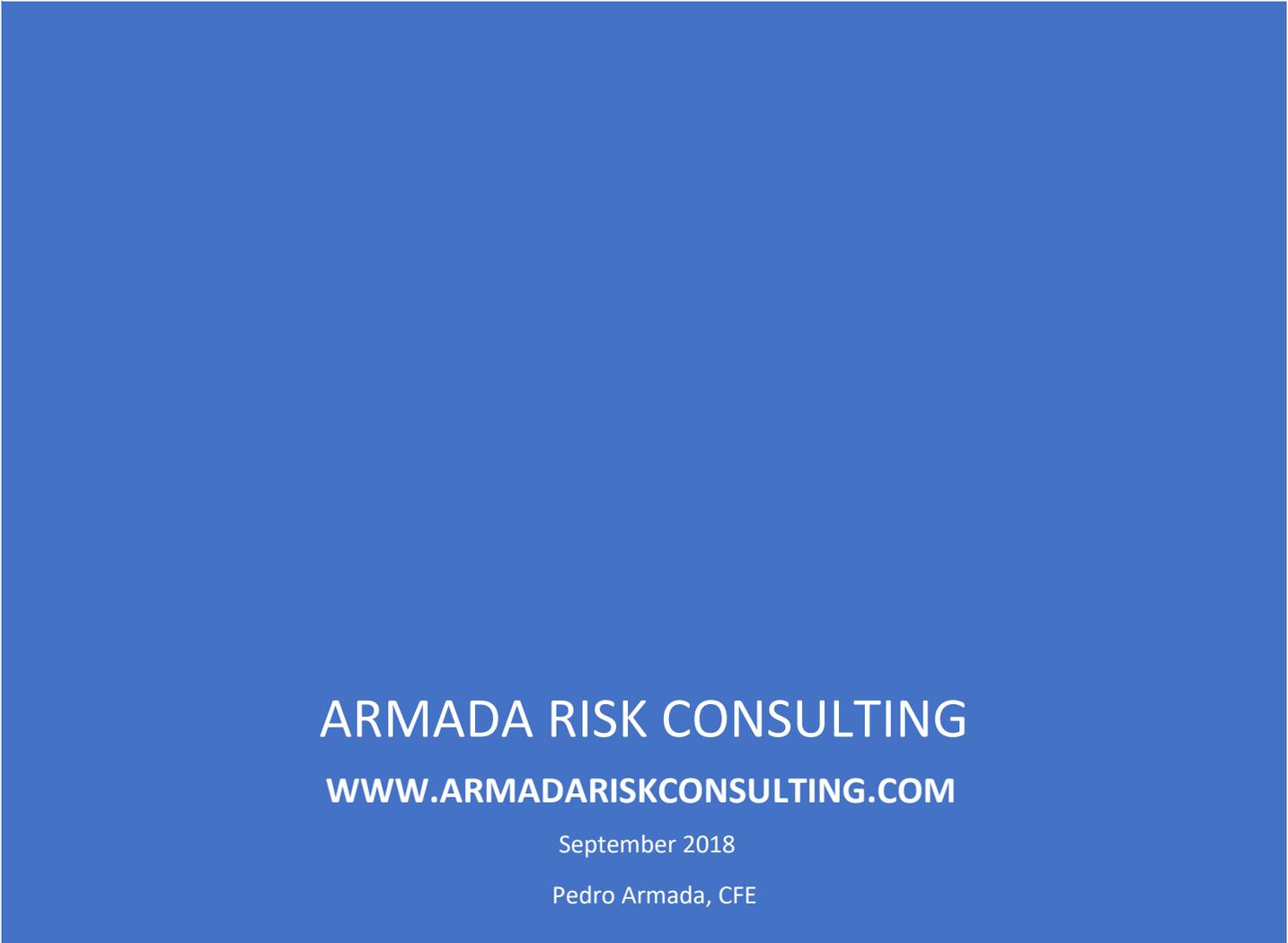




# INTELLIGENCE-BASED RISK MANAGEMENT: LESSONS FROM THE FIELD



**ARMADA RISK CONSULTING**

**[WWW.ARMADARISKCONSULTING.COM](http://WWW.ARMADARISKCONSULTING.COM)**

September 2018

Pedro Armada, CFE

**Contents**

Introduction ..... 2

The Importance of Strategic Risk and Strategic Risk Management within ERM..... 2

Political and Reputational Risk in Emerging Markets ..... 4

Managing Political and Reputational Risk in Latin America: Lessons from the Field..... 6

