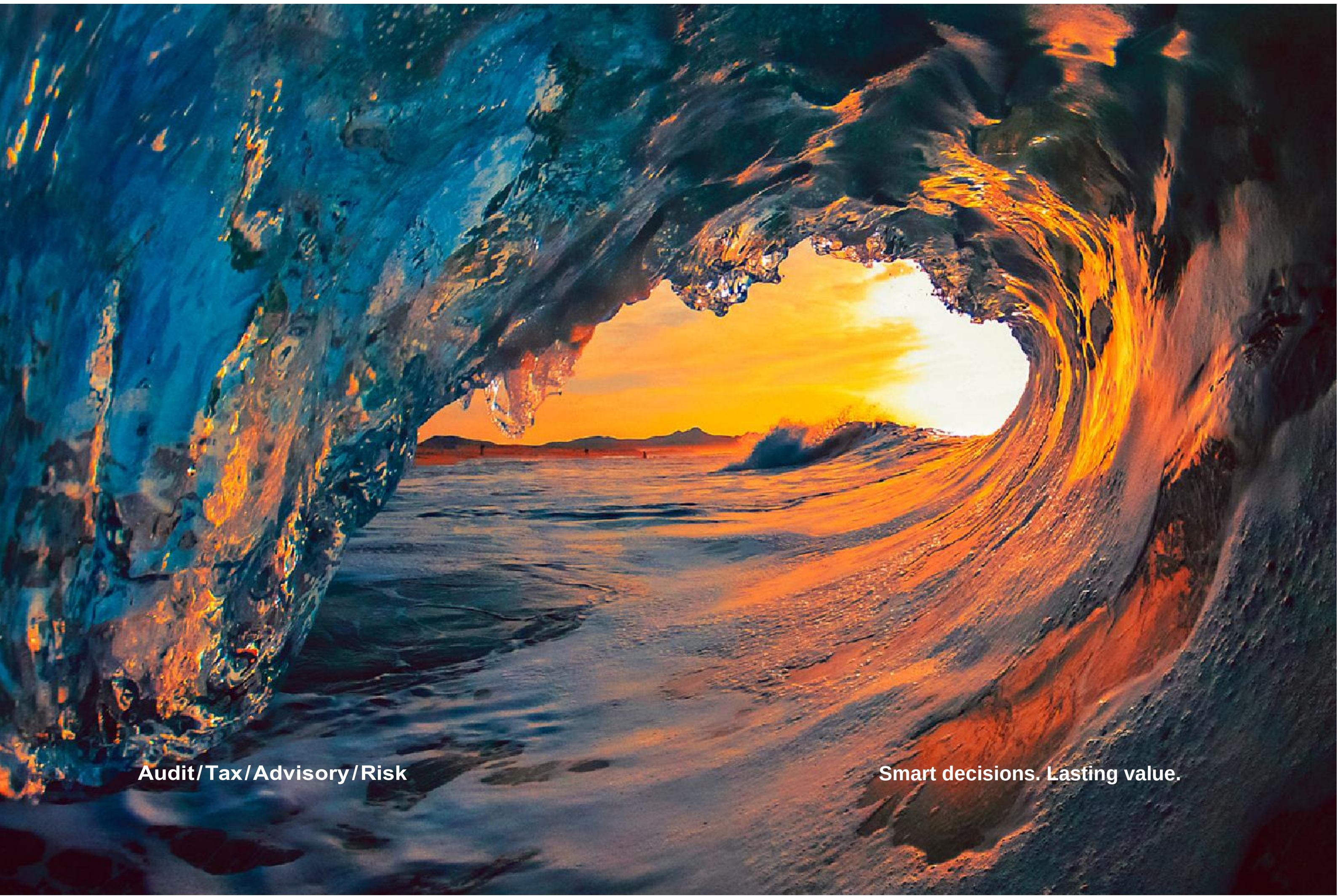
Charities: What has the pandemic taught us about risk management?

