

Strategic Risk Management: The next frontier for ERM

By James Lam

Introduction

Sweat the big stuff first. Senior management should—and usually does—focus on major decisions that have a significant impact on a company. Perhaps the most important task senior management ever tackles is setting appropriate priorities to deploy the limited resources available.

Take, for example, the capital spending approval process. Proposed investments generally exceed the allocated budget, so each must undergo rigorous evaluation to determine which projects offer the most attractive risk/reward trade-offs. But the amount matters too—a \$20 million strategic investment in a new product launch may require board approval, while a department head may have authority to spend \$200,000 on a software upgrade. Senior management handles the big-ticket items and delegates authority for smaller-scale capital investments to middle management.

Why do most enterprise risk management programs reverse this approach? Studies of the largest public companies have shown time and again that strategic risks account

for approximately 60 percent of major declines in market capitalization, followed by operational risks (about 30 percent), and financial risks (about 10 percent).¹ Yet in practice, many ERM programs downplay strategic risks or ignore them altogether.

This misdirected effort assumes greater importance because so many strategic initiatives fall short of expectations. Although the oft-quoted 70 percent failure rate enshrined in management lore lacks empirical support,² complete success is still the exception rather than the rule. In 2008, John Kotter, a leading expert in change management, summed up his experience:

“From years of study, I estimate today more than 70 percent of needed change either fails to be launched, even though some people clearly see the need, fails to be completed, even though some people exhaust themselves trying, or finishes over budget, late and with initial aspirations unmet.”³

Whatever the true failure rate for strategic initiatives, companies have every incentive to improve

1. Lam, J. “Risk Management: The ERM Guide from AFP.” (2011). Association for Financial Professionals. Retrieved from http://www.jameslam.com/images/PDF/AFP%20Enterprise%20Risk%20Management%20Guide_Lam%202012.pdf

2. Hughes, M. (2011). “Do 70 Percent of All Organizational Change Initiatives Really Fail?” *Journal of Change Management*.

3. Kotter, J. (2008). *A Sense of Urgency*. Boston, MA: Harvard Business Review.

performance through higher outright or partial success of their strategic plans.

If the goal of ERM is to enable management to identify, prioritize, and manage risk, ERM programs ought to focus first on strategic risks, followed by operational risks. The financial risks that dominate ERM today should come a distant third.

ERM professionals have focused on financial risks because they are easy to quantify and universally applicable. Several high-profile trading disasters at financial firms have shifted attention over the past decade toward operational risks even though they are harder to measure.

The difficulty lies in the nature of operational mishaps—the vast majority of which are commonplace but financially insignificant. On the rare occasions when operational controls do break down, the consequences can be devastating, and not only for banks. The 2010 Deepwater Horizon catastrophe inflicted enormous financial and reputational damage on British Petroleum, Transocean, and Halliburton.

But the latest yardsticks developed to measure financial risk, economic capital and risk-adjusted return on capital (RAROC), can be applied to operational and strategic risks as well. These measures pave the way for strategic risk management to become a top priority for ERM practitioners—the next frontier in the struggle to control and manage risk.

What is the difference between operational and strategic risk? A company that has unmatched manufacturing processes will still fail if consumers no longer want its products. Whether they knew it or not, even the most efficient buggy whip makers faced an existential threat in 1908 when Henry Ford introduced the Model T. In more recent times, Apple transformed the competitive landscape for cellular handset makers the day it launched the first iPhone. Good strategy means doing the right things, while good operations means doing things right—successful companies must do both.

The ability to recognize and manage strategic risks is critical to the sustainable success of any company. The rest of this paper explains:

- How to integrate strategic risks into the planning process

- The use of economic capital and risk-adjusted return on capital to measure these risks
- How to apply the results in practice

Strategic planning

Companies often start their strategic planning with a SWOT (strengths, weaknesses, opportunities, and threats) analysis to determine where best to focus new initiatives.