    Case Studies ..... 7

Conclusion ..... 9

About Armada Risk Consulting ..... 10

Our Team..... 10

## ***Introduction***

Faced with the prospect of an ever-changing and dynamic marketplace, many companies are increasingly cognizant of the importance of risk management. Still, examples of companies mismanaging strategic risks abound.<sup>1</sup> The incomplete implementation of Enterprise Risk Management (“ERM”), the lack of ERM integration with overall company strategy functions, and the blind spots in understanding certain strategic risks are all ingredients in this equation. This paper seeks to explore the importance of certain strategic risks, particularly in emerging markets like Latin America, and how efforts at risk management can benefit from the proper application of intelligence techniques.

## ***The Importance of Strategic Risk and Strategic Risk Management within ERM***

Within the ERM framework established by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) there are several categories of risk. Strategic risks are those risks which are most consequential to the company’s ability to achieve its business objectives and execute its strategies.<sup>2</sup> Both the ERM framework’s definition of the risk management process as intrinsically tied to company strategic objectives, and the inseparability of risk categories such as strategic and operational risks, have led many academics and practitioners to conclude that risk management and ERM are meant to be integrated into a company’s strategic planning.<sup>3</sup> This conclusion has given rise to renewed calls for strategic risk management, or strategic planning, and fuller implementation of the ERM framework. In practice, however, attempts to fully implement strategic risk management are largely incomplete, according to current research.

In 2004,<sup>4</sup> the COSO published its first integrated ERM framework defining ERM as a process, “designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding

---

<sup>1</sup> Devoldere, B. & Slagmulder, R. *Transforming under deep uncertainty: A strategic perspective on risk management*, Business Horizons (2018) 61, 733-743, <https://doi.org/10.1016/j.bushor.2018.05.001>.

<sup>2</sup> Pierce, E.M. & Goldstein, J. *Int J Discl Gov* (2018) 15: 51. <https://doi.org/10.1057/s41310-018-0033-3>

<sup>3</sup> Pierce, E.M. & Goldstein, J. *Int J Discl Gov* (2018) 15: 51. <https://doi.org/10.1057/s41310-018-0033-3>

<sup>4</sup> COSO has since updated this framework as of 2017.

the achievement of entity objectives.”<sup>5</sup> Where traditional risk management has had a narrow focus on, for instance, compliance or insurance risks, ERM is meant to take a company-wide perspective and incorporate/manage strategic *and* traditional risks.<sup>6</sup>

Still, despite the rhetoric, surveys show actual attempts to implement the ERM framework are quite limited.<sup>7</sup> Surveys by *Deloitte*, for example, suggest that ERM is commonly viewed as simply another compliance function rather than one which should provide insight useful for setting and achieving the company’s strategic objectives.<sup>8</sup> In fact, *Deloitte* surveys (2009-2016) indicate that while most managers see ERM as important, only 11% of firms have fully adopted the practice, while, over the last five years, around 60% of companies feel risks have “mostly” or “extensively” changed.<sup>9</sup> Despite this, “strategic risk management,” concludes a study from the *Economist Intelligence Unit*, “remains an immature activity in many companies.”<sup>10</sup> In addition to incomplete implementation of the ERM framework, research suggests risk managers and auditors spend too little time on strategic risks relative to their financial importance for companies. Instead, risk management has historically focused more than half its time on functions like financial reporting, legal, and compliance, despite the fact that most significant losses in market value are caused by strategic risks.<sup>11</sup>

Strategic and operational risks will naturally vary based on a company’s operating environment and strategic objectives. What is clear is that ERM is meant to look at risk management as both a means of defense *and* offense for the company vis-à-vis its *strategy*. Clearly, proper management of strategic risks cannot be solely reactive

---

<sup>5</sup> <https://www.coso.org/Documents/COSO-ERM-Executive-Summary.pdf>

<sup>6</sup> Devoldere, B. & Slagmulder, R. *Transforming under deep uncertainty: A strategic perspective on risk management*, *Business Horizons* (2018) 61, 733-743, <https://doi.org/10.1016/j.bushor.2018.05.001>.

