Integrating Risk Management With Strategy

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ERM Design Framework

Risk Management as a Component of Enterprise Management

Build & Drive Culture
Enabling activities to operationalize ERM

Build Infrastructure

Policy, Processes, Organization, Reporting, Methodology, Systems & Data

Design Risk Management Process

Identify risks
Assess risks
Prioritize risks
Develop action plans
Test, and monitor risks
Integrate results

Business objectives and strategies

Integrate with Management Processes

Key Planning & Management Processes
The Bulletin

10 Lessons in Integrating Risk Management with Strategy

In recent years, much has been learned about the importance of integrating risk into strategy setting. This integration theme is vital because, if it is ignored, risk becomes an afterthought to strategy and an appendage to performance management.

We’ve distilled the learnings down to 10 lessons for executives and directors to keep in mind when integrating risk into the process of formulating and executing strategy.

What We Don’t Know May Be More Important Than What We Do Know

Focusing on what we don’t know requires a process. One approach is to define the critical assumptions representing management’s view of the business environment during the strategic planning time horizon. These assumptions reflect management’s view concerning the enterprise’s capabilities, competitors’ capabilities and likely actions, expected customer preferences, technological trends, capital availability, and regulatory trends, among other things. They are what two co-authors refer to as management’s “white swans.” These assumptions are important because the strategy is based on them.

One way to cope with uncertainty is to consider the impact if one or more strategic assumptions become invalid. Once management’s assumptions are defined, contrarian statements are developed to suggest plausible as well as extreme scenarios that could affect one or more of them. Management and directors then select the contrarian statements that are likely to have the greatest impact on the company’s ability to execute its strategy and business model if they were to transpire. These high-impact statements would ordinarily reflect situations that would arise from events about which the organization currently lacks sufficient information and that management would likely rationalize after the fact: “Why didn’t we see it coming?”

For the high-impact contrarian statements, management should develop implication statements. An implication statement resolves the conflict between the strategic assumption and contrarian statement by addressing two questions: “What would we do if this assumption underlying our strategy were no longer valid?” and “How would we know if the assumption were no longer valid or were becoming invalid?” As with many strategic uncertainties, action plans arising from an implication statement often include implementing forward-looking trending and other metrics to monitor the vital signs that provide insights regarding the continued validity of the assumptions.

Because no one knows for sure what’s going to happen in the future, the above analysis would at least help management

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2 ibid., pages 53-67.
What we don’t know may be more important than what we do know.

A process is required to do this well…

1. Define strategic assumptions
2. Develop contrarian statements
3. Develop implication statements

Resolves the conflict between the strategic assumption and the contrarian statement.
Financial Crisis Example

Leverage cheap money to achieve volume and speed in lending to the low-income housing (or subprime) sector to facilitate the securitization and sale of these loans as collateralized mortgage obligations (CMOs).

1. Assumption: Increasing or at least stable housing prices.
2. Contrarian: The housing market takes a dive across all segments of the loan portfolio.
3. Implication: Monitor housing market indicators in all US segments with significant loan concentration; monitor sale prices.
#2 – Sooner or later, something fundamental in your business will change

*Competitive intelligence needs to be aligned with what really matters.*

1. **Recall those strategic assumptions?**
2. **Focus intelligence gathering**
3. **Result may be a fundamental change!**
#2 – Sooner or later, something fundamental in your business will change

Borders Example
(could also do Kodak, Encyclopedia Britannica, Blockbuster, etc.)

1. Assumption: Expansive selection of media, including hard to find titles, will make Borders the “place to go”.  

2. Contrarian: The emergence of the internet as a retailing channel poses a significant threat.

3. Implication: Retail brick and mortar bookstores become a relic as customers use the internet to purchase what they want – competitors invest in online capabilities and e-readers.

Competitive Landscape...
The validity of management’s strategic assumptions will come into question over time.

1. Status quo bias – are you in love with your business model?

   Results in a company being overly focused on doing things better, faster, cheaper…

   … and not being focused on competitive intelligence, game changing opportunities, and market disruption

2. Early movers recognize the risk/ opportunity and react!

   “We may have found an invalid assumption – how should we respond?”
#3 – Failure to attain “early mover” status can threaten viability

The validity of management’s strategic assumptions will come into question over time.
Managing reputation is a strategic imperative and is inextricably tied to risk management and crisis management.

1. Suppliers - - suppliers of suppliers, ingredients, working conditions, conflict minerals, etc.
2. Customers - - channels, customer relationships, end users.
3. Tone at the Top - - a culture that allows margin to trump key ethical considerations (safety, transparency, etc.) will have its day of reckoning.
#4 – Reputation is a precious asset, lose it and it’s game over

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Would help if you had your facts straight. Your choice to be a fan. cc get a clue
Occasionally, a contrarian voice is needed at a crucial moment – do you have one?

If risk management is viewed as a check the box activity, it has little strategic relevance.

