strategicrisk

A GUIDE FOR DIRECTORS

OCTOBER 2005

The Actuarial Profession
making financial sense of the future

University of BRISTOL

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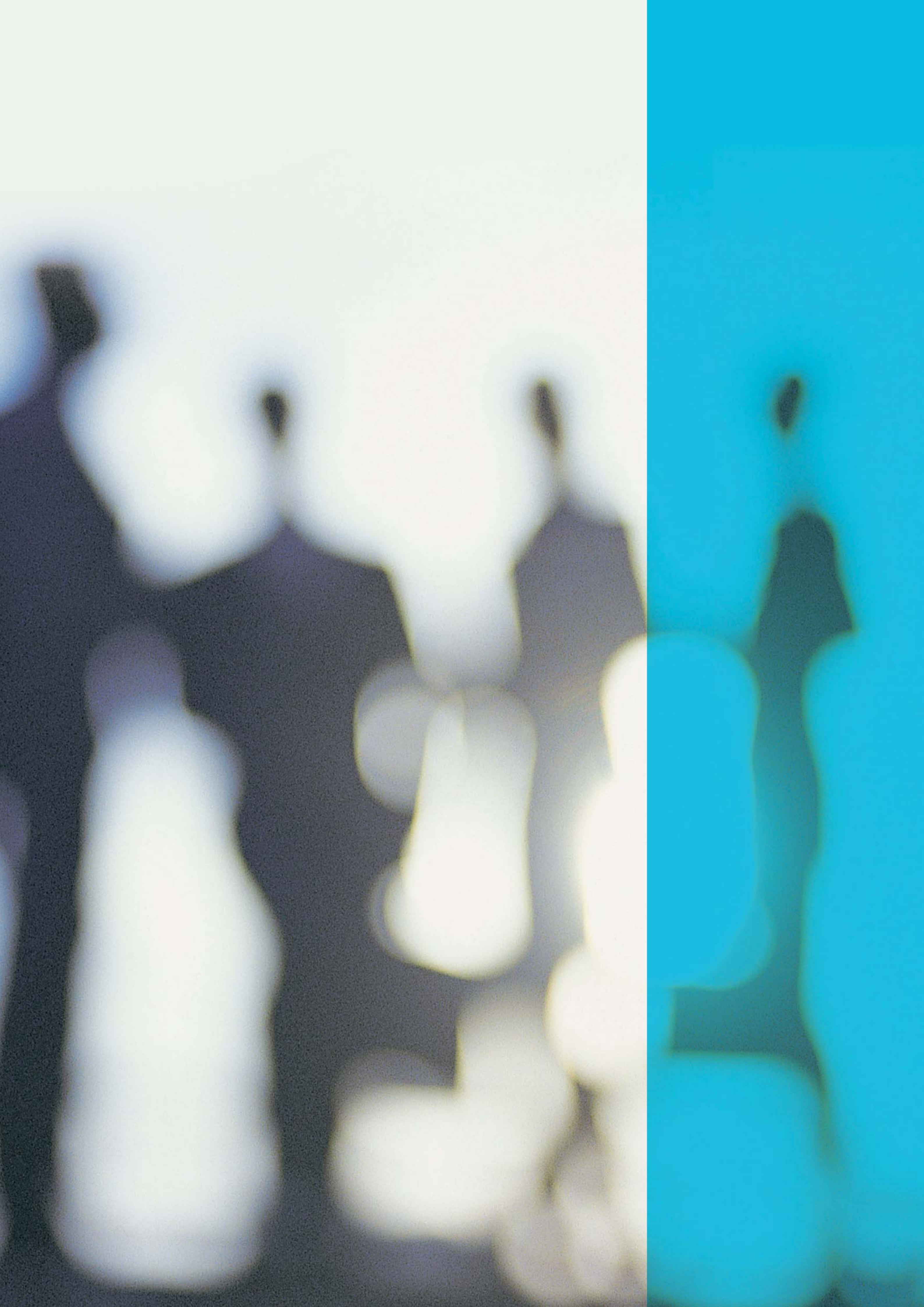

acknowledgements

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There is an accompanying CD-ROM publication, *Template for Change*, which includes the full research report, case studies, more details of the STRATrisk tools, some conclusions from academic studies and a reading list. Copyright of the research report rests with the University of Bath.

Apart from the actuarial and civil engineering professions, the sponsors and supporters of the STRATrisk initiative include

- AMEC
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- Ernst & Young
- Halcrow
- Institute of Risk Management
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why is strategic risk different?

Both the Strategy Unit of the Cabinet Office and the Office of Government Commerce highlight the attributes of strategic risk that are different. Such risks "tend to be less easy to spot, more disruptive, less easy to quantify and often less stable".

