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RK303 - Risk Management and The Board Room: Integrating Risk Management and Corporate Strategy

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BRINGING RISK MANAGEMENT INTO THE BOARD ROOM: INTEGRATING RISK MANAGEMENT STRATEGY WITH CORPORATE STRATEGY

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The stakes in risk management have never been higher. Especially for firms operating nationally or globally in technology- or asset-intensive industries, the potential for debilitating financial loss is great. At the same time, the accelerating pace of global competition and the resulting wave of corporate restructurings have created severe cost pressures on companies in virtually every industry. For the risk manager, this has meant job elimination, dwindling staffs, and shrinking budgets.

With corporate and personal stakes so high, and resources so precious, it is more important than ever for a risk manager to have a well-defined risk management strategy that articulates to senior managers the vital role played by risk management in helping the company meet its goals. The challenge is not so much in crafting a risk management strategy that anticipates and advances the company's business objectives, but in communicating the strategy with words and pictures that grab senior management's attention and drive home risk management's acute importance.

One way to express the vitality of risk management, and thereby ensure that protecting the company's earnings and physical and human assets is foremost in the minds of senior managers, is to tightly link risk management strategy to the company's corporate strategy and its components: competitive strategy, operating strategy, and financial strategy.

The benefits of intertwining risk management strategy and corporate strategy are many. For the risk manager, linking the two provides an architecture for designing a risk management strategy that is comprehensive, cohesive, and consistent. It also elevates risk management's importance by grounding it in concepts and thought patterns that are second nature to senior managers. Meanwhile, the company benefits because potentially crippling exposures to loss are more widely understood and better managed.

The balance of this article describes a framework that will enable a risk manager to effectively unite a company's risk management and corporate strategies, and communicate the union to senior managers using persuasive logic and a familiar language.

While there are many possible definitions for *risk management strategy*, the framework for linking it with corporate strategy defines it as the sum of the choices risk managers and companies make with respect to 1) risk assessment, 2) risk control, and 3) risk finance. It is the interplay of these three disciplines that determines risk management strategy (see Figure 1).

The significance of this definition is illuminated by pairing each risk management discipline with its corporate strategy sibling: risk assessment with competitive strategy, risk control with operating strategy, and risk finance with financial strategy (see Exhibit 2).

Competitive Strategy and Risk Assessment

Risk management strategy begins with risk assessment. In turn, risk assessment--identifying, analyzing, and quantifying the risks of financial loss a company faces, insurable or otherwise--is rooted in the company's competitive strategy.

To persuasively communicate risk assessment's relationship to competitive strategy, a risk manager must strive first to develop a thorough understanding of the company's strategy. Every organization consciously seeks to occupy a place within its industry that will maximize its profit opportunity. Its policies, statements, and actions that contribute to attaining or preserving this place comprise its competitive strategy. Michael Porter, in his book *Competitive Strategy*, identified five forces that influence competitive strategy: 1) the threat of new entrants to the industry, 2) the threat of substitute products or services, 3) the bargaining power of suppliers and 4) customers, and 5) the intensity of rivalry among the industry's existing competitors. A company's response to these five forces can take one or a combination of three basic strategic forms:

- <u>Cost Leadership</u>. The company seeks to be the low-cost producer or service provider in its industry, enabling it to underprice its competitors yet still make a profit.

- Differentiation. Instead of striving to achieve cost leadership, the company seeks a premium price for its product or service by distinguishing it in the marketplace through superior product features and/or outstanding customer service.

- Focus. The company chooses a narrow product-market niche, such as a product targeted to a defined geographic region or to a precise subgroup of the population.

A company's competitive strategy must drive the assessment of its risks. The central question facing a risk manager when linking competitive strategy and risk assessment is: Given the company's strategic focus, what exposures to loss are likely to significantly impact the company's ability to manage its business(es)? Its earnings? Its assets? Its continued growth? Failing to ask this question could lead a risk manager to an incomplete assessment of the company's risks, or worse, to a risk assessment that fails to adequately address the exposures likely to cause the company the greatest financial harm.