<sup>7</sup> Devoldere, B. & Slagmulder, R. *Transforming under deep uncertainty: A strategic perspective on risk management*, *Business Horizons* (2018) 61, 733-743, <https://doi.org/10.1016/j.bushor.2018.05.001>.

<sup>8</sup> Pierce, E.M. & Goldstein, J. *Int J Discl Gov* (2018) 15: 51. <https://doi.org/10.1057/s41310-018-0033-3>

<sup>9</sup> Pierce, E.M. & Goldstein, J. *Int J Discl Gov* (2018) 15: 51. <https://doi.org/10.1057/s41310-018-0033-3>

<sup>10</sup> <http://www.eiuperspectives.economist.com/strategy-leadership/fall-guys>

<sup>11</sup> A study reported on in the *Harvard Business Review* in 2015 found that strategic risks were responsible for 86% of significant losses in market value over the previous decade. See: “How to Live with Risks,” *Harvard Business Review*, Jul-Aug 2015, <https://hbr.org/2015/07/how-to-live-with-risks>

or episodic. Rather, ERM is meant to integrate a proactive and strategically-oriented approach to managing risk; it is meant to both manage risks and aid the company's strategic planning. This is precisely why risk management efforts can benefit from the application of certain intelligence techniques.

### ***Political and Reputational Risk in Emerging Markets***

The same proactive and strategically-oriented risk management approach that informs the logic of ERM and has fueled calls for strategic planning should inform the way that companies deal with strategic risks. Next, let's explore how approaches to managing key strategic risks—namely, political risk and reputational risk—can benefit from the application of intelligence techniques, especially in emerging markets like Latin America.

Traditionally, political risk (also sometimes referred to as policy risk or regulatory risk) has been defined as the risk posed to investors as a result of government action.<sup>12</sup> Other proposed definitions include, "The risk that a government will discriminatorily change the laws, regulations, or contracts governing an investment—or will fail to enforce them—in a way that reduces an investor's financial returns"<sup>13</sup> or "the probability that a political action will significantly affect," a company's business.<sup>14</sup> Reputational risk is, essentially, the risk of, "possible loss of the organization's reputational capital."<sup>15</sup> What's clear about these two categories of strategic risk, apart from the fact that they can be interrelated, is that they are crucially important in emerging markets like Latin America.

Political risk in emerging markets has changed over the years. Where expropriation was once a chief concern, it is now largely a relic of the past.<sup>16</sup> A larger concern for

---

<sup>12</sup> "What is political risk?" *The Economist*, 8 June 2017. See: <https://www.economist.com/the-economist-explains/2017/06/08/what-is-political-risk>

<sup>13</sup> Henisz, W.J. & Zelner, B.A., "The Hidden Risks in Emerging Markets," *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets>

<sup>14</sup> Rice, C. & Zegart, A., "Managing 21<sup>st</sup>-Century Political Risk," *Harvard Business Review*, May-June, 2018 See: <https://hbr.org/2018/05/managing-21st-century-political-risk>

<sup>15</sup> <http://lexicon.ft.com/Term?term=reputational-risk>

<sup>16</sup> Henisz, W.J. & Zelner, B.A., "The Hidden Risks in Emerging Markets," *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets>.

companies today comes from more subtle forms of regulatory control as opposed to outright expropriations.<sup>17</sup> This has also been termed, “creeping expropriation,” whereby governments create difficulties for company operations and eventually force significant losses or a closure of operations.<sup>18</sup> For example, a company in the investment stage of an extractives project in an emerging market may find that the host country government begins to create artificial, bureaucratic barriers, to slow down progress, until, suddenly, a crucial permit is not approved or is rescinded and the project can no longer proceed.

