diagonal line (and all of those below the line) have been designated Tier Two risks. In the case of those Tier Two risks above the line, this is due to either the low perceived severity and impact of the risk, or very high levels of preparedness. In the case of those below the line, these may still be serious risks, but our survey indicates that levels of preparedness are keeping pace with their perceived severity and impact.

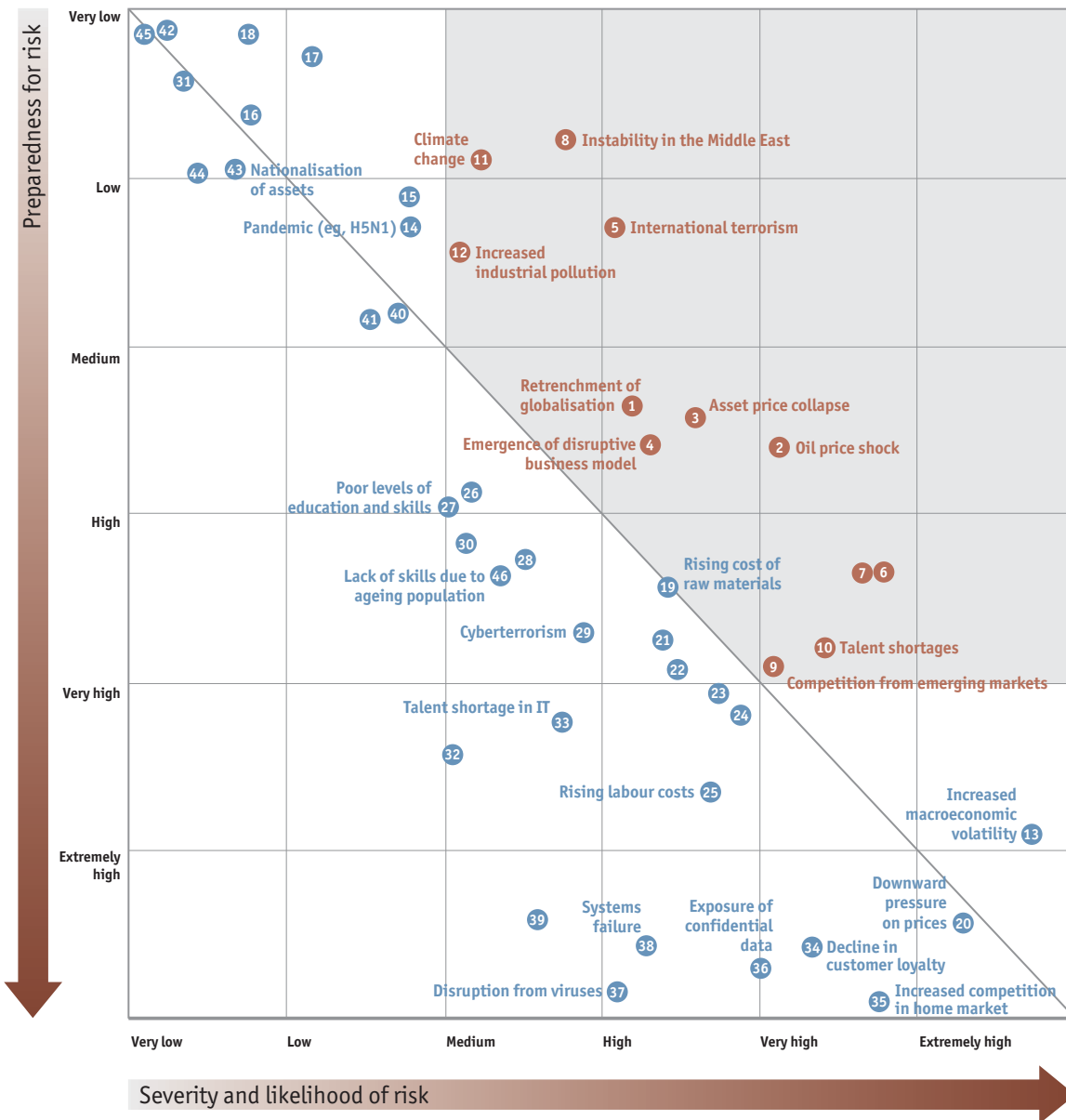
Tier One Risks

- 1 Retrenchment of globalisation/increase in protectionism
- 2 Oil price shock
- 3 Asset price collapse
- 4 Emergence of disruptive business model
- 5 International terrorism
- 6 Unexpected regulatory change
- 7 Global recession
- 8 Instability in the Middle East
- 9 Increased competition from emerging market companies
- 10 Talent shortages
- 11 Climate change
- 12 Increased industrial pollution

Tier Two Risks

- 13 Increased macroeconomic volatility
- 14 Pandemic (eg, H5N1)
- 15 Rise in anti-globalisation sentiment
- 16 Flooding in populated area
- 17 Drought/Lack of freshwater services
- 18 Dramatic increase in communicable diseases (eg, AIDS, malaria, tuberculosis)
- 19 Rising cost of raw materials
- 20 Downward pressure on prices
- 21 Failure to honour contracts
- 22 Recession in country in which you are based
- 23 Significant increase in interest rates
- 24 Disruptive technology forces change in business model
- 25 Rising labour costs
- 26 Decline in recognition of intellectual property rights
- 27 Poor levels of education and skills
- 28 Bribery and corruption
- 29 Cyberterrorism
- 30 Difficulty affording pension obligations
- 31 Dramatic increase in chronic diseases (eg, cancer, heart disease, diabetes)
- 32 Power outage
- 33 Talent/skills shortages in IT
- 34 Decline in customer loyalty
- 35 Increased competition in home market
- 36 Exposure of confidential data
- 37 Disruption to business from viruses, spyware and malware
- 38 Systems failure/downtime of essential IT services
- 39 Decline in customer base
- 40 Fiscal crisis caused by demographic change
- 41 Rise in environmental protests
- 42 Major hurricane
- 43 Nationalisation of assets (eg, in South America/Russia)
- 44 Trade embargo
- 45 Earthquake
- 46 Lack of skills due to ageing population

Source:
Economist Intelligence Unit survey, 2008.