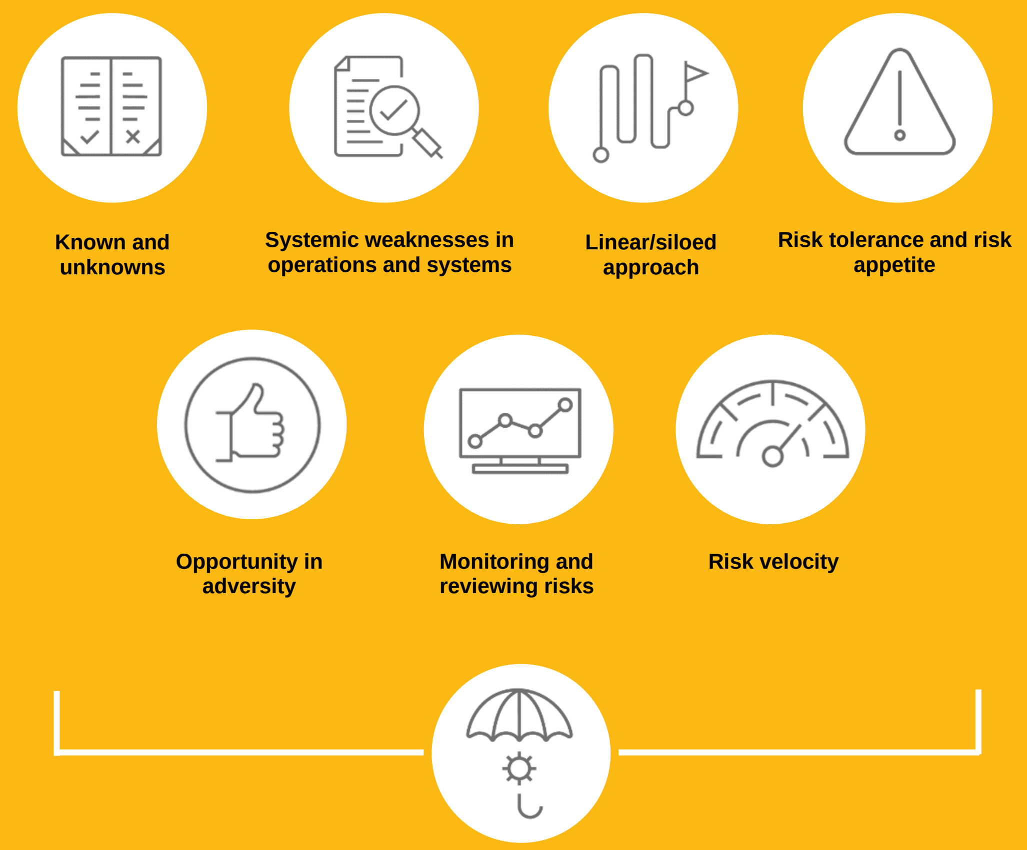
Seven key areas of focus



It has been said for some time now that we live in a 'VUCA' world. A world which is more Volatile, Uncertain, Complex and Ambiguous than ever before. This is no truer than now when we are dealing with the economic, societal, and financial impacts of the pandemic. All organisations are going through change in response to the challenges; re-assessing strategic priorities to ensure that the strategy remains relevant and achievable, and that the organisation is nimble and flexible enough to adapt, survive and thrive.

Risk can be defined as the level of exposure to uncertainties that the charity must understand and effectively manage as it achieves its objectives and creates value for beneficiaries Exposure and uncertainty are important factors in defining risks. However, risk is not the same as uncertainty. Managing risk is easier than managing uncertainties. If there is total uncertainty, which can happen when many issues interact, as in the current environment, it becomes virtually impossible to predict or even identify all the possible outcomes. In such cases strategy and planning should recognise that this stage of total uncertainty is often transitory, and while firefighting and dealing with the present, it is also important to try to identify triggers and trends and be ready to act decisively at the right time to prepare for the future. The key is understanding uncertainty and what could or must change, and an understanding of the known or recognised risks and opportunities to ascertain the gap between the uncertainties and the risks. This requires looking beyond the obvious and considering both direct and indirect factors, and then evaluating the short and long term implications.

