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Black Swans and Risk Management

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On 20 April 2010, there was an explosion onboard BP's oil rig Deepwater Horizon, located in the Gulf of Mexico. The massive fire that ensued caused the death of 11 crew members. Two days later, the rig sank, flooding the seabed with crude oil for 87 days. It is considered the largest accidental marine oil spill in the history of the petroleum industry.

This disaster was described by the BP Group chief of staff, in a 2012 speech, as a "black swan" event. The term is usually used to describe an unprecedented event of major, often catastrophic, impact. It is viewed, in the first instance, as an outlier outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. However, after the event, a black swan is also sometimes rationalised, in hindsight, as something that could have been expected.

This rationalisation was manifested in BP shareholders' attempt to sue the board of directors in the US courts. In January 2013, the derivative suit alleging breaches of fiduciary duty was dismissed by the US federal court on the grounds that the US court was not the appropriate forum for such a lawsuit. Whether a similar suit will be successful in the UK, where BP is incorporated, remains to be seen.

Nonetheless, in September 2014, BP was found to be "grossly negligent" under the Clean Water Act by a US federal court. In the 153-page judgement, instances of BP's cost-cutting measures that undermined safety reflecting "a conscious disregard of known risks" were cited. In July 2015, BP announced an US$18.7 billion settlement to pay the US and five Gulf Coast states for penalties and various claims under US laws.

This judgement showed that even if an event is considered a black swan, there is no escaping culpability if it is deemed that the catastrophic incident could somehow have been avoided. In BP's case, it was the company that was found guilty. Whether the directors would have been liable is debatable, but certainly a cause for concern.

GUARDING AGAINST DIRECTORS' LIABILITIES

In common law jurisdictions (which include the UK and Singapore), every director owes a duty to his company to use reasonable diligence in the discharge of his duties. The standard of care and diligence expected of a director is whether he has exercised the same degree of care and diligence as a reasonable director found in his position. This standard will not be lowered to accommodate any inadequacies in the individual's knowledge or experience. A director who breaches his duty of diligence may be subject to an action by the company against the director for damages suffered by the company.

The board's failure to take adequate action to guard against and address certain risk of loss that a company is exposed to is in breach of its fiduciary duties if it is found that a reasonable board in its position would have prevented it. Whether an event could have been reasonably known and prevented – without the benefit of hindsight – is a question best left to lawyers.

From the perspective of personal risk management, however, directors should be aware and guard against such allegations of breaches of directors' duties. Having robust and well-documented risk management and decision-making processes that incorporate all relevant board deliberations (not just the conclusions) and any third-party assurances is a good starting point.

BEYOND TRADITIONAL RISK MANAGEMENT

To deal with the endless permutations and confluences of risk factors, and to counter hindsight bias, the board and the board risk committee need to look beyond the traditional risk management wisdom of focusing primarily on prescribing a contingency plan for high-impact and high-likelihood risk events. Instead, there needs to be an effort to also identify the high-impact and low-likelihood risk events, building out such scenarios and seeing how they may cause catastrophic results.

In a recent study on risk management, the value killers revisited, Deloitte found that 90 per cent of catastrophic losses were due to more than one risk factor, and the main reason for their occurrence was a silo view of risks within the organisation. Taking a holistic view of risks across the organisation is important to determine how these risks can be combined and interact with each other to create high-impact losses.

Furthermore, most organisations in today's globalised business environment operate as an "extended enterprise" with a large number of third-party business associates in the form of customers, partners, agents, suppliers and service providers spanning multiple regions. The risks posed by these third parties are usually not contemplated by most risk management plans, but they could well be the weakest links in the organisation's defence.

Cyber risk is a good example. Security breaches in a company's internal network can pale in comparison to the compromising of customer data maintained by an IT service provider. Another example is the risk that improper or illegal conduct of foreign agents or consultants implicates the company in bribery or fraud cases.

It is only through the constant challenge of traditional wisdom and assumptions that one can keep complacency at bay and respond effectively to the first sign of trouble. If black swan events are truly unpredictable, the organisation which detects and deals with them faster than others enjoys an overwhelming competitive advantage. ■