Having established priorities for future investments, many companies use Kaplan and Norton's Balanced Scorecard to evaluate each initiative from different perspectives, including customers, internal business processes, organizational capacity (knowledge and innovation), and financial performance. Others prefer Michael Porter's Five Forces model, which analyzes how new initiatives are affected by supplier power, buyer power, competitive rivalry, threat of substitution, and threat of new entry.

Companies that ignore risk in the planning process forgo the opportunity to manage the shape of [the risk bell curve].

These popular strategic planning tools bring structure to the process, but risk professionals have long recognized they suffer from a major flaw—they do not take risk into account.⁴ In the aftermath of the 2008 financial crisis, Kaplan himself acknowledged the shortcoming, "...the measurement, mitigation, and management of risk have not been strongly featured in David Norton's and my work."⁵

Rigorous use of standard planning tools generates an expected value for each strategic initiative, without regard to the distribution of outcomes around the expected value if things do not work out as planned. This kind of risk can also be expressed as a bell curve centered on the expected value. Companies that ignore risk in the planning process forgo the opportunity to manage the shape of that curve.

For example, two initiatives with identical expected values may have quite different risk profiles. One may have a narrow bell, which implies a high probability the expected outcome

4. "A good case can be made that the balanced scorecard (or any other business reporting methodology) should include a risk assessment, either as a separate category or as a part of each of the four performance components." Lam, J. (2003). *Enterprise Risk Management, First Edition*. Hoboken, NJ: John Wiley & Sons.

5. Kaplan, R. "Risk Management and the Strategy Execution System." (2009). Balanced Scorecard Report, Vol. 11, No. 6. Retrieved from <http://www.exed.hbs.edu/assets/Documents/risk-management-strategy.pdf>

will occur, low risk of failure, and little opportunity for an unexpected windfall. The other may have a wide bell, which suggests an outcome other than the expected value—for better or worse—is more likely. Planning tools give no guidance on how to choose between the two, and the right choice will not be the same in every case because companies have different appetites for risk.

What qualifies as a strategic risk? Again, it's the big stuff—any risks that affect or are inherent in a company's business strategy, strategic objectives, and strategy execution. The list includes:

- Consumer demand
- Legal and regulatory change
- Competitive pressure
- Merger integration
- Technology change
- Senior management turnover
- Stakeholder pressure

Other risks may qualify for particular companies depending on the nature of their businesses. In a 2013 Deloitte report, Siemens, the European conglomerate, captures the spirit in its broad definition of strategic risk: "everything, every obstacle, every issue that has the potential to materially affect the achievement of our strategic objectives."⁶

Measuring strategic risk

Identification is the first step, but before a company can manage risks, it must measure them. One of the best available metrics is economic capital—the amount of equity required to cover unexpected losses based on a predetermined solvency standard, typically derived from the company's target debt rating.

Applying a consistent measure of volatility, the economic capital required to support individual risks can be calculated and the results aggregated across all risks, taking correlation effects into account. Economic capital is a common currency in which any risk can be quantified. It also applies the same methodology and assumptions in determining enterprise value. For strategic risks, the calculation is forward-looking—for example, the cushion required to support new product

launches, potential acquisitions, or withstand anticipated competitive pressure.

Dividing the anticipated after-tax return on each strategic initiative by the economic capital generates RAROC (risk adjusted return on capital). If RAROC exceeds the company's cost of capital, the initiative is viable and will add value. If RAROC is less than the cost of capital, it will destroy value.

However, the decision whether to back an initiative should not depend on a single case reflecting the expected value. The company should run the numbers for multiple scenarios to see the distribution of results in both more and less favorable circumstances, or in combinations of better and worse conditions over time. The final decision will depend on the specific company's risk appetite.

Risk management is a dynamic process in which information flows from line managers up to senior managers who monitor progress and, when necessary, develop action plans and send instructions back down to line managers.