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Examining the risk environment

Economic risks

A significant proportion of the Tier One risks identified in the survey are economic, such as the potential for an oil price shock ², asset price collapse ³ and the threat of global recession ⁷. Respondents in North America are most jittery about the potential for a recession in their home market, which reflects the impact of current turmoil in the housing market and lingering issues in the financial markets that are currently being felt most acutely there. The EIU's forecast is that the US will grow by only 0.8% in 2008, compared with 1.7% for the Euro area and 9.5% for China. It assumes that the US will fall into recession in the first and second quarters of the year and that growth will be subdued in the third quarter.

Despite the perceived severity and likelihood of an increase in macroeconomic volatility ¹³, respondents report relatively higher levels of preparedness to deal with this issue than with other economic risks. Although volatility is certainly still a concern, as is currently being seen with the credit crisis, the trend in recent years has been for economic crises to be weathered more smoothly. For example, overall economic growth in developed countries was not severely affected by shocks such as the Asian currency crisis of 1997 or the Russian debt crisis of 1998. The ability of the economy to withstand these crises has in no small part been attributable to developments in risk management.

Respondents appear less prepared, however, to manage risks associated with oil price shocks ². With the price of oil having breached \$100 a barrel, and concerns regularly raised about the possibility of declining supply in a world of spiralling demand, energy security has become a vital issue for business, and one that is now going beyond the realm of being

manageable using hedging techniques.

The potential for an oil price spike is seen as a particular concern among respondents in Asia-Pacific. The rapid economic development currently underway in this region is dependent on the supply of fossil fuels, and the region arguably has more to lose than more developed markets from a sudden spike in the oil price.

Concerns about the cost of oil are closely linked to instability in the Middle East ⁸, which also registers as a Tier One risk. The dependence of the world on oil supplies from a region that suffers in some countries from serious instability, and the threat that this could worsen should the situation between the US and Iran deteriorate, is clearly on the minds of our respondents.

Although seen as less of a concern than the threat of an oil price shock, the rising cost of raw materials ¹⁹ is nevertheless a worry among respondents. Again, it is respondents in Asia-Pacific who seem most concerned by this trend.

Rapid development in Asia, the Middle East and elsewhere is pushing up the prices of metals and other materials. Base metal prices alone are estimated to have risen by 13% in 2007, according to the EIU. Soft commodities, such as food and beverages, have seen even bigger increases, with the EIU's index for food, feedstuffs and beverages estimated to have risen by 20% in 2007. This surge is being driven by a number of factors, including droughts in key production areas, reduced crop acreage and a shift in land use to biofuels. If this trend for rising commodity prices continues, the impact could be higher inflation and a dampening of consumer confidence at the precise time when growth is slowing and financial markets are at their most vulnerable.



Matthew Hulbert, global issues analyst at Control Risks Group, a risk consultancy, points out that there is a strong political undercurrent to the scarcity of any commodity. “Where most of this goes wrong is the political decisions that drive the scarcity and instability rather than the physical availability,” he says. “With so many of these risks, the political element is the backdrop but it tends to get lost in the debate.”

Competitive risks

A general point to note about the findings is that the most severe risks, and those for which respondents are best prepared, tend to be those associated with the competitive space. For example, respondents recognise that risks such as downward pressure on prices ²⁰, a decline in customer loyalty ³⁴, and increased competition in the home market ³⁵ are among the most severe that they face, but they also have a very high degree of confidence that they are well-prepared to deal with them.

For Mr Kelly of Global Business Network, this reflects the huge progress that has been made over the past few decades in understanding the competitive space. “The business world in general has become very accomplished at operating within the transactional or market space but unfortunately this is no longer enough to guarantee success,” he says.

Not all competitive risks are under control, however. The survey indicates that respondents feel that they lack preparedness for dealing with the possible threat from a disruptive business model ⁴, which is a Tier One risk. In his book *The Innovator’s Dilemma*, the Harvard Business School professor Clayton Christensen summarises this problem by describing how large companies have problems embracing disruptive technologies or business models. When they first emerge, disruptive technologies are likely to result in worse performance, at least in the short term, so the organisation tends to overlook them in favour of “sustaining technologies”—those that provide

incremental improvements in performance and with which the business is familiar. By the time disruptive technologies provide the performance the large organisation needs, it is by then too late and the company will have been overtaken by smaller, nimbler rivals that adopted these technologies from the outset.

A second Tier One risk in the competitive space is increased competition from emerging market companies ⁹. As leading companies in China, India and elsewhere flex their muscles and become more ambitious in their global ambitions, as evidenced by recent cross-border acquisitions such as that made by Tata for Corus Steel, it is clear that the global competitive environment is becoming more intense.

Technology risks

Respondents generally exhibit very high levels of preparedness to deal with technology risks, such as disruption to the business from viruses ³⁷, the exposure of confidential data ³⁶ and systems failure ³⁸. The huge vulnerability of businesses should they experience problems with their technology infrastructure has encouraged a strong focus on risk management in these areas, although the severe nature of these risks means that continued vigilance is essential.

Cyberterrorism ²⁹ is the technology risk with which respondents feel least comfortable, although respondents in North America appear better prepared than those in Asia-Pacific or Europe. Mr Hulbert points out that there is a growing trend for state-based actors to launch attacks of this nature that are largely based around political disputes. “It is not a new phenomenon but companies are increasingly being caught in the crossfire,” he says.



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Environmental risks

Environmental risks generally come fairly low on the priority list for respondents. Despite the huge amount of attention devoted to climate change ¹¹ among the media, pressure groups and, increasingly, governments, the issue is not seen as one that is especially severe or likely to cause an impact over the next ten years. Respondents also exhibit relatively low levels of preparedness to deal with climate change, which is the reason for its inclusion as a Tier One risk.

“Climate change is an issue that organisations have an eye on but I’m not sure they’re taking many concrete steps to deal with it,” says Mr Maxwell. One reason why climate change, and other “megatrends” such as demographic change, may not top the risk priority list is that they are issues that are inherently long-term with impacts measured in decades rather than years. This is at odds with the focus of many companies, which tends to be on shorter-term performance. “Companies, especially listed companies, are constrained from looking too far into the future because of their quarterly reporting requirement,” says Mr Maxwell. This problem is compounded by the short tenure of most CEOs, which tends to average at around five years.

A further obstacle to considering longer-term trends such as climate change is uncertainty around future government responses to them. “It is very difficult for companies to do anything effective about many longer-term risks,” says Mr Hulbert. “Without the right government policy steers, for example, it becomes quite likely that they will back the wrong horse.”