So, what has the pandemic taught us about risk management?



Known and Unknowns

In 2002, Donald Rumsfeld, the United States Secretary of Defense, famously responded to a question to a U.S. Department of Defense news briefing about the lack of evidence linking the government of Iraq with the supply of weapons of mass destructions as:

> "There are known knowns; there are things we know that we know. There are known unknowns; that is to say, there are things that we now know we don't know. But there are also unknown unknowns – there are things we do not know we don't know."

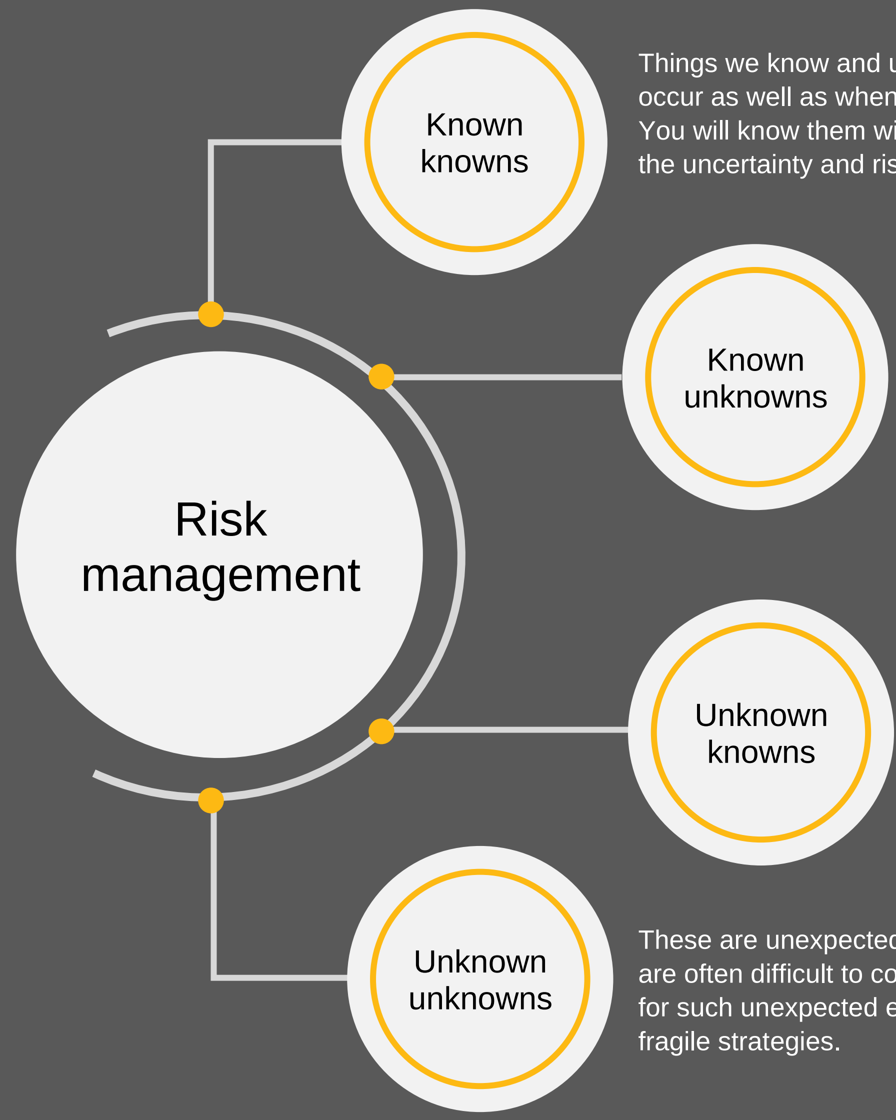
The pandemic has taught us that while most organisations and indeed governments are good at capturing known knowns and known unknowns, they are less able to identify unknown knowns and unknown unknowns. Unknown unknowns are the truly surprising events which are unpredictable where the risk is inconceivable, and where preparation for such an event is nearly impossible.