In any case, the fact remains that while outright expropriations have largely declined, political risk has become increasingly important in emerging markets having dramatically increased since the 1980s.<sup>19</sup> Recent (February 2018) research by insurance broker *Willis Towers Watson* has found that more than 50% of companies with revenues of at least \$1 billion have experienced losses of over \$100 million due to political risks, of key concern in emerging markets.<sup>20</sup>

But reputational risks, also of crucial importance, can be interrelated with political risks. To understand this, one need only recall the effects of Odebrecht SA’s recent involvement in a major bribery scandal and the effect this had on the company’s bond prices, or the negative media sentiment toward AES in the wake of the 1997 Christmas black out in Brazil, which contributed to the award of a major energy supply contract to a competing consortium.<sup>21</sup>

---

<sup>17</sup> Henisz, W.J. & Zelner, B.A., “The Hidden Risks in Emerging Markets,” *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets>

<sup>18</sup> Ralph, O., “Global political risks pose growing threat to companies,” *Financial Times*, 23 February 2018. See: <https://www.ft.com/content/b3e18b26-bdc0-11e8-8274-55b72926558f>

<sup>19</sup> Henisz, W.J. & Zelner, B.A., “The Hidden Risks in Emerging Markets,” *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets>

<sup>20</sup> Ralph, O., “Global political risks pose growing threat to companies,” *Financial Times*, 23 February 2018. See: <https://www.ft.com/content/b3e18b26-bdc0-11e8-8274-55b72926558f>

<sup>21</sup> Henisz, W.J. & Zelner, B.A., “The Hidden Risks in Emerging Markets,” *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets> and Parra-Bernal, G. & Federowski, B. “Odebrecht bonds slump as scandal spillover fans investor skepticism,” *Reuters*, 3 March 2017, See: <https://www.reuters.com/article/odebrecht-bonds-idUSL2N1GG0YQ>

## ***Managing Political and Reputational Risk in Latin America: Lessons from the Field***

While it's clear that political and reputational risks are of critical importance for companies operating in emerging markets, devising adequate strategies for managing such risks can be challenging for many companies. Our experience in Latin America has been that the evolution of political and reputational risks (among other risk categories) can often have geopolitical aspects that are critical to consider, and that intelligence techniques, when properly applied, are of significant help.

The adaptation of various techniques common in intelligence circles—such as stakeholder risk management, scenario planning, war-gaming, and influence mapping—to risk management exercises has gained increasing currency in management literature of late.<sup>22</sup> However, while it is true that, as such literature points out, these techniques are aimed at fostering creative thinking and that firms can benefit from hiring outside experts such as global political consultancies,<sup>23</sup> there is also a critical missing ingredient from these discussions, namely, the role of human intelligence (“HUMINT”). It is the combination of well-sourced, actionable, strategically valuable HUMINT<sup>24</sup> with proper analysis that is best suited to help companies manage strategic risks, especially in complex regions like Latin America.

It is precisely well-sourced HUMINT that allows for those with the proper expertise to conduct an analysis that can drastically improve a company's predictive and planning capabilities. This process allows us to answer questions like, “If X happens, how will X affect Y and Z?” and facilitates company risk management and adoption of contingency plans in complex operating environments. Thus, the above-described intelligence techniques cannot be limited to insular exercises merely aimed at fostering “creative thinking” nor can companies depend fully on global political

---

<sup>22</sup> Henisz, W.J. & Zelner, B.A., “The Hidden Risks in Emerging Markets,” *Harvard Business Review*, April 2010. See: <https://hbr.org/2010/04/the-hidden-risks-in-emerging-markets> and Rice, C. & Zegart, A., “Managing 21<sup>st</sup>-Century Political Risk,” *Harvard Business Review*, May-June, 2018 See: <https://hbr.org/2018/05/managing-21st-century-political-risk>.

<sup>23</sup> Ibid.

<sup>24</sup> For more on our view of what this means, see: <https://www.armadariskconsulting.com/single-post/2018/08/07/Separating-Fact-from-Fiction-Perceptions-of-HUMINT>

consultancies who limit themselves to analyzing open sources of information. Ultimately, an approach limited strictly to analyzing open sources from an office in London or New York leads to circumscriptive induction rather than allowing for a more deductive, intelligence and field-based approach.

Indeed, today's competitive market requires a strategic rather than an episodic or reactive approach to risk management and even "traditional" compliance activities. There is something to be said for *Lego's* more proactive approach of, "keeping an eye out for potential risks and opportunities," as opposed to conducting *ad hoc* analyses only when issues arise.<sup>25</sup> For example, in our experience, a pre-transactional due diligence exercise is often seen as a subset of compliance activity, but we find that diligence adds significantly more value in markets like Latin America when it is executed with a view towards the company's existing strategy. Our view is that diligence should seek to move far beyond issue-spotting and provide companies with context about, *inter alia*, how potential issues with a target may develop, how key stakeholders/players in the market are involved with those potential issues, and how those issues/stakeholders are likely to affect the company's strategic objectives in the future. The critical ingredients in these sorts of Strategic Due Diligence exercises are, given our experience, proper HUMINT, open source intelligence, and proper analysis.