An additional problem that may prevent attention being given to climate change is that it is difficult for executives to see a tangible benefit from any action that they take. “Spending towards prevention is a very tough organisational sell,” says Mr Hines. “It’s human nature for executives to favour issues where they can quickly and easily see the benefits.”

The threat from industrial pollution ¹² is another environmental risk that has Tier One status. Levels of preparedness to meet the challenge over the next decade seem fairly low among respondents, although they are higher in Asia-Pacific than elsewhere. Asian respondents also believe that this risk will be more severe and impactful over the next decade than their peers elsewhere. This is likely to reflect concern about increasing environmental degradation in China and other rapidly developing countries in the region.

The possibility of a bird flu pandemic ¹⁴ has been an issue that has troubled public health officials for several years, but again, it is a surprisingly low priority for respondents. Although the impact of an H5N1 pandemic would dwarf the threat posed by terrorism should it mutate into a form that is easily transmittable among the human population, it receives considerably less attention in our survey in terms of perceived severity and likelihood.

“There’s a huge lack of preparedness for pandemics,” says Mr Hulbert. “As far as we can see, it’s definitely dropped off the radar. This is possibly because of fatigue given that we’ve been told about this threat for several years, but it could also be a cost issue. Our perception is that not many companies, or indeed governments, see the value in investing in vaccines, when there is still a major question mark over how effective any vaccination programme would be.”

Several interviewees questioned for this report express surprise that hydrological risks, such as flooding and water shortages, do not figure more prominently. “Industry is by far the biggest user of water, so it’s surprising it’s not on the radar,” says Mr Hulbert.

He adds that this is a risk that is closely interlinked with demographic change and urbanisation. “Companies don’t necessarily see the impact that larger populations will have on issues like water security and energy security,” he says. “When they look at demographic change, they tend to focus on where their next burgeoning markets might be.”



Human capital risks

Demographic change is also having a profound impact on the availability and location of human resources. Ageing populations in many developed countries are shifting old-age dependency ratios and reducing the availability of young workers to enter the workforce. Meanwhile, in emerging markets, levels of skills and education are rising, but so too are labour costs. This upward pressure on salaries is causing high attrition rates, with employees quick to jump ship in search of higher pay.

These problems have placed talent shortages ¹⁰ high on the corporate agenda and they are included in our grid as a Tier One risk. Concerns about talent do not appear to be based around poor levels of education and skills ²⁷—that particular risk is given a relatively low score for severity and impact. Risks associated with ageing populations ⁴⁶ are also not seen as especially severe, perhaps reflecting a perception that greater longevity also presents an opportunity in terms of being able to recruit a more experienced workforce, in addition to a growing pensions burden.

Respondents in Asia-Pacific appear to be particularly affected by human capital risks. Compared with their peers in Europe and North America, they perceive talent shortages, lack of skills due to ageing populations, talent and skills shortages in IT ³³ and rising labour costs ²⁵ to be more severe and impactful. This is likely to be attributable to a combination of factors, including rapid economic growth in the region that is outpacing levels of education, rising salaries and the emigration of skilled workers.

Globalisation and protectionism

Recent years have seen a significant rise in protectionism, with several countries tightening investment rules and blocking cross-border mergers

and acquisitions in certain strategic sectors. This trend has been exacerbated by the growing clout of sovereign wealth funds in the Middle East and China, the rise of nationalism in Latin America and the renegotiation of energy contracts with multinational companies in Russia and elsewhere.

Thanks to a combination of relatively high severity and likelihood, and relatively low levels of preparedness, a rise in protectionism and retrenchment from globalisation ¹ is a Tier One risk that is among the most worrying that respondents face. Respondents from Asia place slightly higher levels on the severity and likelihood of this risk, and are also most likely to be concerned about a rise in anti-globalisation sentiment.

Terrorism

The threat from terrorism remains very much in our midst, and few commentators expect a decline in this risk over the next decade. Mr Hulbert of Control Risks Group says that his organisation predicts more of the same over this period, although he warns that this could be punctuated with a major chemical, biological or nuclear attack.

Despite the serious concerns that persist about terrorism, Mr Hulbert points out that priorities can sometimes be skewed among businesses. “There’s a fixation with terrorism, but this isn’t the key political risk that companies face,” he says. “The far greater risk is from state-based actors. We’re seeing much higher levels of expropriation, nationalisation and refusal of payment in Latin America, sub-Saharan Africa and elsewhere that has a bigger impact, at least in business terms.”

This bias is clearly evidenced by our survey. International terrorism ⁵ scores as one of the most pressing Tier One risks that companies face, while the nationalisation of assets ⁴³ barely registers.



Risk management as a strategic tool

What are the roles and responsibilities of the risk management function? On the face of it, this should be a fairly straightforward question. Most functions in an organisation, such as sales, marketing or human resources, have clear objectives that will be common across most companies and industries. And yet in the case of risk management, the roles and responsibilities are less clear cut. Is the purpose of the function primarily to ensure compliance and protect against loss, or does it have a more strategic role to play in the opportunistic activities of a business, such as new product development and geographic expansion?

Risk management appears to be a function in transition. While it retains its responsibilities as a source of assurance that ensures regulatory

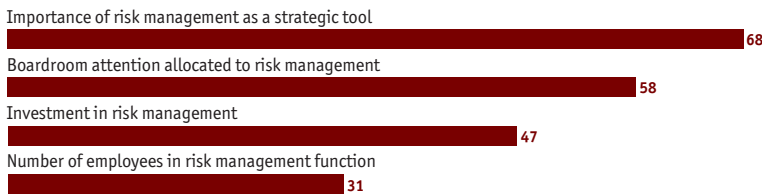
compliance and helps the organisation to avoid loss, it is now expanding beyond this traditional heartland to assume a broader role. Among our survey respondents, there is general agreement that risk management will encompass more strategic activities over the next ten years, with two-thirds expecting an increase in the use of risk management as a strategic tool.

As this transition continues its course, it naturally follows that there is greater boardroom attention being devoted to the function. According to our respondents, this focus will become more pronounced over the next decade, with 58% expecting an increase in attention to risk management among the board. The appointment of chief risk officers in many organisations is helping to strengthen this trend.

A fast-changing and dynamic risk environment, along with the need for a fuller understanding of the uncertainties that the organisation faces, has been an important factor in helping to precipitate this shift in priorities. "The world has never been static, simple or certain," says Eamonn Kelly, chief executive of Global Business Network and part of the Monitor Group, a future-oriented consultancy, "but it is not an exaggeration to say that it has never been as dynamic, complex or uncertain as it is now."

