

The other day, I had a chat with a risk management consulting colleague who was working with and focusing on legal risks. He had trouble doing this well as he found that people with a legal background:

- Have limited or no insights into statistics
- Rarely, if ever, work with a spreadsheet
- Find it hard to quantify risks and opportunities

My colleague mentioned, that even a heat-map can be hard to understand for people unaccustomed to addressing issues like “likelihood”. Now, how do you, with these people, define what reserves you need to have in place.

Now I, being my engineering self, found it hard to contemplate a concept like legal risk and having reserves ready. “Are you considering breaking the law as a viable option, and now you wish to calculate how much to set aside for fines?”, I asked.

“That is not it”, I was told. “This is not about whether or not you are breaking the law, but whether or not you or your business partner are in breach of a business contract, and about handling contract disputes, which can be complicated”. I simply stood corrected – I admit that.

Then I started thinking, how do you as risk manager help the legal community develop and execute quantitative and valid management of legal/contractual risks and opportunities – acknowledging that those involved are not mathematically trained, and probably and reasonably, unwilling to become that for the sake of risk management.

The no-go approaches

An approach often taken by risk managers is to accept using one or both of the inadequate tools and processes, i.e.:

1. Applying and using qualitative measures in terms of low/medium/high assessments based on the multitude of biases each of us are affected by. Human beings are very simply very bad at estimating (i.e. guessing).

Decision and behavioural science research have documented time and time again, that such assessments are invalid and hence more likely to lead to bad decisions than good decisions.

2. Collecting assessments/data in a red/amber/green heatmap with 3, 5 or whatever levels of “accuracy”.

Heatmaps are useless on a good day, and downright dangerous on a bad day. Just consider these questions:

- Risk A may have an impact of 10 k\$ or one of 10 m\$ - where do you “put it” in the heatmap?
- How many amber risks does it take to be worse than one red?
- How many risks will have to happen within any given period of time to bankrupt the company?

Finally, a heatmap will give you absolutely no clue as to which level of reserves you will need – which was the conundrum we were facing to begin with.

The solution ... collaboration

With the above avenues closed, we still need to lift the task, and the way forward is collaborating across business competencies and simply collaborate on the task of generating a valid assessment of plausible outcomes.

Leverage the skills of three categories of people:

- The **legal expert** who knows the contract, how to read this and the risks and intricacies of these and how to read and leverage these in a dispute. The legal expert will be able to identify “what may happen” that could lead to a dispute.
- The **business expert**, often a business controller, who understands the business and is able to “translate” any described event into a tangible impact measure (often a loss or a cost). The business expert knows/understands how things affect company performance and/or know how to figure this out – not as single point estimates, but as ranges based on former events or like analytics.
- The **risk expert** who knows how leverage the insights of the two others as well as functioning as a “process jockey” and “devil’s advocate”. The risk expert (often) drives the discussion and is expected to keep asking questions and discuss issues until we have adequate insight to validly address the risk.

The outcome of this will be a list of issues, some risks and some opportunities (i.e. events which may have a positive impact on performance). Each of these will be listed with an outcome range or distribution if the risk materializes.

Between the team, they also discuss the likelihood of the risk NOT happening at all. For instance, Risk A will have a minimum impact of 100 k\$, most likely it will be 1 m\$, but it may have an impact of as high as 10 m\$. Still, based on the best insights we can muster, there is a 90% likelihood it will not happen at all.

The outcome – Intelligent risk taking

This, the risk expert can leverage in modelling and calculating the outcome range of the contract as well as whatever reserves are needed in terms of a calculated outcome range of the portfolio of risks and opportunities embedded in the contract.

Ideally, contract uncertainties should be embedded as well, but for the sake of simplicity, let us just state the value of this contract to the company is 50 m\$ - no more, no less and assuming nothing happens. Based on this, the risk expert can leverage Monte Carlo simulation to calculate the outcome range and may find that based on the risks and opportunities, there is a 5% likelihood the value of the contract is as little as 30 m\$, corresponding to a performance loss of 20 m\$. The value of the contract will in average be 48 m\$ (loss of 2 m\$) and the 5% best case is as high as 60 m\$ (a gain of 10 m\$).

Furthermore, the so-called “tornado diagram” of the Monte Carlo simulation will show which particular risks and opportunities have the highest impact on overall performance and hence direct any measures/controls/adjustments to implement to improve expected performance. As an example, we may find that delivery delays are the most important risk – and opt to collaborate with the business

partner on how to monitor and support timely deliveries and/or be able to address delays effectively if/when they emerge.

Executing this is risk management on a legal contract – legal risk management. Doing this does not eliminate the risks of a contractual relationship. Instead, this will make the outcome visible and known to decision makers – validly enabling them to make those decisions which optimally serve company performance. That is intelligent risk taking.

Conclusion

There is no such thing as an unquantifiable risk or opportunity. As demonstrated by Douglas Hubbard in his books, there are two avenues to intellectually prove this:

The positive argument:

- If the risk happens, it will affect your business
- This means that you will know whether or not the risk has materialized
- That means you have seen some impact/outcome of the risk
- That impact/outcome can be measured

The negative argument:

- You (insist, you) cannot measure the impact of a risk
- That means, you cannot know, whether the risk has materialized or not
- This means the risk has no impact on your performance
- As it does not affect your performance, it is not a risk to you, it is just an event, somewhere

No single person has all the insights needed to make all the decisions – and any company prosper based on the cumulative and synergetic effort and insights of the entire workforce. Leverage this and make a valid risk management of your legal – and any other – decisions and processes.

Optimal risk management is, oddly enough, not about managing risks, nor is it about minimizing risk taking. Optimal risk management is about enhancing performance through intelligent risk taking.

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