Some examples will help to show how a firm's competitive strategy informs risk assessment. One example is a retailer whose competitive strategy is to achieve cost leadership through ever-increasing operational scope and scale, and is therefore expanding into global markets and pursuing vertical integration in the manufacturing and supply chain. For this expanding retailer, a risk assessment rooted in its competitive strategy would focus on concentrations of property values exposed to loss, both in the U.S. and abroad; on the risks facing global flows of merchandise, information, and people; and on the business interruption risks inherent in an interconnected supply and distribution network.

Another example is a manufacturer whose strategy is to achieve industry differentiation by appealing to affluent customers who are willing to pay more for branded products with a perceived value-added difference. For this company, risk assessment would focus on product quality and safety, from how the product is manufactured, to how it is sold and used, to how it is supported by service after the sale.

The last example is a pharmaceutical company seeking to grow by acquiring biotechnology companies with promising new products. Like the manufacturer seeking product differentiation, a risk assessment based on this company's competitive strategy would concentrate on product quality and safety, but would focus, too, during the due diligence process on assessing the known and potential liabilities of acquisition targets.

Operating Strategy and Risk Control

The second leg of the three-legged stool of risk management strategy is risk control. After bringing to senior management's attention the magnitudes and probabilities of pure loss implicit in the firm's competitive strategy, a risk manager should strive to ensure that his or her initiatives to control these risks are grounded in the organization's operating strategy.

Doing so will lead not only to measures with a greater likelihood of avoiding and reducing loss, but also to more effective communication of risk control's importance to the company.

A company's operating strategy has several dimensions, among them:

- The degree of organizational centralization or decentralization, either functionally or by business unit.

- The degree of operational flexibility. In other words, how swiftly the manufacture of products or delivery of services can be modified or moved.

- The degree of skilled vs. unskilled workers in the labor force, as well as the concentration of union vs. nonunion workers.

To illustrate the effect of a company's operating strategy on its risk assessment and risk control strategies, consider the example of a company–it could be a manufacturer or service provider--that has two deeply-ingrained operational strategies: a) it employs the technique of stockless inventory, or just-in-time delivery of the inputs to the production or service delivery process, and b) total quality management, or TQM.

Risk assessment and risk control efforts for this company would need to recognize that stockless inventory and TQM techniques create strong webs of interdependency within and between both related and unrelated companies.

For this company, a risk assessment rooted in its competitive strategy would pay close attention to the exposure to direct and contingent business interruption losses stemming from perils affecting its--or its key suppliers'--operations. It also would focus on exposures arising from poor quality inputs entering the manufacturing or service delivery process.

Similarly, risk control initiatives grounded in the company's operating strategy would center risk avoidance and reduction techniques on supplier-partners. It might take the form of assisting in the risk management efforts of these suppliers, or it could involve seeking multiple suppliers of critical parts, components, or products. Because of the rigorous requirements placed on suppliers by stockless production and TQM, however, the pool of qualifying vendors could be limited, making it especially difficult to find suitable alternates.

Also illuminating the need to match risk control strategy to operating strategy is the example of a decentralized company which is comprised of several autonomous business units. In such a firm, centralized risk control initiatives would have limited effectiveness because tactical and even strategic decisions are made locally. To carry clout, risk control measures would have to put incentives in place at the profit center level, perhaps in the form of a loss-sensitive cost-of-risk-allocation system. Business unit managers then would have a financial stake in risk control efforts. It goes without saying that such a system would need the imprint and active support of senior management, making the strategic framework outlined in this article all the more important to a risk manager as a communication tool.

Financial Strategy and Risk Finance

So far the importance of relating risk assessment to the company's competitive strategy and of grounding risk control efforts in operating strategy have been examined. The third leg of any risk management strategy is risk finance. As with the two previous risk management disciplines, to be truly effective, the financing of a company's risks should be tailored to its corporate strategy twin--in this case, financial strategy.

A company's financial strategy is embodied in its policies and decisions with respect to such things as:

- Earnings goals. Some firms stress earnings growth, while others emphasize earnings consistency.

- Capital structure. All firms establish target ratios for maximum total indebtedness to total capital.

- Tax policy. Some firms seek to maximize current deductions, while others--firms experiencing operating losses, for example--do not. Also, some companies are more willing than others to assume audit risk, or the risk that aggressive deductions will invite IRS scrutiny.

- Investment strategy. Each firm has a distinct risk personality when it comes to the kinds of businesses and securities in which it is willing to invest.

