CLCI

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Two halves of a whole…………
Balanced Scorecards and Risk Management

There has been a dramatic increase in focus on managing risk over the past several years.

The "Great Recession" has made it clear to many companies that assuming unmanaged risk can have grave consequences. Ironically, many of these same companies have embraced balanced score carding with great success.

Many of these organizations, however, haven't made the connection between their strategy map, and the risks that will prevent them from achieving their objectives.

Where do you look for risk?

There is a simple question to use when you are identifying risk in your organization. "What may prevent us from achieving our objectives?" It is an effective question because it focuses on the risks that are most important to the performance of your company. It also gives your respondent a context to discuss risk.

If your head of manufacturing has 4 key objectives this year then you simply ask them this question four times, once for each objective. I also find it very helpful to have a list of risk categories to show someone who is identifying risks to help them consider all the risks related to a given objective.

Given this link between objective and risk, the obvious place to align them is in your Balanced Scorecards. This approach to risk identification will be very appealing to management and your Board as they will see the direct connection between your risk management efforts and the performance of your company.

This leads to the next question about how to position this to the highest levels in your organization.

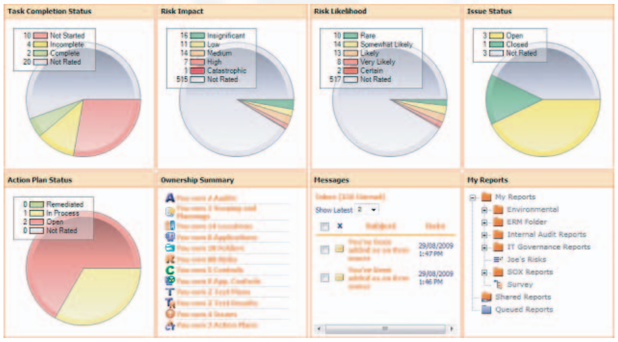
How should your position strategic risk management to management and the Board?

Firstly, expect that the CEO or CFO may not fully understand the benefits of risk management and may interpret this as a challenge to their corporate governance.

It is important to communicate the benefits of an ongoing risk management process upfront. Show them how it is integrated into your Balanced Scorecards. Clarifying to management that this is a value sustaining or value creation activity is critical.

Here are several key benefits:

- Increase the likelihood that your organization will achieve its objectives
- Lowering business volatility by increasing visibility on events that can derail your performance
- Treating risk as "neutral" so that opportunities can also be identified and pursued
- Creating a centralized view or risks and creating efficiencies in risk identification and treatment
- Closing the gap between risk management and capital allocation



Secondly, position it as a process, as opposed to a project. Processes get dedicated resources, projects don't!

Thirdly, demonstrate how a well run risk management program creates a culture of accountability across the organization for identifying and managing risk. This will result in higher product/service quality, fewer incidents, and better planning overall.

Finally, show your CEO how the market rewards companies with sound risk management practices. Ratings agencies, capital markets, and creditors are all starting to differentiate risk-informed companies from the rest of the competition.

Who should own the operational risk management mandate?

A common practice recently has been to assign the operational risk management mandate to Internal Audit (IA). IA spends time assessing risk each year to develop their annual audit plans. Auditors also spend time analyzing and assessing controls inside the company. However, the goals of ERM have evolved from an audit-type exercise to much more of a performance-focused process. As a result, organizations need to reconsider who owns it and how it is run.

We have seen a very successful migration of ERM ownership to the Strategic Planning (SP) department. SP, who also owns the balanced score carding mandate can then successfully integrate both areas. The process they follow for implementing the program is as follows:

1. Develop corporate strategic goals (often using the previous year's risk register as a reference)
2. Convert the strategic plan into a more comprehensive score card with strategy map by department
3. Identify risks for each department's objectives
4. Draft a risk register with tolerances for each risk (note that risks are now categorized by departmental objectives, rather than by the traditional risk categories such as HR, financial reporting, IT, etc)
5. Identify risk owners
6. Risk owners develop a risk treatment plan for the risks that are above accepted tolerance levels
7. Resources and funding are applied to risk treatment plans
8. Execute the risk treatment plans

These are just some of the tangible benefits that you should communicate to your management team to ensure they are supportive of your risk management program. It is the ideal way to link your risks and score card into one integrated approach for your organization.

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Fusion of Risk Management and Strategy Execution

The Balanced Scorecard (BSC) concepts were developed by Harvard University Professors; Drs. Kaplan and Norton.