Economic capital and RAROC analyses work for both organic growth initiatives and potential acquisitions. In mergers and acquisitions, a company can leverage economic capital and RAROC to evaluate how the enterprise risk profile of a potential acquisition would complement its own. As decision support for the board and management, this analysis can quantify the risk/return economics of the merger, including diversification benefits, debt rating impacts, enterprise value and earnings, as well as the maximum price that the company should be willing to pay.

A decision tree that maps the probabilities and consequences⁷ of different outcomes not only provides a better feel for the risks and rewards, but also helps identify trigger points for action if the initiative lags behind expectations. The optimum risk management profile resembles a call option: limited

6. "Exploring Strategic Risk." (2013). Deloitte. Retrieved from <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Governance-Risk-Compliance/dttl-grc-exploring-strategic-risk.pdf>

7. The classic decision tree is a similar construct as a bell curve, except that it is displayed sideways and used to support decision making at critical junctures.

downside exposure with unlimited upside potential. The sooner a company recognizes an initiative is in trouble, the sooner it can take corrective action—whether that be to steer the initiative back on track, deploy risk mitigation strategies, or shut it down.

Managing strategic risk

Risk measurements have limited value unless the company has a robust procedure for monitoring, feedback, and action. Suppose a company does the preliminary analysis described above and approves a new initiative. Six months later, if results come in ahead of expectations, the company could decide to accelerate the plan to take advantage of the early success—but only if senior management knows what has happened.

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The nature of new initiatives approved and the triggers for acceleration or corrective action all depend on a company's risk appetite. ERM implementation requires a company to create a risk appetite statement that defines how much risk it will take in pursuit of its business strategy. For strategic risks, the risk appetite metrics are typically defined through the potential impact on earnings, enterprise value from adverse business decisions, or lack of response to industry changes.

To support strategic risk management decisions, the company's performance management system must integrate

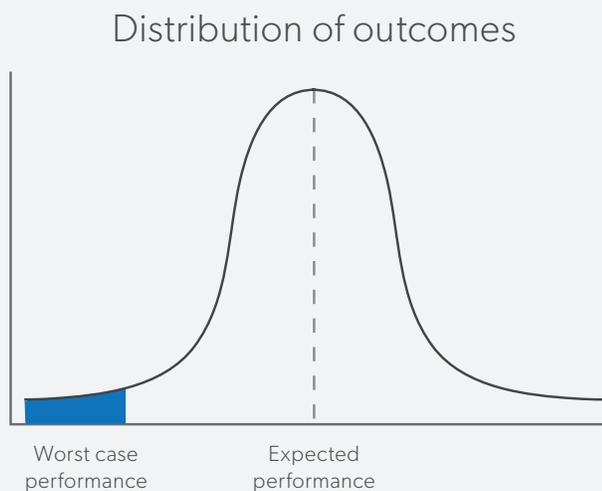
key performance indicators (KPIs) and key risk indicators (KRIs). This process is illustrated in exhibit A. As with any other risk, strategic risk can be depicted as a bell curve, with the expected level of performance in the center of the distribution. ERM should focus on mitigating downside risk, i.e., worst-case performance, but also help management optimize overall risk-return trade-offs.

In this integrated process, the company:

1. Defines its business strategy and a defined set of strategic objectives
2. Establishes KPIs and targets based on expected performance for those strategic objectives
3. Identifies strategic risks that can drive variability in actual performance for better or worse through risk assessments
4. Establishes KRIs and risk tolerance levels for those critical risks
5. Provides integrated reporting and monitoring in support of strategic risk management

Unfortunately, many companies perform steps 1 and 2 through the strategic planning and/or finance functions and report the results to the executive committee and full board. Separately, they perform steps 3 and 4 through the risk function and report the results to the risk and audit committees. In order to effectively manage strategic risks, these steps must be fully integrated.