These are the 'black swan' events made famous by Nicolas Taleb in his book, and include events like that of September 11, 2001. Some people have suggested the pandemic is an example of unknown unknowns but in fact, it is a great example of an unknown known - we knew the risk existed although we may not have been able to assess its full impact – so we knew it could happen but we were unwilling to act or indeed didn't want to believe it.

It was the subject of the famous Ted Talk by Bill Gates in 2015 and was cited by numerous others in assessment's of high impact/high likely global risks. The uncertainty was large and the risk was underestimated because of fear or irrational bias or indeed, wishful thinking. In an organisational context an unknown known is information that the organisation or an individual within it has in their possession, but whose existence or relevance has not been evaluated.

From an organisational perspective, turning unknown unknowns into known unknowns is, while difficult, probably one of the best things the board and management of a charity can do. There are two ways this can be done while acknowledging that, by definition, it is not possible to know all the unknowns. Critically it's about ensuring that there is better situational or organisational knowledge of the impact of the global and local contexts, and the impact of that on the individual charity.

Firstly, the management team must have a broad view of the economy and the charity's operating environment, ensuring there is diverse external knowledge and perspective, and that this is shared within the organisation. Secondly, it is about having an organisational culture which allows, and indeed encourages, the free flow of information up, down, and sideways — so that people in the charity want to share information instead of hoarding it.



Known knowns: Things we know and understand which can occur as well as when they are likely to occur. You will know them with reasonable accuracy; the uncertainty and risk can be measured.

Known unknowns: We know that the event can happen but possibly not when, or how often. They are real life situations that happen under unusual/special circumstances.

Unknown knowns: Things that we don't know that we know or don't want to believe will happen and/or are unwilling to act as if they will.

Unknown unknowns: These are unexpected, surprising events that are often difficult to conceive. We can prepare for such unexpected events by using anti-fragile strategies.

Systemic weaknesses in operations and systems

Undoubtedly, the pandemic has shone a light on systemic weaknesses in operations and systems which are now causing reputational, operational, and financial risks. For example, we have known for some time that the value proposition of face to face fundraising has been diminishing and that there has been a need to diversify fundraising approaches and find new routes to engage donors. While some charities have been focusing on new approaches, many have struggled.

A consequence of the pandemic has sadly been the cancellation, or postponement, of a number of fundraising events exposing some charities to serious financial risks. In some cases, these were identified as a risk by the charities and appeared on their risk registers, but the key question is what risk management measures were in place? Did the charity understand its exposure to these risks and ensure that it built in financial resilience?

Another example is third party suppliers. Much of the focus of organisations has been on ensuring there are robust procurement procedures including carrying out a thorough due diligence of suppliers.

Perhaps though, there has been less focus on identifying key suppliers and ensuring that there is a proper understanding of the suppliers' business continuity and risk management processes.

The speed and the ease with which charities responded to moving to a remote working environment was as much about their different activities as about the tools and technologies that enabled them to move to a remote environment.

Clearly for some charities, such as those in the arts and culture sector, and visitor attractions, it was not possible to carry out their activities remotely. For others though, it was whether they had invested sufficiently in the hardware and the technologies and software that allowed them to do their 'business' as well as their back office functions from a remote setting.

Linear/siloed approach

The problem with traditional risk management has always been that it looks at one risk at a time without consideration of linked risks and the 'domino' effect. Most major value losses involve the interaction of more than one risk. Many catastrophic losses are the result of a series of small events rather than a single large event. The pandemic has reinforced this in that what started as a health crisis has had significant societal and economic impacts which in turn have impacted all charities who have had to manage their cashflow and liquidity carefully.

Often, risk management does not address the interaction of separate adverse events or the exposure to a portfolio of risks. An isolated concentration on value at risk can sometimes result in not spotting 'risk contagion' – in other words where one low impact risk leads to another and another so that the cumulative impact is catastrophic.