BSC has been selected by Harvard Business Review as one of the most influential management ideas of the past 75 years. The underlying philosophy of BSC is to seek balance between achieving short and long-term strategic objectives.

Recent financial crisis revealed a gap in management focus. Companies were focused on shareholders value, revenue growth, productivity, cost control and quality without explicitly incorporating risk management as part of their strategy execution exercise.

In a recent HRB Article* BSC creators have acknowledge that the measurement, mitigation and management of risk has not been featured in their work in the past and the recent economic meltdown has prompted them to think more deeply about incorporating risk management into strategy execution framework.

An analysis of risk management - its history and mainstream approaches - and of resulting market failures leads to conclude that risk management should be viewed as the third leg of shareholder value creation, along with revenue growth and productivity.

Dr. Robert Kaplan offers some very enlightening concepts and ideas on how to integrate Strategy and Risk Management - a brief of his ideas follow.

Despite elaborate ERM practices, regulations and emphasis many companies affected by the crisis failed because of their excessive exposure to risk. Two main factors that contributed to this failure are:

- Companies did not explicitly accounted for risk when formulating strategy
- Companies failed to manage the risks they assumed

Traditionally senior executives have considered Risk Management a compliance function and delegated it to risk professionals. However, the recent meltdown has forced organizations to get serious about risk management - they are now embedding it into the routines and processes of senior management.

A three level hierarchy of risk

Dr Kaplan classifies risks into three categories based on degree of predictability, controllability, management and on the magnitude of their consequences to the organization. These three categories are listed below where level 3 is the lowest and level 1 is the highest:

Level 3 Routine Operational and Compliance Risk

These are errors in routine, standardized, and predictable processes that expose the firm to substantial loss. Level 3 risks are known and avoidable. Risk management of these processes strives to achieve 100% compliance and zero defects.

Level 2 Strategy Risks

To mange this category of risk the company should identify major plausible risk inherent in the strategy; attempt to mitigate and manage those risks; and then continually monitor the risk exposure it has accepted to earn superior returns from its strategy.

The strategy map provides a natural framework for identifying and mitigating the risks to a company's strategic objectives in an integrated and comprehensive manner.

Some organizations incorporate a risk management theme into their strategy map which highlights risk management as a key component of the company's strategy and makes it visible for resource allocation, monitoring and discussion at regular strategy review meetings.

Strategy is about the company's way forward towards achieving breakthrough performance - strategy map and scorecards provide the road map to guide this strategic journey.

** Balanced Scorecard Report - Harvard Business Publishing - Volume 11 Nov - Dec 2009*

Risk management, in contrast, is about identifying, avoiding and overcoming the hurdles that the strategy may encounter along the way. Avoiding the risk does not advance the strategy; but risk management can reduce obstacles and barriers that would otherwise prevent the organization from progressing to its strategic destination.

Since measuring and managing risk differs so substantially from measuring and managing strategy that it may be preferable to develop a completely separate risk scorecard.

To build a risk scorecard we can start from a strategy map by first identifying for each strategic objective the primary risk events that would prevent the objective from being achieved. For each risk event we would select metrics that would be early warning or leading indicators of when the risk event might be occurring.

Level 1 Global Enterprise Risks

If we can say that level 3 and 2 risks were "known unknowns" then risks in level 1 category can be described as "unknown unknowns".

These are the unpredictable, unprecedented occurrences that create external risks. Companies need to consider what unlikely event or combination of events could lead to their demise. Some companies do their level 1 risk planning by conducting active discussions of unlikely events and their consequences.

In Kaplan/Norton strategy execution model, managers can address level 1 enterprise risks during test and adapt the strategy stage.

The leadership team could engage in scenario planning, war-gaming, and tail-risk stress-test to learn sensitivity of the company's strategy to events that occur outside normal business operations that they cannot control.

Conclusion:
Integration of Strategy and Risk Management is an essential missing part and Senior Leadership today is focusing on this much needed fusion. The recent partnership between CLCI and BPS Resolver greatly facilitates this integration.

The Five Principles of Strategic Risk Management

Strategic Risk Management parallels the approach to strategy management embodied in Kaplan and Norton's five principles of a Strategy-Focused Organization

From a presentation by Jack Klinck EVP and Global Head of State Street Alternative Investment Solutions at the Palladium Group's April 2009 Strategic Risk Conference