RELATIONAL RISK
A briefing paper for the Relational Thinking 2015 conference

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The idea of risk

Risk is a perception of the future: individuals, organizations and nations plan their future actions with a view to achieving gain and avoiding loss. Such calculations have probably been going on longer than recorded history. By comparison, formal mechanisms for transferring risk – like insurance, hedging and securitization – are recent developments, and risk management as an academic discipline and corporate function is still emerging.

In current usage, a *risk* is defined as a probability or threat of damage, injury, liability, loss or other adverse event caused by internal or external vulnerabilities and, at least theoretically, avoidable through pre-emptive action. *Risk exposure* is the degree of risk to which an individual or organization is subject through a certain situation or course of action.

Two other widely-used distinctions are worth noting.

First, there is a difference between *pure risks*, which are unavoidable and can only result in loss, and *speculative risks*, which are accepted by a risk-taker on the basis of a cost-benefit calculation. Examples of pure risk include natural disasters, pandemics, fire, premature death, identity theft, and weather events. The most familiar type of speculative risk is investment, but the class also covers such activities as research and development, advertising campaigns, military ventures and, more broadly, any purposive action.

Second, there is a difference between risks that can be mitigated by *diversification* (for example, an investment portfolio with holdings across a variety of sectors) and s*ystemic* or *fundamental* risks – like climate change or a global stock market collapse – where all assets are affected and the risk is too pervasive to be undertaken by insurers.

While single risks are relatively easy to understand, a major challenge for large organizations is to identify, evaluate and mitigate all the relevant sources of risk on an enterprise-wide basis. In the corporate sector, the introduction of risk management criteria by credit rating agencies has helped push risk management to the top executive level. Multiple risk categories – operational, political, foreign exchange, regulatory, liquidity, asset, credit – have to be quantified and applied to the bottom line. Not only are risks diverse; they are also intricately interlinked and constantly shifting. Here risk assessment encounters the same problems as systems analysis: the larger the system under consideration, and the longer the projection period, the more the analysis falls prey to indeterminate outcomes, unknown factors, and unexpected interactions. Even apparent gains can generate new sets of risks. For example, greater longevity actually increases the incidence of cancer,

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and thus casts a long shadow over risk exposure for insurance, healthcare and social service provision.

The scope of relational risk

The terms *relational risk* and *relationship risk* have already entered the lexicon of risk management, but not with standard definitions. Often they are used to denote a specific class of risk associated with business alliances.[2]

Relational Thinking treats risk as an inherently relational issue. While some adverse events have purely natural causes, most are a product of human interaction, and in every case the impact is absorbed, transmitted and mitigated through relational networks. There are four specific ways in which relationships underlie risk.

ONE: Relationships create networks of risk exposure

Any decision to associate yourself with another person or organization comprises an extension of risk exposure. Partners entering marriage or civil union are formally combining not just their strengths but their vulnerabilities. Taking on a new employee requires active trust in that person's competence, operational ability, and willingness to comply with health and safety regulations. Similarly, no relationship fails in isolation. The impact of a separation, resignation or betrayal ripples through families, friendship networks, workplaces and sometimes whole organizations. The recent dropping of footballer Luis Suarez by 888poker, and of South African sports personality Oscar Pistorius by Nike, indicate the sensitivity of sports sponsorships to risk events occurring in the life of one individual.

Ultimately, all risk exposure is borne by people – whether as individuals, as stakeholders in corporations, or as taxpayers – and the impact of major risk events will radiate widely in space and time. Austerity policies in Europe can be traced back to risk management failures in major banks in the lead up to the 2008 credit crisis. More recently, the 2015 bankruptcy of Radio Shack, after a failed attempt to move into the mobile phone retail market, threatened individual job losses, with consequent impacts on families and communities, in 4,485 stores across the US.

TWO: Relationships are the channels of moral hazard

The distribution of risk through relational networks inevitably raises questions about responsibility.

Moral hazard – the tendency to be lax about risk-taking if the cost is borne by others – is the term most often used to associate risk with human behaviour. Its origins lie in the insurance industry, where contracts are perceived to encourage risk-taking and raise the number of claims, the cost of which the insurer passes on to all clients in the form of higher premiums. In fact, moral hazard is a relational risk set up in any situation where one party to some degree guarantees the wellbeing of another. Failures to tackle current environmental problems or to perpetuate national debt are, in effect, decisions to load risk onto the next generation. The principle of *caveat emptor* addresses the risk taken on by giving currency in exchange for goods that might or might not justify the valuation. Moral hazard also surfaces in the treatment of company expense accounts, in tenured academic

[2] "Relational risk is an individual's perception of the risk associated with a cooperative alliance with a business partner." Susan Costa e Silva and Luciara Nardon, "Exploratory Study of Perceptions of Culture Distance and Relational Risk, in *New Perspectives in International Business Research*, ed. Maryann P. Feldman and Grazia D. Santangelo (Bingley: JAI Press, 2008), 47.

posts, in bailouts, in tax evasion, in fraud, in price-fixing, in the use of NHS services, and in virtually any situation where one individual has the opportunity to lean on another's goodwill.