At the same time, risks that are off the radar can lead to problems. For example, charities that are not involved with public service delivery and do not get their funding from federal or state government, may think that cuts in public spending will not impact them. However, charities that are involved in public service delivery, having recognised that this income is under threat, have geared up their fundraising efforts in other areas. This can and will have a cascading effect on other charities.

Risk tolerance and risk appetite

The pandemic has led each of us to individually re-examine our own risk tolerance. So, for example over the last 12 months there has been a discussion about what level of risk a household is willing to tolerate when deciding on their holiday plans. Some people have decided that they want a holiday but they are not willing to travel on a plane and opted for a staycation. Others have decided that they want a holiday, they are willing to travel on a plane as getting away is worth the risk of travel.

Similarly, charity boards and management have had to revisit their risk appetites and have had made decisions based on their tolerance of perceived risks and consideration of what is deemed as an acceptable risk. So, for example, a charity foreseeing a loss of future income will need to decide what costs to cut, this will be based on an understanding and a perception of risks, and a consideration of what is acceptable – how much do we cut without jeopardising our future recovery.

Risk appetite:

The amount of risk that a charity is willing to seek or accept in the pursuit of its long term objectives.

Risk tolerance:

The boundaries of risk-taking outside of which the charity is not prepared to venture in the pursuit of its long term objectives.

Risk universe:

The full range of risks which could impact, either positively or negatively, on the ability of the charity to achieve its long-term objectives.