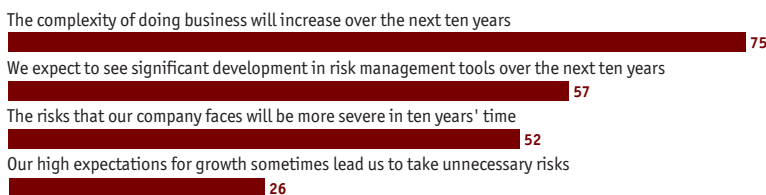
Our survey of more than 600 senior executives suggests that this is a view that is widely held. Around three-quarters of respondents say that they expect the complexity of business to increase over the next ten years, and 52% think that the risks their company faces will be more severe a decade into the future. More than ever before, companies need help to navigate these uncertainties and are calling on risk management to play a more active role in anticipating the major changes that lie ahead.

Between now and 2018, across which of the following aspects of your risk management function do you expect an increase? Please select all that apply.
(% respondents)



Source: Economist Intelligence Unit survey, 2008.

With which of the following statements do you agree?
(% respondents)



Source: Economist Intelligence Unit survey, 2008.



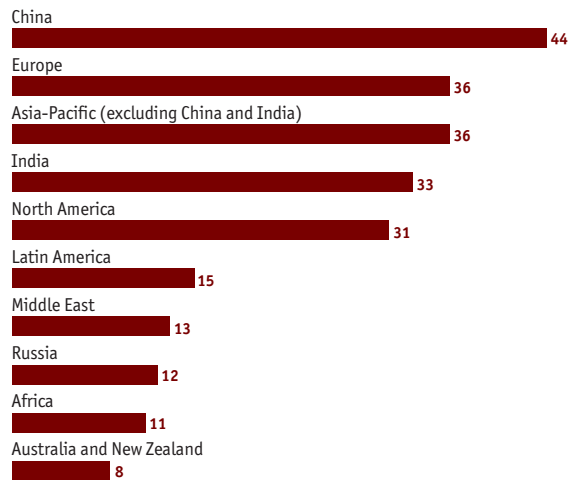
A focus on the upside

Just as the risk environment has become more complex, so too the opportunities created by technology, globalisation, a sustained period of economic growth and other major trends have become more varied and numerous. These opportunities continue to be a source of long-term optimism for the future among our survey respondents, despite the ravages of the credit crisis. More than one-half of respondents are very confident about the prospects for their industry, region and company over the next ten years, and just under half express a similar degree of confidence for the global economy.

Asked about the countries or regions from where they expected the most significant increases in contribution to revenue over the next decade, respondents point to emerging markets as playing a key role. China leads the pack, followed by Europe (including Eastern Europe) and Asia-Pacific (excluding India and China). More mature markets, such as North America, and Australia and New Zealand, are predicted to make far less contribution to an increase in revenue over the next decade.

As companies seek out potential for new growth in far-flung countries, there is a growing expectation that risk management must play a central role in evaluating these opportunities, as well as providing management with a timely assessment of the risks involved. "I have definitely noticed an increasing

Looking ahead to 2018, in which regions do you expect the greatest increases in contribution to the revenue for your company? Select up to three.
(% respondents)

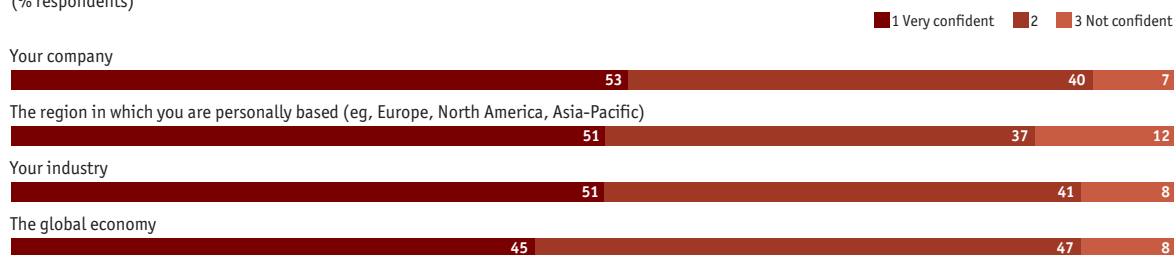


Source: Economist Intelligence Unit survey, 2008.

desire for risk management to be seen less as a tactical, defensive posture and more as one that is embedded within and linked to strategic planning," says Mr Kelly.

This perception that risk management should address both the downside and the upside is one that resonates with Paul Schoemaker, chairman and chief executive of Decision Strategies International, a consultancy that specialises in strategic planning. "I have noticed two shifts in the scope and nature of risk management," he says. "First, it is moving from just looking at the downside to looking at the upside

Looking ahead to the next ten years, how confident are you about the prospects for profitable growth across the following areas?
Please rate on a scale of 1 to 3 where 1=Very confident and 3=Not confident.
(% respondents)



Source: Economist Intelligence Unit survey, 2008.



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as well and second, it's moving away from a purely quantitative activity to one that is more qualitative."

This shift from quantitative to qualitative is especially pertinent in the context of strategic risk. While many companies—especially in the financial services sector—were assumed to have developed strong capabilities in financial, regulatory and operational risk, an understanding of strategic risk and the management capabilities to deal with it have been slower to materialise.

Part of the problem has been the inherently qualitative nature of many strategic risks. "Strategic risk involves companies asking about what the impact of investing in a certain area might be," says James Maxwell, senior vice-president in the risk consulting practice at Marsh, a risk consultancy. "It requires companies to use tools such as scenario analysis to find out what might happen, and how a strategic decision might affect the company over a three- to five-year time horizon. There's massive value in improving the strategic side of things but I don't think organisations have yet done as much as they could."

Inge Boets, a partner in the Business Risk Services division of Ernst & Young, believes that risk management and controls now have two parallel dimensions: what she describes as the more traditional "keep me out of trouble" side of risk and the emerging "make my business better" aspect. "It is increasingly being recognised that managing risk in the proper way can be a competitive advantage," she says. "It can help improve your performance, it can help improve your processes, and it can lead to competitive advantage."

These higher expectations that are being placed on the risk management department are leading to greater scrutiny on the metrics that are used to demonstrate these improvements. "There's a greater

focus on the tangible benefits of risk management," says Mr Maxwell. "For example, companies are looking at how risk management information can lead to reduced volatility of earnings. They are asking whether that leads to a better perception of the company by external stakeholders, such as analysts and rating agencies, and whether that then translates into a higher share price or credit rating."