The widely-acknowledged need for trust in business dealings presupposes a risk that the other party will fail to keep its side of the bargain. Verification of trustworthiness features strongly in online commerce (testimonials, likes, feedback, star-ratings). A breach of trust will tend to raise a party's relational risk profile. When former Tesco CEO Sir Terry Leahy commented in 2015 that the grocery chain had "eroded customers' trust" he meant that customers no longer assumed Tesco would offer them the cheapest deal.[3] This reputational blow was worsened by media coverage of the company's investigation by the Serious Fraud Office for a £263m mis-statement of its forecasted profits.[4]

THREE: Relationships as role definitions generate systemic risk

The complication with moral hazard, of course, is its necessity. Regulations can be framed in such a way that the cost of failure falls principally on the risk-takers: banks can be allowed to fail, buildings can be allowed to burn down uninsured, investors can be made liable for the debts their company cannot pay. The result would be a containment of risk exposure: risk takers would operate without safety-nets, and taxpayers would not become the unwilling insurers for markets. By the same token, however, individuals and organizations would become strongly risk averse, placing serious restraints on enterprise, innovation and economic growth. If savings aren't guaranteed, money is withdrawn from the banks and put back under the mattress.

There is a reason why limited liability had the effect of an adrenalin shot on the economies of Western countries in the nineteenth century: progress depends on limiting risk exposure. The statutory status of limited liability institutionalizes moral hazard, officially incentivizes risk-taking, and thus establishes relational risk at a systemic level. That this way of doing things delivers, not only growth, but obvious injustices and sometimes staggering economic reversals, draws attention to the kinds of relationship within which moral hazard is being handled.

In general these relationships are remote and intermittent. In plcs, risk-taking boards of directors work at considerable relational distance from suppliers of capital, to whom they are nonetheless obliged to report profit levels on a quarterly basis. Not all stakeholders in organizations are equally represented or enjoy equal access to management. Regulation is often patchy, insufficient, or applied after the fact. And stakeholder interests may overlap in complex ways: the retail customer pressing for lower prices may hold shares in the same retailer via a pension fund. Generally, the scale and pace of the modern economy tends to connect people as classes, and to rely on dealings transacted over distance by people whose lives otherwise barely intersect.

FOUR: Relationships as a fundamental asset are subject to depreciation

The risk *from* relationships – to organizational goals like profitability – is easy to understand. Where people do not cooperate effectively, targets will be missed, quality of service will go down, and the enterprise will lose reputation, market traction and profitability.

But there is also a risk *to* relationships. The way in which people and organizations relate to one another add up to a form of capital that can appreciate or depreciate in value and utility. This relational capital consists of a number of elements, including the ability of a society to balance cooperative and competitive behaviours, the number and depth of social bonds, and the

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[3] Tesco also built new stores in a number of locations against the objections of the local community – notably in Cambridge, Gerrard's Cross and Sheringham.

[4] See "Sir Terry Leahy: Tesco 'eroded customers' trust'," January 19, 2015, http://www.bbc.co.uk/news/business-30881267

effectiveness with which relational skills and continuities are handed from one generation to the next. Relational capital is a shared asset at local, national, organizational, and global levels, and can refer to an asset ”owned” at an organizational level and comprising the quality of relationships across all stakeholder groups involved in a company's operations. It can be damaged by catastrophic events like wars and natural disasters (for example, through mortality and displacement of populations)[5]. It is also – and far more relentlessly – subject to systemic relational risks, including both the rules of engagement set by organizational practice and the wider political-economy, and the cultural attitudes governing the way relationships themselves are conducted and valued.

The culture of long working hours in South-East Asian tiger economies, for example, has impacted strongly on family formation and reproduction rates, decimating the future workforce. Globally and nationally, mobile capital drags employees to current growth centers, fueling inter-regional or international migration problems and dismembering family and community support networks. Additional stress on relationships results from pervasive consumer debt and cyclic recessions. And closely interwoven with these forces are cultural attitudes that idealize, among other things, individual self-realization and achievement, the effects of which include a lack of consensus on what constitutes wellbeing, and a tendency for social cohesion and the defense of rights to pull in opposite directions.