Furthermore, each of the decisions companies make regarding earnings goals, capital structure, tax policy, and investment strategy help to determine its overall cost of capital, which is a key yardstick for senior managers when considering the merits of alternative financing decisions.

To examine the importance of linking a risk finance program to the company's financial strategy, consider a company whose senior management a) seeks rapid growth in earnings, b) adheres to a reasonably conservative debt policy because its businesses are characterized by a high degree of operating leverage, c) wants to shelter as much income from taxation as possible, and 4) desires to invest in high-growth businesses. At the same time, surplus cash is invested in relatively low-risk securities while management scans for appropriate acquisition candidates.

In designing a risk finance program for a company with this financial profile, some tentative conclusions can be made. First, any surprises in the form of large unforeseen losses that might constrain or cripple the company's ability to grow would invite senior management's wrath, suggesting the need to transfer significant amounts of risk. Second, increases in total indebtedness, in the form of large self-insured reserves, might conflict with the company's capital structure targets. Third, current deductions for insurance premiums would assist in the sheltering of income. And last, investments in any risk financing vehicle--for example, in the form of funds dedicated to a captive insurer or other alternative risk finance program--would be weighed vis a vis other investments the company could make. Any scenarios that did not measure up to its cost of capital or other appropriate cost of funds benchmarks would likely be rejected.

While there are many risk financing schemes that could support the conclusions drawn from this simple example, to fit snugly with the company's financial strategy, at a minimum its risk finance program would have to transfer significant amounts of risk. Furthermore, while it may be simple, the example reinforces the need to match risk finance with financial strategy, and highlights the framework's usefulness in engineering a risk finance program and communicating its importance to senior management.

In addition to the framework for linking risk management strategy and corporate strategy, another way for risk management to gain currency among senior managers is to ensure that its elements--assessment, control, and finance--incorporate the key financial, accounting, tax, and legal considerations employed by the company when making any strategic or tactical decision (see Exhibit 3).

Financial Considerations

As has been discussed already, financial considerations are very important when assessing a company's risks. Identifying and quantifying the potential losses of earnings and resources arising from operational exposures is the first step to building an effective risk management program. They are important, too, when designing and implementing risk control measures. An effective way to measure the success, prospectively or retrospectively, of an investment in risk control is to quantify its cost/benefit or return on investment.

By definition, financial considerations are key to risk financing decisions. The questions a risk manager should strive to answer in considering the merits of different programs are: How are investment decisions made at the company? What criteria are used? And, How will funds invested in a risk financing program be viewed vis a vis alternative investments?

Accounting Considerations

Accounting considerations generally are not important when assessing risk. They are more important when making risk control decisions, inasmuch as the controls insisted upon by the company's inside and outside auditors contribute to controlling its fidelity, fiduciary, and directors and officers risks.

In contrast to risk assessment and control, however, accounting considerations are very important to risk financing decisions. To be consistent with financial strategy, any proposed risk finance program should recognize and incorporate the company's tax and financial accounting policies. A basic example of the importance of accounting considerations is that of the company weighing the benefits of a loss portfolio transfer. If the cash required to transfer the presently self-insured liabilities to an insurer is less than the book value of those liabilities on its balance sheet, the company can recognize an accounting gain, and thus boost earnings. If, however, the book value of the liabilities is less than the cost of risk transfer, the transaction will have an adverse effect on earnings.

