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Getting Strategic About Risk Management: How Business Can Move Forward Through Greater Risk Awareness

By Lou DiSerafino

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Abstract

Many top-performing businesses aren't just risk aware, but rather risk intelligent. Such a posture helps prepare companies for a major event and can demonstrate to a regulator or auditor that an appropriately strong control framework is in place. Better still, companies gain real strategic value from a "risk adjusted" understanding not only of their threats and vulnerabilities, but also the upside opportunities associated with various risks. It starts with having both qualitative and quantitative information to identify, assess and manage risks.

Strategic risk management, at its core, is about creating value by increasing transparency and accountability, and quality of information. More than a mere compliance exercise, effective risk management enables more informed strategic decision-making, increased accountability and transparency, a greater likelihood of organizational success, and—ultimately—competitive advantage, as borne out by many studies that correlate risk management and financial results.

1. Introduction

In the insurance industry, enterprise risk management (ERM) has become a high-priority and hot topic area of investment. In many cases, the effort has been guided primarily by the need to meet new regulatory standards. Meeting minimum requirements for Own Risk and Solvency Assessment (ORSA), stress-testing programs and concerns about being designated as a systemically important financial institution (SIFI) were the key considerations. In other words, the setting up of ERM programs was not strategically oriented. The plans lacked a clear business case or compelling value proposition.

To some extent, ERM has become a standard part of the management infrastructure for large insurers. At top performers, ERM has matured. More risk-informed thinking is now embedded in the business to an unprecedented degree. The board, C-suite and business unit leadership now have a clearer grasp of the extent, diversity and severity of risks they face. And they turn to senior risk management leaders as trusted advisers when key business decisions are to be made.

However, there remain nagging concerns about the ability of ERM programs and investments to boost business performance, beyond ticking the box of regulatory compliance and protecting the business.

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Even as the impacts of the global financial crisis further recede, more stakeholders are seeking the next horizon, where risk management is truly and deeply integrated into the business. That's where strategic risk management (SRM) comes in.

2. Defining Our Terms: What is a Strategic Risk?

At the highest level, strategic risks are those that may cause organizations to fail outright or necessitate a fundamental change to the core business model or mission statement. While they can take various forms—from game-changing, disruptive technological advancements to new regulatory requirements—all strategic risks present existential threats to a company. Consider a few examples.

- Blackberry's emphasis on security over the user experience and apps introduced by the iPhone was a strategic gamble that cost them dearly in terms of their market leadership position.
- The Patient Protection and Affordable Care Act is reshaping the health insurance market, as might significant changes to the tax status of health savings accounts and/or employee benefit plans.
- Chipotle's recent E. coli outbreaks at some of its stores threaten to counteract its "food integrity" brand positioning. (The impact of Taco Bell's E. coli outbreaks was less than Chipotle's because its brand doesn't stress healthy, high-quality ingredients.)
- Airbnb and Uber have disrupted the hospitality and transportation industries, respectively.
- At MCI/WorldCom and Enron, senior management were strategic risks due to management fraud and resulting loss of consumer trust. Volkswagen's might be also for that same reason.
- For BP, the 2010 oil spill in the Gulf of Mexico became a strategic risk largely due to their mishandling of the response, resulting in the sacking of their CEO and loss of organizational trust. (Compare that to the stellar response of the Chilean government when miners were trapped below ground—an event which demonstrates how a disaster can lead to greater confidence in an organization based on the quality of the response during stressful conditions.)
- Fax machine, meet email. Now say goodbye to fax machine.
- Within financial services, the emergence of the "robo-advisers" is a strategic risk for traditional wealth management and financial planning firms.
- Appointment TV is replaced by the DVR.
- The music industry underestimated the strategic nature of the threat presented by digitization, playing defense against file-sharing when it should have focused on product distribution models.