At a global level, beyond which total risk cannot be further diversified, relational capital strongly resembles the natural environment. In fact, relational risk stands logically and operatively prior to environmental risk because threats to the natural environment (emissions, wastes, resource depletion, irreversible destruction of food chains) are a product of behaviours driven by the way relationships are structured in the international political-economy.

Assessing and managing relational risk

Relational capital and relational risk are closely connected. *Relational capital* is a measure of the strength of the relationships which join individuals together and which form the internal and external connectivity of organizations. *Relational risk* centers on the threat that relational capital will depreciate at personal, organizational and systemic levels.

Relational risk can be assessed in terms of the *expected level* and *probability* of relational capital depreciation.[6] The resulting relational risk profile will be a view from the perspective of the commissioning organization, although it also deals with relationships between relevant stakeholders: for example, the relational risk between companies and clients, or companies and suppliers, may have a significant impact on sustainability.

The impact of relationship failure

The impact of a relationship failing reflects the importance of the relationship to the current and future prosperity of the organization.[7] Importance is context-specific. A company might identify the client relationship as the most crucial in determining future prosperity; for an elderly person, the most crucial relationship might be with a daughter or next door neighbour.

[5] In the *Guerra Grande*, which ended in 1870, Paraguay is estimated to have lost up to 90% of its male population through combat and disease – the impact of which is still felt today.
[6] Impact and probability are standard metrics for nearly all forms of relational risk assessment.
[7] Ideally, prosperity is assessed using triple bottom line criteria rather than simple profitability. This step is not as easy as it may seem. In a number of LIC dictatorships, top appointments have often gone to presidential insiders with a view to bolstering short term security, and the resulting in incompetent government, corruption, slowing growth, rising imports, rapidly expanding external debts, and the erosion of goodwill among businesses and taxpayers.

Important relationships for an organization may be internal or external. They may also reference specific pairings of individuals or – typically in larger organizations – roles between office bearers or between stakeholder groups. With developments in IT and social media, many important connections are now discovered and maintained online. Search engines have produced something of a relational opportunity dividend, exponentially increasing the ease with which like-minded people can find one another and associate. The recent raising of over one million dollars by crowd funding for a single middle school in the US highlights the significant contribution made by temporary connections, and the key role played by media personalities and popular websites in directing public interest.[8]

By contrast, connections with key stakeholders or collaborators may be underused or unmanned – as instanced in the failure of inter-agency relationships involved in the care of Victoria Climbié.[9] Sometimes the stakeholder relationships with the greatest capacity to meet organizational goals have simply not been created, or have been degraded or lost in the process of staff turnover.

The probability of relationship failure

The probability of a relationship failing can be estimated using relational risk mapping based on the relational proximity criteria of touch, time, breadth, overlap and balance.

These provide a reading of a relationship's "bandwidth". Touch, time and breadth deal with the nature and frequency of interactions. Overlap and balance indicate how far the parties pursue the same goals and the steepness of the power gradients that separate them. Mapping the major relationships between stakeholder groups highlights vulnerabilities of the kind that have led to abuse of the disabled, elderly or children in care (weak oversight and accountability), fatal mismanagement of high-risk individuals in the community (multi-agency social service coordination) and aviation accidents ("cockpit gradients" where co-pilots feel unable to question a senior pilot's errors).

It is characteristic of relationship problems that they multiply if not addressed. Poor communication up the chain of command can mean that the employee's issues and grievances build up unnoticed by management, and are likely to become contagious. The outworking of relational problems at home or in the workplace become visible in the form of absenteeism and lowered productivity. Sometimes success and sustainability rest on apparently simple adjustments to relational proximity, including prioritizing regular face-to-face meetings, willingness to accommodate, keeping adequate records, and holding information in one location where different parties can get access to them.

Relational risk and strategy

As in standard risk assessment, it is possible for relational risks to be high impact but low probability (for example, the death of an entrepreneur in a small company) or low impact and high probability (for example, consumer complaints at the discontinuation of a non-core product).

Relational capital changes slowly, rather like heat in the oceans. This is an advantage and also a reason to be cautious. Individuals, organizations, and nations tend to see relationships as adaptable to economic necessity, and to trade on relational capital even while the resources are being depleted. This passive decision to retain relational risk is unlikely to work long-term. And given the ubiquity of human relationships, avoidance of relational risk is all but impossible. The remaining

[8] See: https://life.indiegogo.com/fundraisers/let-s-send-kids-to-harvard. The fundraising was started by Humans of New York.
[9] See G Meads and J. Ashcroft, *The Case for Interprofessional Collaboration in Health and Social Care* (Oxford: Blackwell, 2005).

strategies are relational risk reduction – in effect, positive action to increase the available relational capital – and to find new ways to distribute risk to stimulate enterprise while discouraging abuse.

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