A further trend that is encouraging a shift towards the alignment of risk with strategy is the changing nature of the organisation. "We are moving towards these hybridised networks with organisations that depend more on alliances, outsourcing and virtualisation," says Mr Kelly. "This creates new categories of risk to which organisations need to pay closer attention."

Many companies have already learned to their cost the serious risks that can be associated with outsourcing arrangements. Consider, for example, the damage caused to British Airways in the wake of the industrial dispute at Gate Gourmet, the company to which it had outsourced catering, or the recent problems experienced by Mattel, when it was found that toys manufactured by a Chinese supplier contained lead paint.

The transition of risk management to become part of the strategic toolkit is causing a fundamental change in perceptions of the discipline among the broader business. Where once it was seen as a discrete, stand-alone function whose role was to observe strategy from a distance, this view is now becoming outdated, according to Mr Maxwell. "That approach takes away from management the responsibility for having to think about risk," he says. "A more mature risk management function supports and enables the business. It's not there to manage risk as such—that's the job of the business itself."



“It is tough to make predictions, especially about the future.”

Niels Bohr (also attributed to Yogi Berra).

Looking to the future

As risk management makes the transition to adoption as a strategic tool, there is inevitably greater focus on the ability of the discipline to prepare an organisation for an uncertain future. Executives are looking for guidance on how major trends, such as climate change, demographic change, the economic development of emerging markets and the impact of new technologies, might affect their long-term strategy. They want to understand how their customers might change, how their industry might evolve, and how the competitive environment might respond to a range of different scenarios.

The sheer power of these uncertainties means that they cannot be ignored, and yet the traditional risk management toolkit may not be appropriate for considering them. “The more traditional tools that people used to manage risk, such as risk analysis and portfolio optimisation, worked well for a certain type of risk but the focus now needs to shift from one of managing risk to one of navigating uncertainty,” says Mr Schoemaker.

The management writer Donald Sull has written how “all our knowledge about the future is provisional” and cautions companies against setting long-term vision based on assumptions about a foggy future in an unpredictable environment. This is a theme that is echoed by the writer Nassim Nicholas Taleb, in his book *The Black Swan*, whose title refers to rare, unexpected events—both positive and negative. “We tend to tunnel into the future, making it business as usual, Black-Swan free, when in fact there is nothing usual about the future,” he writes.

Challenging our mental models

The ability of executives to draw conclusions about what lies ahead is further hampered by a tendency to see the future through the prism of the present. All too often, there is an assumption that past successes will translate into future successes and that entrenched situations and viewpoints will remain consistent. “One of the biggest risks that companies face is the gap between their mental models and the emergent reality,” says Mr Kelly. “Our mental models are deeply steeped in their own history.”

In his book *The Fifth Discipline*, the business writer Peter Senge describes mental models as “deeply held internal images of how the world works, images that limit us to familiar ways of thinking and acting. Very often, we are not consciously aware of our mental models or the effects they have on our behaviour.” These mental models foster a highly conservative way of thinking about the world and can prevent organisations from accepting new ideas. Challenging these mental models thus becomes an imperative for executives as they look at an unpredictable future.

As an example of a persistent mental model, Mr Kelly cites the widely held assumption that the west will continue to lead the world in innovation and that companies in India and China will lag behind for the foreseeable future. “We don’t think of Indian companies such as Infosys and Wipro as innovators, and yet by taking very complex tasks, disaggregating them and getting them performed as quickly and efficiently as possible before seamlessly reintegrating them, they are doing nothing less than inventing the future of work. They’re innovating when many in the west think they’re adding incremental improvements, and the risk is that companies in the west will simply miss the boat.”



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Scanning capabilities and peripheral vision

So, how should companies reconcile their need to make assumptions about the future to guide strategy with the inherent unpredictability of what lies ahead? For Ms Boets of Ernst & Young, a fundamental requirement is for companies to put in place a capability for scanning the external and internal environment for potential risks. “The best thing you can do is to have a robust process for identifying risk, and not just on an annual basis but on a continual basis,” she says. “You need to keep track of what’s happening in the economic environment and your industry, make sure that you are as informed as you can possibly be, and leverage all the experience and insights you have within your organisation to identify and assess those potential risks.”

By strengthening their peripheral vision, while admitting that they cannot predict the future, companies stand a better chance of being able to identify risks or opportunities more quickly than the competition—a crucial advantage in today’s highly unpredictable environment. This ability to identify risks then needs to be tied to the capacity to respond quickly to change, a capability that Mr Kelly describes as a company’s “adaptive advantage”.

“Over the decades, companies have developed a very good understanding of competitive advantage,” he explains. “But today there is the additional imperative of adaptive advantage. This involves having a much better understanding of the changing context and conditions, together with the capacity to respond quickly and coherently to those changes.”

Mr Schoemaker agrees, suggesting that, beyond looking to the future, companies need to develop a flexible strategy and agile organisation to enable them to respond quickly to a crisis or opportunity. This is one of several “levers” that he believes are required to manage uncertainty; the others are the ability to manage in real time—enabled by information

technology and executive dashboards—and strong leadership. “To prepare themselves for events or trends they are not anticipating, companies need to develop this combination of organisational capacities,” he says.

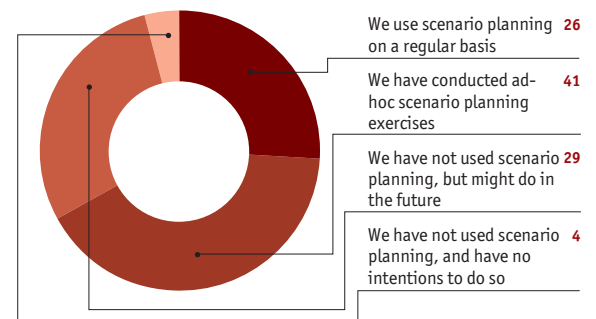
Scenario planning

One of the tools that companies are using to help them understand their environment and consider what the future might hold is scenario planning. Developed by the US military soon after World War II, and first used commercially by Royal Dutch/Shell in the 1970s at the time of the oil price shocks, scenario planning enables companies to imagine a range of possible futures. These are described as plausible narratives, rather than predictions of the future, and might encompass a number of divergent outcomes.