Interestingly, existential threats that rise to the level of strategic risk may also present transformative opportunities—where companies more in touch with their risk appetites may make more informed and better bets in driving the business forward. Indeed, PricewaterhouseCoopers' 2015 Risk in Review survey found a strong link between risk management capabilities and overall performance; during the previous three years, 55 percent of leading risk management companies recorded increased profit margins and 41 percent earned an annual profit margin of more than 10 percent.[2]

Research from Ernst & Young has reached similar conclusions. The most mature risk organizations enjoy a 50 percent advantage in annual revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) growth. How do they do it? By embedding advanced risk management strategies, implementing strong controls and rigorous processes, and effectively communicating risk coverage.[3]

However, it's important to note that not every significant regulatory or technological risk is a strategic risk. While the new fiduciary rules enacted by the U.S. Department of Labor are widely considered to be a strategic risk (because they may necessitate fundamental shifts in business models and even cause some insurers to close their wealth management or investment advice businesses), minor modifications to Sarbanes-Oxley Act of 2002 requirements do not meet the threshold, given their relatively limited impact. Similarly, new social media platforms today are less likely to have the enormously disruptive impact that Facebook did.

Thus, strategic risks are largely defined and evaluated based on their potential impact, likelihood of occurrence and their relationship to core strategies or overall organizational mission. Strategic risks may also be more common, pervasive and severe than many think—they are definitely not "black swans." In fact, according to the Corporate Executive Board and Harvard Business Review, while a full 86 percent of significant losses in market value were caused by strategic risks in the past decade, auditors spent only 6 percent of their time reviewing or analyzing such strategic risks.[4] See Figure 1. It would appear there's a mismatch between where auditors spend their time (i.e., which risk types) versus their opportunity to make an impact.

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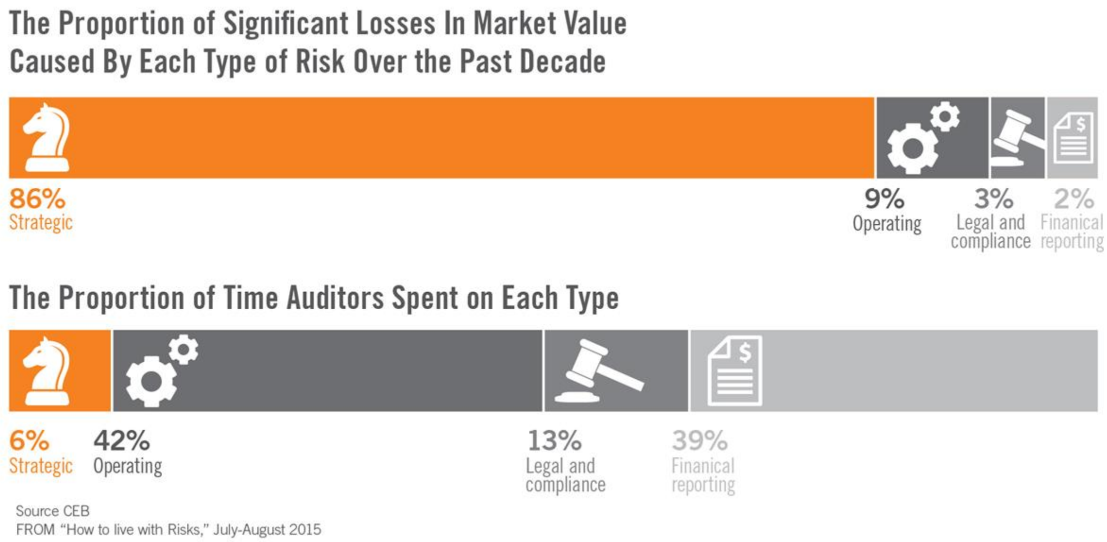
[2] PricewaterhouseCoopers, "Risk in Review: Decoding Uncertainty, Delivering Value," April 2015, http://www.pwc.com/us/en/risk-assurance-services/risk-in-review/assets/risk-management-financial-leadership.pdf.

[3] Ernst & Young, "Turning Risk into Results: How Leading Companies Use Risk Management to Fuel Better Performance," 2012, http://www.ey.com/Publication/vwLUAssets/Turning_risk_into_results/$FILE/Turning%20risk%20into%20results_AU1082_1%20Feb%202012.pdf.