Exhibit A: Integrating performance and risk monitoring



Integrating strategy and ERM

1. Define business strategy and objectives
2. Establish KPIs based on expected performance
3. Identify risks that can drive variability in performance (risk assessments)
4. Establish KRIs for critical risks
5. Provide integrated monitoring with respect to 1–4

Practical examples

Duke Energy – In the late 1990s, the market for electric power went through wrenching change when states began to deregulate utilities. At a strategy session in July 2000, Duke Energy identified three possible scenarios for its future business environment:⁸

- Economic Treadmill, in which U.S. economic growth would stagnate at 1 percent per year
- Market.com, in which the internet would revolutionize the relationships between buyers and sellers
- Flawed Competition, in which uneven deregulation would continue in the energy industry, causing significant price volatility in different regions

The timing proved prescient. Duke had appointed its first chief risk officer earlier that year, and the U.S. economy had begun the slide that burst the internet bubble.

Duke set early warning signals for each scenario:

- Macroeconomic indicators
- Regulatory trends
- Technology changes
- Environment issues
- Competitive moves
- Patterns of consolidation in the energy industry

It soon became apparent that Flawed Competition was the most likely outcome, which enabled Duke to take evasive action against potential adverse consequences. Unlike many competitors, Duke scaled back its capacity expansion and concentrated on maximizing returns from its existing portfolio—even if that meant shedding assets. Anticipating oversupply of power generation in Texas in the coming years, Duke sold some new plant projects in the state before construction was complete.

Duke reaped the rewards of its foresight in subsequent years and has continued to perform well relative to its competitors. As shown on their company website, in the five years through November 2014, Duke stock rose by 69%.⁹

Citigroup – In the early 1990s, Citigroup suffered severe losses from three separate crises: developing nation debt default/restructuring, U.S. residential mortgages, and commercial real estate. Senior management recognized the need for a global process for scenario planning and risk management to flag potential problems earlier, which resulted in its Windows on Risk program.

Upon launch in 1994, Citigroup called it a system that “regularly monitors the state of the economy in different countries and the extent to which the bank’s exposure to lending, underwriting, or trading might be affected according to 12 key factors.” In 1999, Windows on Risk had expanded into “a forum for reviewing risk tolerance and practices,” and by 2002 it was embedded in Citigroup’s Balanced Scorecard planning.¹⁰

In essence, Windows on Risk involves the development of a global business outlook, risk analyses, and tripwires in 16 windows, e.g., country risk, industry concentration, technology risk, etc., as well as preemptive plans for risk management strategies to mitigate each risk if it occurs. The process soon proved its worth: In 1997 Citigroup weathered the Asian currency crisis better than most of its competitors.¹¹

GE Capital – During the 1990s, GE Capital created Policy 6.0, a strategic risk management framework applied to all new businesses, products, and investments. It requires a detailed analysis of strategic risks associated with any new initiative and quarterly reviews between business leaders and GE corporate executives to check that the business is performing at or above expectations. The major components of Policy 6.0 include:¹²

- Key assumptions: The new business must identify the key assumptions that support its feasibility, which often represent the most critical strategic risks, including business trends, customer needs, and disruptive technologies.

8. Wysocki, B. (2000, July 7). Power Grid: Soft Landing or Hard? *Wall Street Journal*. Retrieved from https://business.illinois.edu/~s-darcy/Fin590/2005/WSJ_July%207%202000.pdf

9. “Stock Information.” (2015). Duke Energy Corporation. Retrieved from <http://www.duke-energy.com/investors/stock-information.asp>.

10. Gilad, B. (2003). *Early Warning: Using Competitive Intelligence to Anticipate Market Shifts, Control Risk, and Create Powerful Strategies*. New York, NY: AMACOM.

11. “Weathering financial crises: bond markets in Asia and the Pacific.” (2012). BIS Papers: No. 63. Retrieved from <http://www.bis.org/publ/bppdf/bispap63.htm>

12. “GE Capital Finance Overview.” (2008). GE. Retrieved from http://www.ge.com/pdf/investors/events/12022008/ge_webcast_presentation_12022008.pdf

- **Monitoring systems:** For each assumption, the business must identify monitoring systems for key performance indicators, key risk indicators, and early warning indicators. They must also specify the individuals responsible for oversight.
- **Trigger points:** For critical metrics, the business must establish predefined positive, expected, and negative trigger points, which initiate management action between quarterly reviews. Breaches of significant thresholds may trigger immediate escalation and special reviews.
- **Management decisions and actions:** Positive signals mean things are going better than expected, which may prompt management to accelerate the business plan or take more risk. Negative signals give management the opportunity to initiate risk mitigation strategies, or, if key metrics and trends are well below expectations, an exit strategy.