By thinking through different futures, executives have the opportunity to stress test their strategy and to challenge the assumptions they hold about what might be successful in the years ahead. “Scenarios enable companies to take a fresh look at how the world is changing around them,” says Mr Schoemaker. “By looking ahead—say to the next ten years—they can envisage how a number of different scenarios might fit their platform of capabilities.”

Among our survey respondents, 26% say that they

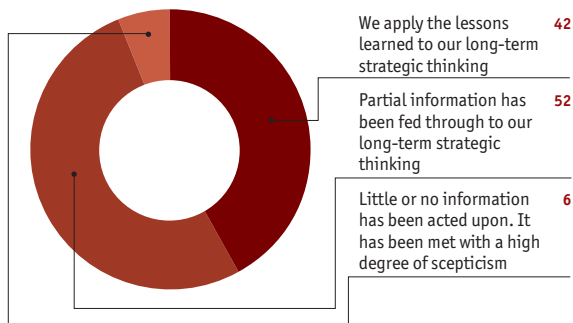
What use do you currently make of scenario planning as a tool to guide your long-term strategic planning? Please select the answer that most closely corresponds with the situation in your company. (% respondents)



Source: Economist Intelligence Unit survey, 2008.



What impact has scenario planning had on your corporate strategy? Please select the answer that most closely corresponds with the situation in your company.
(% respondents)



Source: Economist Intelligence Unit survey, 2008.

use scenario planning on a regular basis, while 41% say that they use it on an ad hoc basis, and 30% say that they have not yet used the technique, but plan to do so in the future.

The content for scenarios may come from the viewpoints of executives, but also those of customers, analysts, partners and suppliers. Andy Hines, a futurist and director of consulting at Social Technologies, a future-oriented consultancy, advocates a multi-disciplinary approach to ensure the input from as wide a range of perspectives as possible. "It's useful to have people who are unconnected with the industry involved in the process because they bring different experiences that might have relevance to your operations," he says. He also advises companies to think laterally about the information upon which they draw. "More often than not within an industry, you'll find that people are all reading the same things and gathering the same information, and then they wonder why they're all coming up with the same ideas," he explains.

A potential danger with scenario planning is that it can end up being an interesting intellectual exercise, but one that has little practical impact on how a company conducts its strategic planning. Among our survey respondents who currently use the technique,

this does not seem to be a widespread concern. Some 42% say that they apply the lessons learned from scenario planning to their strategic thinking, while 52% feed through partial information to their strategy and only 6% say that little or no information gets used.

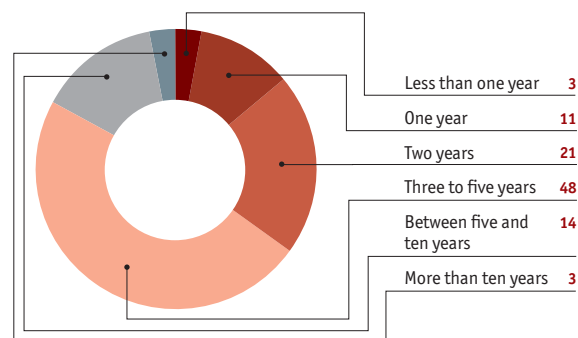
So how should a company apply its scenarios in practical terms? According to Mr Schoemaker, executives can map their existing strategy and competencies against each scenario to determine how valid they would be in each context. "They might find that a particular competency shows up in multiple scenarios, while another might be more fragile and apply to fewer scenarios," he says. "In the case of those that show up frequently and are robust across a range of scenarios, it makes sense to fully commit to these. With those competencies or elements of strategy that are more fragile, the company may want to take a calculated bet—perhaps by sharing the risk with someone else—or it may want to reduce its commitment in this area."

Time horizons

Despite the impossibility of obtaining anything other than provisional information about the future, the question inevitably arises as to how far ahead companies should look when considering risks that might affect their strategy. Among respondents to the

When considering the risks that could impact its business strategy, how far into the future does your company typically plan?

(% respondents)



Source: Economist Intelligence Unit survey, 2008.

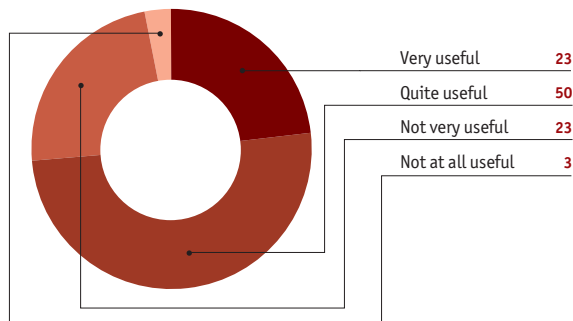


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If your company does or were to consider the risks it is likely to face in ten years' time, how useful do you think this exercise is/would be?

(% respondents)



Source: Economist Intelligence Unit survey, 2008.

survey, 48% say that they look between three to five years into the future. It is rare for respondents to look further ahead, with just 14% looking between five and ten years into the future, and just 3% looking more than ten years ahead.

“A lot of companies perform strategic risk assessment and analysis over a period of time that coincides with the period of time they use for their strategic planning,” says Ms Boets. “That is probably why there is this three to five year average in the survey, as this is also the average period over which companies consider their strategic planning.”

This is not to say, however, that looking further into the future would not be a useful exercise in certain circumstances. Some scenario planning exercises looking at major trends, such as climate change, might warrant a longer time-frame. Among our survey respondents, there is a recognition that

long-term consideration of risk could have value: asked how useful they thought it would be to consider the risks they might face in ten years' time, 23% thought it would be very useful and 51% thought it would be quite useful.

The time horizon over which companies choose to look will vary depending on the industry. Energy companies—the early proponents of scenario planning—will typically have projects that might take at least six years from the decision to invest to coming on stream and that may have a lifespan of more than 20 years. It is therefore extremely important for them to consider risks over a long time horizon. Technology companies, on the other hand, may have much shorter-term priorities related to technological innovation or changing customer preferences. “It’s not how far you look out, it’s how far you look relative to your time horizon,” says Mr Hines. “A technology company, for example, might have an 18-month product life-cycle, so if they’re looking out to three years, then they’re doing a pretty good job.”

The examination of risks over the long term may have serious constraints, but evidently there is an appetite for exploring the range of possibilities that the future might hold. In enabling an exploratory approach that does not require executives to tie themselves to any specific prediction, scenario planning provides a credible way of thinking about an uncertain future. “We all implicitly have a mental model about how the future is going to unfold,” says Mr Schoemaker, “Challenging that model, either collectively or individually, is always a good exercise.”