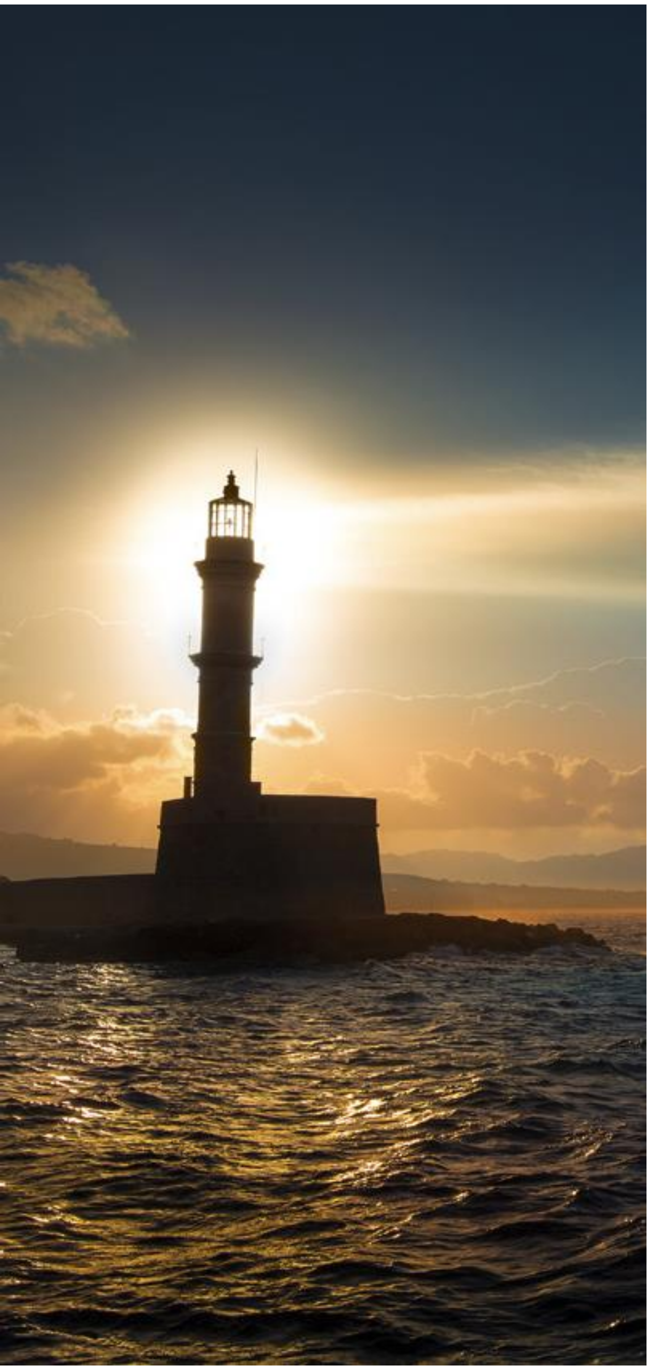
Opportunity in adversity

Risk is an umbrella term that encompasses both opportunities and threats. A threat is a risk with negative effects while an opportunity is a risk with positive effects. For some time now the thinking has focused on the concepts of rewarded and unrewarded risks. Some risks are all downside and no upside. For example, if a charity fails to comply with laws and regulations there can be significant consequences, but there is no extra credit for being even more compliant. Similarly, it is important to avoid disruptions to critical operations and systems but doing so simply meets expectations rather than being seen as something that deserves reward. These are the unrewarded risks. They cannot be ignored, but the primary incentive for dealing with them is value protection. Other risks are about upside; for example, introducing new innovations in service delivery or expanding into new areas of income generation.

The primary reason for taking these risks is to add value. While taking these risks might have a downside, the potential upside is greater.

Charities that succeed are not the ones that avoid risk but are those that look for opportunities, and this has been particularly true during the pandemic where some charities have been actively looking for new opportunities or moving on with previous plans for changes to their operating or business models but with a greater urgency. Ensuring that operations and resources are sustainable is becoming more difficult. Therefore, there is now a greater need to look out for opportunities. Good risk management will lead Boards to consider the various options open to the charity in pursuit of its charitable objectives such as collaborations, mergers, or strategic alliances.

Monitoring and reviewing risks



Often charities spend time and energy putting in place, or refreshing, their risk management, but then don't give it the time that it needs on a continuing basis. For risk management to be effective, it needs to be embedded in the organisation, which requires engagement at all levels and leadership and direction from senior management and Boards.

Risk management needs to be a live process and the risk register shouldn't be left on the shelf to gather dust or brought out once a year because the auditors ask for it. There should be a regular review and monitoring of risks. Those organisations which did not maintain a live up to date risk register, and those who did not have a robust risk management process properly embedded, would have found it harder to identify and update their response to the risks and opportunities brought about by the pandemic.

Charity boards and management should revisit their risk registers to check it is up to date and ensure that it is maintained as a living document. There should be discussions on key learnings from the pandemic on management of key risks including the response to the pandemic, as well as a review of the governance and decision making processes.

Risk velocity

Traditional risk scoring methodology focuses on the impact and likelihood or probability of a risk; a two-dimensional approach captured on a risk heat map. This approach does not take account of the speed at which an exposure can impact the organisation, the 'risk velocity'. Risk velocity is the speed at which the organisation goes from the onset of the risk to first feeling its impact. For example, the impact of a breach of regulations would generally be felt more slowly than the liquidity risks brought about by the pandemic, where in some cases, income stopped immediately but expenditure continued at previous rates.

So, while consideration of timescales has been a key element of capturing risks on a risk register, some consider that risk velocity should be introduced as a third dimension to the risk assessment process. Recognising that while some risks may have similar likelihood and impact ratings, they may take different lengths of time to impact the organisation and therefore an appropriate response should take account the velocity of the risk. Low velocity risks give you time to prepare a response whereas high velocity risks will not. Therefore, an organisation must plan to implement risk management measures for such risks to reduce them to a manageable level, which will ultimately enable the organisation to respond quickly and return the organisation to a sure footing. There should also be a check to ensure that appropriate escalation processes are in place for high velocity risks.

There are different approaches to measuring and representing risk velocity. Once a value is attributed to risk velocity, this can be added as a new column to the risk register, or incorporated into the total risk measure.

Another much simpler approach is to use a simple scale of 'Very Rapid, Rapid, Slow' on the risk register, or in plotting against the two-dimensional risk heat map.

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