### Case Studies

Below we present illustrative case studies that highlight the effectiveness of a more strategic and intelligence-based risk management approach. Details have been altered in order to preserve client confidentiality.

#### **Acquisition in the Services Industry: ServCo**

We were approached to assist with a pre-acquisition reputational due diligence on ServCo, a multinational company in the services industry. The client expressed significant concern over ServCo's Latin American operations given

---

<sup>25</sup> Rice, C. & Zegart, A., "Managing 21<sup>st</sup>-Century Political Risk," *Harvard Business Review*, May-June, 2018 See: <https://hbr.org/2018/05/managing-21st-century-political-risk>.

regulatory/compliance risks inherent in ServCo's industry, such as AML concerns and corruption, which are particularly acute in Latin America. The client had already worked internally with its compliance team to identify the four (4) countries in particular that it considered "risk hotspots" for the acquisition. Our work involved significant gathering of HUMINT in those countries from key industry contacts, government officials, and others. Through open source information and HUMINT, we assisted the client in identifying potential legal and reputational risks at ServCo's various regional subsidiaries. However, one country in particular, Country X, raised additional questions.

ServCo had entered the market in Country X in the 1990s through concessions and privatizations spearheaded by President A, who was in power at the time. President B, the immediate successor of President A, came to power having run on a campaign of rooting out corruption in government. President B's government began investigating a number of cases of corruption involving the prior administration. President B went on to make public statements questioning ServCo's licenses as an ongoing investigation of President A's dealings with a local ServCo partner wound its way through the courts. President A was eventually arrested and detained for some time, but the criminal investigation lost steam years later and was closed.

This situation left the Client with a critical question:

*Could the issues raised by President B regarding ServCo's licenses likely become problematic under the current administration of President C or under a future administration?*

Not only did our HUMINT collection disclose credible *indicia* of an extortion campaign by President B against both ServCo and President A, but also, our open source research allowed us to clarify pending legal questions regarding the matter for the Client. Finally, we provided a forecast using these data points to answer the Client's question of potential *future* reputational risk to ServCo by contextualizing the political obligations and constraints of President C regarding ServCo, its industry, and the actions of President B as well as examining potential outcomes for ServCo. The Client went on to acquire ServCo.

## **Joint Venture in the Finance Industry: BankCo**

Our Client was considering a joint venture with, BankCo, a significant player in Country Y's financial markets and the broader region. However, the Client had reservations about certain reputational risks involving the joint venture. Namely, BankCo's president and founder, Jose Borero ("Borero"), had been the subject of accusations of involvement in money laundering and his relationship with Country Y's embattled President P was not immediately clear. To make matters worse, Country Y had been plunged into political unrest by ongoing street protests against President P. Separately, BankCo's operations in Country Z had raised concerns due to AML enforcement actions there.

We leveraged our HUMINT source network to obtain further granular details about the money laundering accusations against Borero, his relationship with President P, and enforcement actions against BankCo in countries Y and Z. In addition, using both HUMINT and open sources, we analyzed the strategic obligations and constraints of Borero, key players in his industry, and President P (and his loyalists). We then conducted analysis on both macro and more granular issues of concern to the client. We provided a scenario-based geopolitical forecast outlining the past and present operating environments of countries Y and Z as well as a forecast of likely geopolitical scenarios affecting both countries, Borero and BankCo's operations there. The key was having the necessary well-sourced, actionable, and strategically valuable intelligence from sources on the ground in Country Y in order to analyze the constraints, obligations, and likely future actions of the key actors, including Borero. The Client opted for a proactive approach of conducting periodic intelligence monitoring of both countries through our source network in order to better evaluate and mitigate the risks within the structure of the proposed joint venture.