Conclusion

The rapid development of risk management, and its shift towards becoming a strategic tool that supports the business, could not have come at a more opportune time. The growing complexity of global business, and the multiplying risks that lurk in every corporate activity, mean that there is more need than ever before for a function that can help to identify potential problems and opportunities.

It smacks of hubris to say that one can predict the future, but this does not mean that there is no benefit to be gained from considering what the coming years might hold. Just as corporate strategy relies on planning several years into the future, so too risk management needs to consider what potential problems might lie ahead in tandem with the planning process. Techniques such as scenario planning enable executives to consider possible futures and understand the interdependencies between different categories of risk in a credible way, and can be a

valuable tool to help them see how their strategy might be affected by a range of potential outcomes.

Recent troubles in the credit and housing markets, and downbeat predictions by some commentators that the economic cycle may have turned, emphasise the need to understand the scope and nature of risks that the company faces. Respondents to our survey cite economic risks, such as oil price shocks, asset prices collapses, and global recession as among the most severe that they face—troublingly, they also believe that these risks are fairly likely to materialise.

There is growing recognition that companies must do more to address longer-term risks, such as climate change and demographic change, but levels of preparedness in these areas are currently fairly low. The short-term focus of many companies—especially public ones as a result of pressures to meet quarterly targets—may contribute to this lack of planning.

Appendix: Survey results

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Appendix: Survey results

In autumn 2007, the Economist Intelligence Unit conducted a survey of 600 senior executives. Our sincere thanks go to all who took part in the survey.

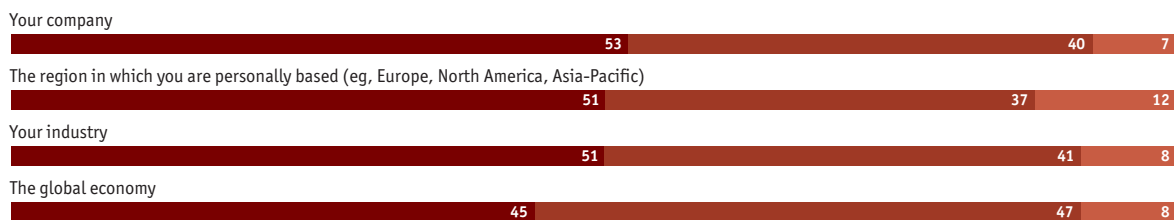
Please note that not all answers add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

Looking ahead to the next ten years, how confident are you about the prospects for profitable growth across the following areas?

Please rate on a scale of 1 to 3 where 1=Very confident and 3=Not confident.

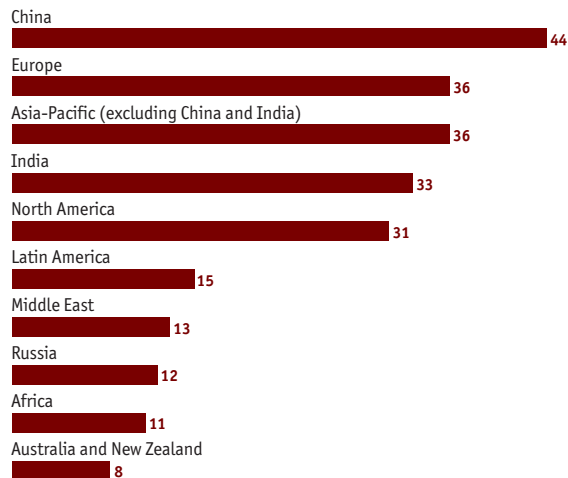
(% respondents)

■ 1 Very confident ■ 2 ■ 3 Not confident



Looking ahead to 2018, in which regions do you expect the greatest increases in contribution to the revenue for your company? Select up to three.

(% respondents)



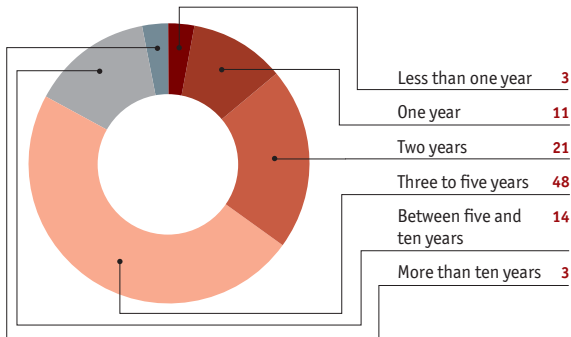
Between now and 2018, across which of the following aspects of your risk management function do you expect an increase? Please select all that apply.

(% respondents)



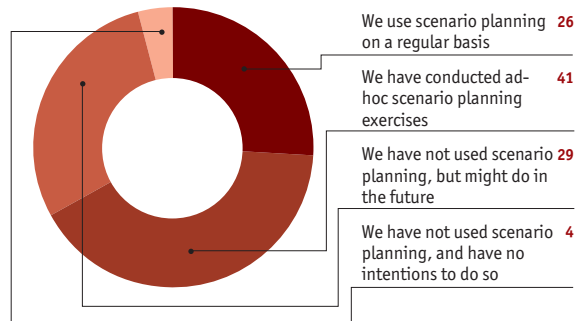
When considering the risks that could impact its business strategy, how far into the future does your company typically plan?

(% respondents)



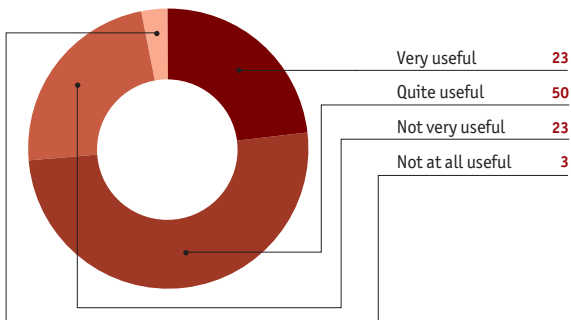
What use do you currently make of scenario planning as a tool to guide your long-term strategic planning? Please select the answer that most closely corresponds with the situation in your company.