1. Leaders of risk management functions should be viewed as peers to business line leaders.

2. There should be a reporting line to the board without access constraints; executive sessions should be conducted.

3. A formalized escalation process should exist.
Occasionally, a contrarian voice is needed at a crucial moment – do you have one?

**Washington Mutual Example**

1. **Largest bank failure in American history.**

2. **Multiple CROs were ignored, isolated, and terminated.**

3. **2007 board memos indicated that “an asset price bubble could deflate at any time”.... and that there was “no way for the company to achieve earnings targets without more loan activity.”**

**Do we feel like we are making progress in this room?**

- **Seat at the table**
- **Reporting line**
- **Escalation processes**
#6 – Every organization can be expected to be tested eventually – are you ready?

What do we do when one of the risks we plotted on a heat map actually happens?

**Velocity** – is the scenario’s impact immediate, or may it lurk for years in a company process or within a 3rd party?

**Persistence** – is the headline lasting, or will it quickly become yesterday’s news?

**Resiliency** – how effective will the company response be?

Leverage these criteria to better inform high impact/low likelihood items to prioritize preparedness activities.
#6 – Every organization can be expected to be tested eventually – are you ready?

Fukushima Example

1. Engineers ignored well-documented evidence of large earthquakes every thousand years or so that exceeded high water models, which only considered quakes since 1896.

2. High impact, high velocity, high persistence.

3. A more effective implication statement perhaps would have resulted in evaluation of safety planning (including the location of backup facilities) in light of this catastrophic tsunami scenario.
Overconfidence in a vision is driven by prior success and management’s strong convictions.

2 example tools to evaluate management’s views on the future.


2. Scenario Planning – visualize future scenarios or events and determine what their consequences might be; determine benefits or responses from the scenarios.

We’ll explore an example in a few minutes…
The execution of any strategy is governed by the willingness to accept risk in the pursuit of value creation. This is hard!!

1. Risk appetite statements outline the organization’s accepted risks, as well as other important risk parameters.

   Serve as a guidepost when new opportunities or risks emerge

   Gets driven down into the organization through tolerance and limit structures.

2. Risk tolerance – acceptable levels of variation around performance targets (time, quality, cost, customer satisfaction)

3. Limit structures – when these are approached, its time to revisit objectives and strategies
#9 – Focus the Board’s risk oversight on the critical enterprise and emerging risks

**Establish simple risk language that provides context for the Board and management to delineate risk oversight processes. (NACD)**

1. Governance risks – exclusively in the Board’s domain

2. Board approval risks – aligning the Board w/ management

3. Business management risks – typical risks (operational, compliance, financial, etc.)

4. Critical enterprise risks

5. Emerging risks

The Board must satisfy itself that management has processes in place to identify and manage enterprise and emerging risks — this enables a proactive risk management approach!
Strategy setting and risk management share a common focus – both are forward looking!

Time spent looking at retrospective performance indicators is of limited value when looking forward.

That said… I do recommend a deep dive on a risk event to determine lessons learned.

Companies must evaluate how the business environment is changing!

Let’s explore an example…
What about this scenario?

**Autonomous World:** A future state when intelligent technology systems, operating without human participation, enable new business models in a more efficient society.

What role do humans play when robots do it better? What are the business strategies required to compete in the autonomous world?

**Scenario Planning** – visualize future scenarios or events and determine what their consequences might be; determine benefits or responses from the scenarios.

*Source: When Robots Take the Wheel: The Future of Mobility In An Autonomous World – Crowd Companies*
Estimated Cost Per Mile Of Vehicle Service For Consumers

- San Francisco Taxi: $2.25
- UberX: $2.15
- Personal Vehicle: $0.76
- Shared Autonomous Vehicle: $0.25 (estimate for the year 2020)

Source: ARK Research
EXPERTS PREDICT SELF-DRIVING CAR CONSUMERIZATION BEGINNING IN 2018, INCREASING SAFETY ON THE ROAD
Time of Adoption

- **PHASE 1 2012-2016**
  - “Passive” autonomous driving

- **PHASE 2 2015-2019**
  - Limited driver substitution

- **PHASE 3 2018-2022**
  - Complete autonomous capability

- **PHASE 4 (two decades)**
  - 100% autonomous penetration, utopian society

Source: Company data, Morgan Stanley Research
ASSUMPTION 1
Self-driving cars will reach complete autonomous capability by 2022.

ASSUMPTION 2
Self-driving cars with complete autonomous capability will be as safe as, if not safer than, human-driven cars.

AUTONOMOUS VEHICLE DISRUPTIONS WILL IMPACT EVERY INDUSTRY
Scenario planning is an art

Visualize future scenarios or events and determine what their consequences might be.

Determine what the opportunities, benefits, and risks might be.

Help management challenge assumptions and expectations.

Deepen their understanding of the pain or opportunity - - help facilitate contingency plans or additional analysis.

The right kind of scenario analysis leads to a business discussion, not a risk discussion.