Tax Considerations

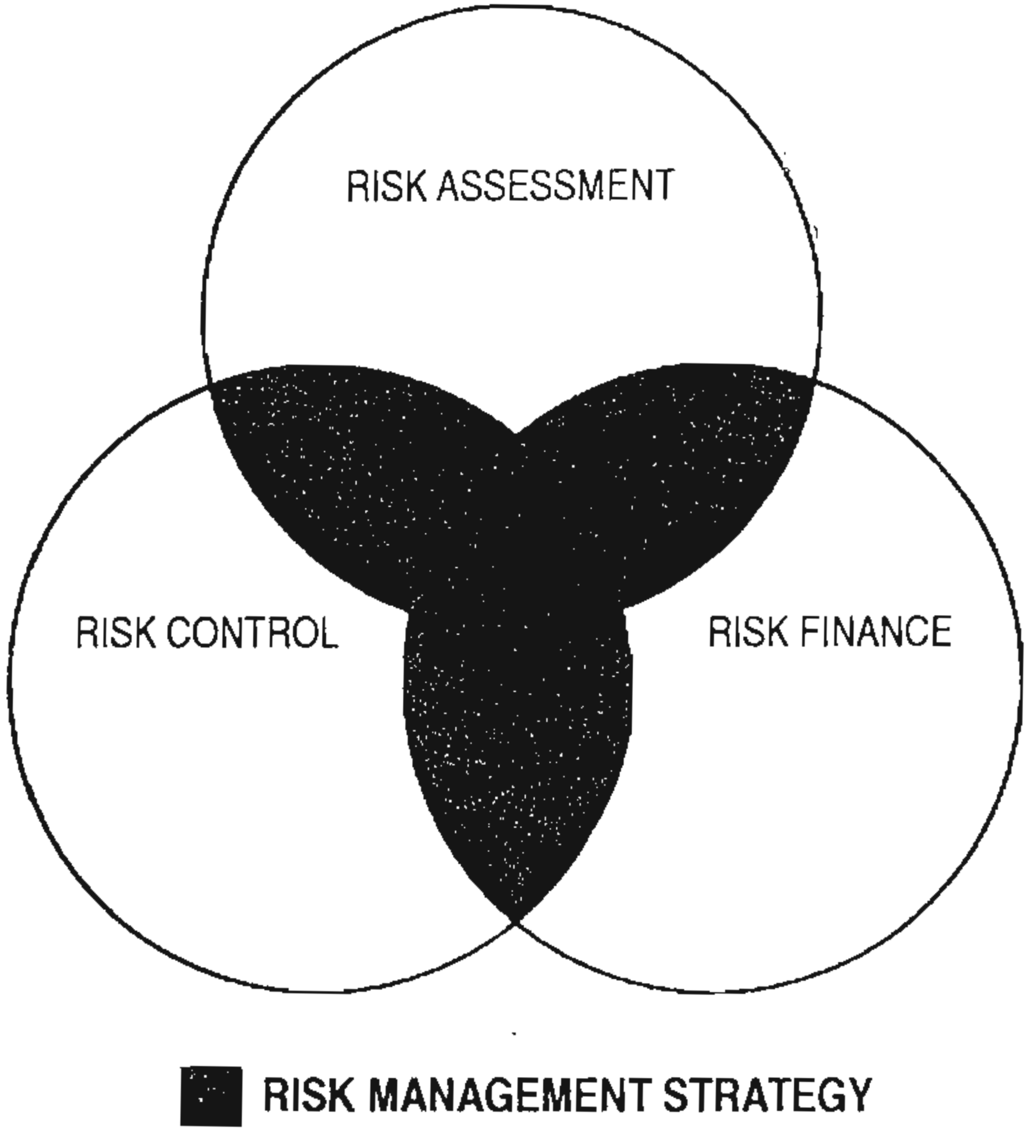
Tax considerations are not important to risk assessment, and generally are not important to risk control decisions. An exception to this might be if an investment in risk control were to provide an investment tax credit. In this case, a risk control decision should incorporate its relevant tax consequences. Tax considerations are very important to risk finance decisions, as was illustrated when financial strategy and risk finance was discussed earlier.

Legal Considerations

Legal considerations are very important in assessing a company's risks. Key questions to answer include: What is the legal climate in each of the countries in which the company has operations? What legal liabilities could arise from the pursuit of the company's business strategies, now and in the future? So, too, are legal considerations important when making risk control decisions, especially with respect to the protection of workers, customers, and the environment. Workers compensation risk control is informed by OSHA regulations, federal and state product safety laws help guide liability risk control, and federal and state EPA requirements drive environmental risk control.

Legal considerations also are important when making risk financing choices. The central question to answer is: What are the country, state, and local legal requirements, restrictions, and opportunities with respect to any proposed risk financing program?

Risk managers, like virtually everyone in today's leaner companies, must do more with less. Furthermore, with flattened and more decentralized organizational structures, they must influence through persuasion rather than fiat. Therefore, the advantage goes to the risk manager who can craft a potent risk management strategy and communicate its vitality to senior management. In the end, effective risk management is the result of a sound risk management strategy that is grounded in the realities and culture of the company, and that has top management commitment. Proper packaging does not hurt, either.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