(% respondents)



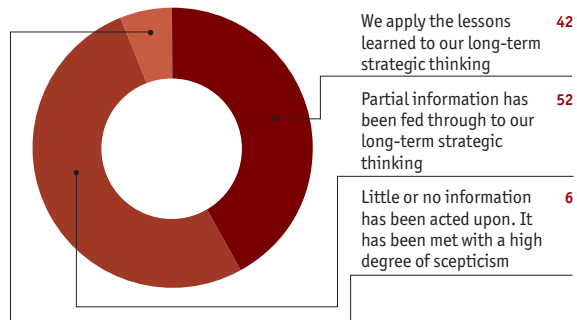
If your company does or were to consider the risks it is likely to face in ten years' time, how useful do you think this exercise is/would be?

(% respondents)



What impact has scenario planning had on your corporate strategy? Please select the answer that most closely corresponds with the situation in your company.

(% respondents)



With which of the following statements do you agree?

Select all that apply.

(% respondents)



Appendix: Survey results

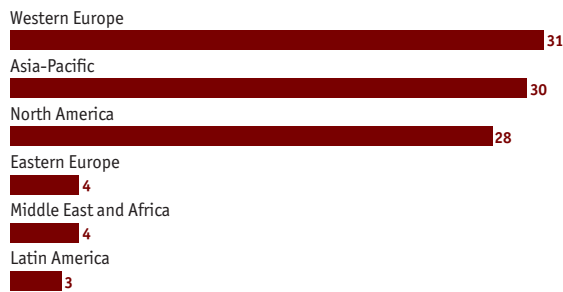
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About the respondents

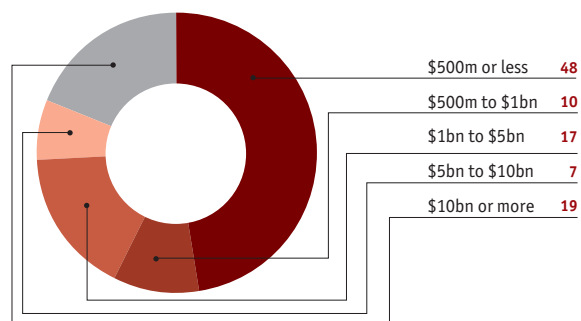
In which region are you personally based?

(% respondents)



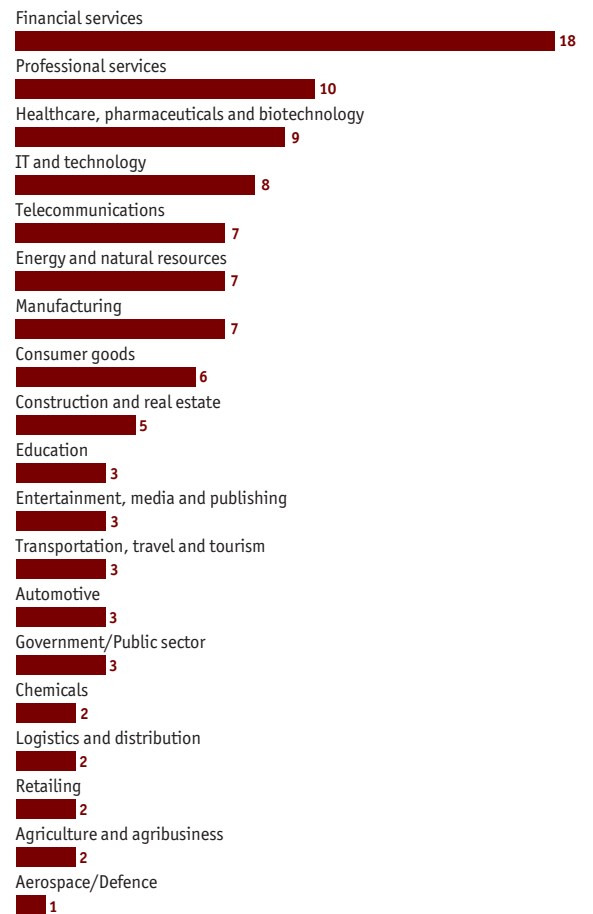
What are your company's annual global revenues in US dollars?

(% respondents)



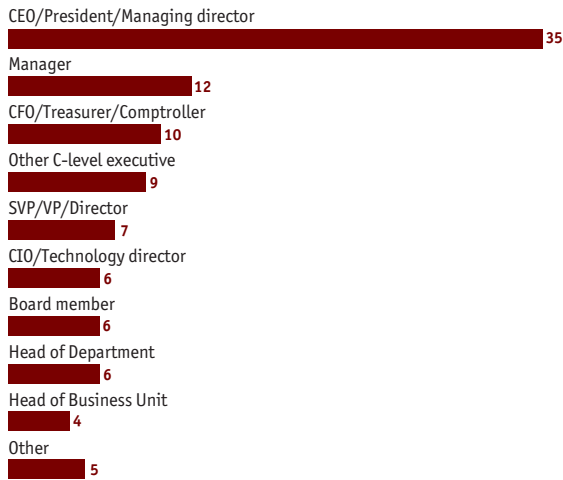
What is your primary industry?

(% respondents)



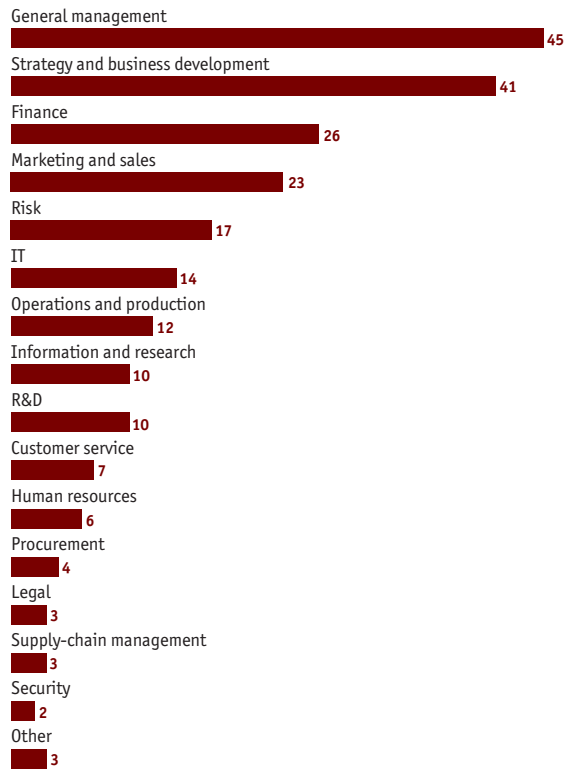
What is your title?

(% respondents)



What are your main functional roles? Please choose no more than three functions.

(% respondents)



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