"…there are some risks that you may not identify, may not even consider, partly because you don't understand what it is that you are doing."
Major contractor

A research study by Deloitte (*Risky Business?*, August 2005) concluded that, in the decade 1995–2005, nearly 40% of UK firms in the FTSE 100 and FTSE 250 indices experienced a loss of share value amounting to 25% or more in a single day, and that one-quarter of them never recovered their value during the period. On the other hand, the value-creating companies studied had well-balanced portfolios of risk and value management strategies and were constantly looking for ways to improve and differentiate themselves. By focusing on value creation they were able to create a "value cushion" that helped to protect them from volatility and risk and enabled them to recover quickly from one-off shocks.

Strategic risk consists of the most important risks that an organisation faces, i.e. the possible future scenarios that would make a material difference (for better or worse) to its ability to achieve its main objectives or even to survive. These risks differ in magnitude from *project risks* or *operational risks*, which are generally more limited in their impacts. Strategic risks are more strongly influenced by people's perceptions and their behaviour. They are more dynamic, uncertain and interconnected, and therefore they often need to be managed as complex processes rather than discrete events. This requires a shift in the way we think about them and the way we manage them.

Wherever we mention strategic risk in this guide we include both strategic threats and strategic opportunities, two sides of the same coin.

Failure to think sufficiently deeply about strategic risk has caused serious problems at such firms as Enron, Arthur Andersen, Kværner and Equitable Life. In the public sector, the UK failed to plan for a foreseeable outbreak of foot-and-mouth disease, while in the USA Hurricane Katrina revealed that the federal government's strategic disaster planning was inadequate.

Our research has shown that people's perceptions, and their subsequent behaviours, are the principal source of those strategic threats and opportunities which arise from within an organisation or at the points where it interacts with the outside world. In addition, people are the principal resource that can be harnessed to identify and manage strategic risk, wherever it arises. Hence managing people in the right way, within an appropriate culture, lies at the heart of our approach.

Strategic risk cannot be viewed in isolation from the other two types of risk to which an organisation is normally exposed, i.e. project risk and operational risk (see Figure 1). This is because risks in these two latter categories can sometimes develop into strategic risks.

Figure 1. Principal categories of risk

The large triangle in Figure 1 represents the totality of risks to which the organisation is exposed, i.e. *enterprise risk*. Strategic risk is that subset of the triangle which could impact significantly on the achievement of the organisation's objectives, either positively or negatively. It includes the risks arising from the processes by which strategy is converted into a programme of different projects, for example the risk that the projects selected may not be the ones to achieve the strategic objectives. Project risk consists of the various opportunities and threats which arise within the projects that the organisation undertakes from time to time, such as investing in new facilities, launching a new product or undertaking a business change initiative. Operational risk consists of all the organisation's other risks in its ongoing business, such as health and safety, fraud, currency exchange, litigation, etc. Both project risks and operational risks need to be managed well, but this guide concentrates on strategic risk, the management of which needs a different approach: one linked to people, behaviour and culture.

The risks that were most consistently mentioned by respondents in our research programme were

- **reputation**
- **government policy and politics**
- **staffing and resourcing**
- **customers and clients**
- **financial.**

A checklist of all the strategic risks that were identified during the research is set out in Appendix 2.

recommended approach

Role of the board

- **Understands risk, contains sufficient diversity, provides risk leadership.**
- **Focuses on risks to purpose and main objectives.**
- **Identifies and manages the "top ten" threats and opportunities.**
- **Determines overall risk-management policy.**
- **Reviews risks regularly.**

"…the non-executive directors are the people that spend most of the time talking in the board and that is what we like."
Contractor

Involvement of the board

The board itself needs to be fully involved in the risk management process, because

- it is usually only at board level that a sufficiently holistic approach can be taken, bringing together and prioritising the major risks in various parts of the business and making the connections between them
- the board, working collectively, is likely to be multidisciplinary and have longer and broader experience than most members of senior management
- it is the board which has the authority to ensure that risk management is given sufficient attention throughout the business, despite other pressures.

Real commitment and leadership are needed to ensure that the management of strategic risk is actually given the focus and attention it deserves. The board itself should take ownership on an ongoing basis, though one member of the board will normally have special responsibility for implementation. There needs to be sufficient diversity of experience and perception within the board, possibly by appointing non-executive directors from outside the industry concerned. Positive assurance processes and regulatory compliance should continue in addition to the steps outlined here.

It is the board's responsibility to understand the main risks and uncertainties and to give guidance to the rest of the organisation. We suggest the following four principal steps.

- Ensure that all board members have a good understanding of the nature of risk and uncertainty and the processes available to manage them, as well as knowledge of the proven dangers of "groupthink" and the reasons why bias can occur in risk assessments.
- Using the tools described in this guide, identify a shortlist of up to, say, ten key strategic threats which could prevent the achievement of the organisation's purpose, strategy or objectives, or even threaten its survival.
- Similarly identify a shortlist of key opportunities that could enable the organisation to achieve its purpose, strategy or objectives to a greater extent or with greater likelihood of success.