## ***Conclusion***

The risk landscape for companies operating in today's global marketplace, let alone in emerging markets, is increasingly complex. Despite calls for implementation of ERM and a more strategic approach to risk management, industry has been slow to adopt these frameworks. There are, however, heartening signs that many

companies are beginning to appreciate a more strategic approach to managing risk. Properly implemented intelligence techniques, fueled by both proper analysis and HUMINT, can serve as tools for strategic risk management. Used effectively, in the context of a proactive strategic risk management approach, these tools can improve companies' predictive and planning capabilities and help manage the risks of an increasingly fraught global marketplace.

### ***About Armada Risk Consulting***

Armada Risk Consulting is a boutique consulting firm based in Panama City, Panama, that was founded to provide bespoke strategic intelligence and risk advisory services across Latin America. By leveraging our deep knowledge of local markets and our extensive network of contacts across Latin America, we help our clients understand and mitigate risks, so they can inform their legal and business decisions. Our professionals have experience servicing clients ranging from multinationals to family offices and approach every matter with a keen legal mindset and exacting professional discipline.

Learn more at: [www.armadariskconsulting.com](http://www.armadariskconsulting.com)

### ***Our Team***

#### ***Pedro Armada, Founder and President***

Pedro is an experienced investigator and risk consultant having worked in the industry since 2009. Prior to founding Armada Risk Consulting, he worked as an investigator conducting national security and suitability background investigations on behalf of the US government.

Pedro later spent half a decade managing investigations including FCPA/White Collar defense, internal investigations, asset tracing, cross-border litigation/arbitration support, and due diligence matters across Latin America for an international investigative firm with clients that include Fortune 500 companies, hedge funds, financial institutions, and high net worth individuals. Over the years, he has managed and conducted high-risk and complex engagements in virtually every jurisdiction in Latin America.

He is a Certified Fraud Examiner and a Certified Forensic and Investigative Auditor. He holds a BA in Political Science and Philosophy from Florida International University (US) and is completing an MSc in Forensic Accounting via the University of Portsmouth (UK). He is a native Spanish speaker and is fluent in English and Portuguese.

*Diego Solis, Managing Director, Strategic Intelligence*

As head of Armada Risk Consulting's Strategic Intelligence function, Diego Solis helps clients make sense of Latin America's operating environment, by combining strategic, human intelligence with analysis of the geopolitical dynamics of the region. In addition to maintaining a first-class network of regional sources, to guarantee the quality of our top-notch field investigations, Diego also oversees and manages Armada Risk Consulting's Latin America-based field investigators.

Prior to joining Armada Risk Consulting, Diego was Regional Director for Latin America at Stratfor, a US geopolitical intelligence firm. At Stratfor, Diego conducted sensitive field investigations throughout Latin America while analyzing the geopolitical drivers that influence the behavior of government entities. Prior to this position, Diego was Strategic Management Advisor at a high-net worth Latin America-based private investment group. Diego has roughly a decade of field experience, having conducted field work in various high-stakes environments, including, Afghanistan, Iran, the rainforests of the Congo, the mountains of the Russian North Caucasus, and the slums of Venezuela.

Diego graduated with a bachelor's degree in business administration, from Embry-Riddle Aeronautical University. He also obtained a Master of Science in Geopolitics & Security in the prestigious Dept. of Geography at Royal Holloway, University of London, graduating with merits. Diego is a fluent speaker of English, Spanish, French, Italian and Portuguese, he also speaks Mandarin at an intermediate level.

*Eduardo Lamphrey, Managing Director, Legal Affairs*

Eduardo is a qualified attorney admitted to the bar in Panama. A seasoned investigator, litigator and counselor, he has represented companies and individuals

in countless civil, criminal, administrative and labor matters before Panamanian tribunals and advised clients on matters ranging from company formation and real estate transactions to trust/estate law and commercial/criminal disputes. Before beginning his legal career, Eduardo served in the Colombian Army in Military Police and Anti-Guerrilla units.

Eduardo manages various aspects of field investigations for Armada Risk Consulting, particularly in Panama and Colombia. He has published two books as well as several articles on legal topics in major newspapers in Panama. He holds an LLB from the University of Panama, a Bachelor's in Religious Studies from the Catholic University of Santa María la Antigua (Panama) and diplomas in: forensics and expert witnessing as well as mediation and dispute resolution from the University of Panama where he is also completing an LLM in Procedural Law. He is a native Spanish speaker and has intermediate knowledge of English.