A strategic risk management framework helps management allocate scarce human and financial resources to the most successful initiatives and take corrective action to forestall losses from unsuccessful projects.

Although these companies are engaged in quite different businesses, their strategic risk management has three common themes:

1. Strategic planning and analysis
2. Metrics and trigger points
3. Decisions and actions

A strategic risk management framework helps management allocate scarce human and financial resources to the most

successful initiatives and take corrective action to forestall losses from unsuccessful projects.

Conclusion

Although strategic risks pose the greatest threat to most companies, few have yet incorporated strategic risk management into their ERM program. Strategic initiatives always involve risk, and some will not pan out as expected no matter how carefully planned.

Companies that manage strategic risk skew the outcome in their favor. They can ramp up initiatives that exceed expectations and spot potential losses in time to take corrective action before significant losses accumulate. Risk management should improve the percentage of successful initiatives, but even if it does not, the process creates a financial profile similar to a call option, with limited downside risk and unlimited upside potential.

One key benefit of strategic risk management is early warning of potential problems. If an initiative falls behind expectations, alarms sound. Management then has the opportunity to redirect the effort, lay off risk, or if the project is unable to be salvaged, implement an exit strategy early on. The ability to fail faster will improve a company's financial performance.

Lack of reliable metrics is no longer an obstacle to strategic risk management. Economic capital is a common currency in which any risk can be quantified, and the RAROC expected in various scenarios allows management to determine which initiatives mesh best with the company's risk appetite.

Even Robert Kaplan recognizes how important risk management has become to companies and their executives: "...despite the difficulty of risk management, senior executives who avoid, de-emphasize, or delegate it do so at their peril."¹³

Robust ERM programs already boast a lower cost of capital, higher growth, and greater appreciation in the stock market. Companies that integrate strategic risk into their ERM frameworks will likely further enhance all three attributes to the benefit of shareholders, other stakeholders, and society at large.

13. Kaplan, R. "Risk Management and the Strategy Execution System." (2009). Balanced Scorecard Report, Vol. 11, No. 6. Retrieved from <http://www.exed.hbs.edu/assets/Documents/risk-management-strategy.pdf>

About the author



With over 25 years of risk management experience, James Lam is often cited as being the first Chief Risk Officer. An early advocate for enterprise risk management, he served as Partner of Oliver Wyman, Founder and President of ERisk, Chief Risk Officer of Fidelity Investments, and Chief Risk Officer of GE Capital Market Services.

Lam is currently the president of James Lam & Associates, a leading risk management consulting firm. In addition, he is a member of the Board of Directors at E*TRADE Financial Corporation where he was named Chair of the Risk Oversight Committee. James also serves as a Senior Advisor for Workiva.

Lam's many accolades include receiving the inaugural Risk Manager of the Year Award from the Global Association of Risk Professionals in 1997. Additionally, he was named one of the "100 Most Influential People in Finance" three times by *Treasury & Risk Management* magazine.

After receiving his BBA from Baruch College and graduating summa cum laude, Lam completed his MBA with honors at UCLA. In addition to lecturing at Harvard Business School, he has taught courses in risk management at Babson College and Hult International Business School.

About Workiva

Workiva (NYSE:WK) created Wdesk, a cloud-based platform for enterprises to collect, manage, report, and analyze business data in real time. Wdesk includes a sophisticated productivity suite for business data collaboration and reporting that is used by thousands of corporations, including more than 65 percent of the Fortune 500. See what we can do for you at workiva.com.