[4] *Harvard Business Review*, "How to Live With Risks," July–August 2015, https://hbr.org/2015/07/how-to-live-with-risks.

Figure 1. **Proportion of Significant Market Value Losses vs. Auditor Time**



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James Lam, noted risk management author and reputedly the first executive ever to hold the title of chief risk officer, describes this phenomenon as a failure to "sweat the big stuff first":

> If the goal of ERM is to enable management to identify and prioritize risk, ERM ought to focus first on strategic risks, followed by operational risks. The financial risks that dominate ERM today should be a distant third.[5]

Lam acknowledges that financial risks are easier to quantify, so many actuarial- or accounting-minded risk managers are more comfortable modeling those.[6]

Given the unique nature of strategic risks, strategic risk management should be viewed as a critical but distinct component of ERM, which incorporates many more factors and capabilities, from "three lines of defense" models to cybersecurity, to Sarbanes-Oxley, internal audit and financial reporting. ERM also focuses on financial, operational, regulatory, reputational and other risks that may not reach the level of existential threat.

3. Why it Matters to the Business

There is a longstanding and largely understandable perception that any type of risk management is equivalent to "playing defense," or protecting the business from a range of threats. This is a myth that

[5] James Lam, "Strategic Risk Management: The Next Frontier for ERM," Workiva white paper wp0416, April 2016, https://www.workiva.com/sites/workiva/files/Resources/Whitepaper/strategic-risk-erm-white-paper-k4272-20160504.pdf.

[6] Ibid.

very much needs to be retired within insurance, and strategic risk management may be the most effective means for doing that. That is, the effective practice of strategic risk management may lead companies to determine that they are not taking enough risk to meet their growth goals, expand their customer base or otherwise improve performance.

In this sense, strategic risk management programs are most concerned with:

- Defining clearly a company's risk appetite relative to a complex set of risks and interdependencies
- Challenging and evaluating corporate strategies, including the underlying market, macroeconomic, financial, demographic, operational, technological and other assumptions upon which those strategies are based
- Determining the right key risk indicators, based on the complex and sophisticated risk appetite statement, with upper and lower limits stipulated for each indicator
- Providing contingencies, fallbacks and other risk control techniques, once the strategy and risk appetite are aligned, to reduce the uncertainty of successful outcomes, allowing greater risk-taking to increase value

4. Strategic Risk Management in Action

Strategic risk management is gaining traction in a range of industries largely because it's delivering results. ACE Group, one of the largest global multiline property and casualty insurers, implemented an ERM program focused on identifying and managing critical risks. The company's senior leadership expressed its belief that the new approach, with its focus on critical risks, was a contributing factor to the company's share price improvement and the 50 percent increase in the company's market value of equity from 2002 to 2003. According to the company's 2013 annual report (Form 10-K) filing, the ERM framework is "integrated into management of our business and is led by ACE's senior management. As a result, ERM is a part of the day-to-day management of ACE and its operations."[7]

Companies outside insurance and financial services are also winning with strategic risk management. Lego, the legendary toy company, assembled a new strategic risk management approach to augment an ERM program focused on operational risks, employee safety, information technology security, and financial and legal risks. Before 2006, when it added strategic risk management, its average market growth was 2 to 3 percent and average return on sales growth was 17 percent. The new strategic risk management program accounted for shifting demographics, regulatory changes and new competitors.

[7] Robert E. Hoyt and Andre P. Lienenberg, "Evidence of the Value of Enterprise Risk Management," *Journal of Applied Corporate Finance* 27, no. 1 (2015): 41–47, http://onlinelibrary.wiley.com/doi/10.1111/jacf.12103/pdf.

In SRM program's first five years, Lego saw average market growth spike to 20 percent and return on sales growth reach 31 percent.[8]

At Nissan, the global car maker, large-scale investments in strategic risk management were critical to its resiliency after the 9.0 magnitude earthquake and resulting tsunamis that struck the east coast of Japan in March 2011. About 80 percent of Japan's automotive plants suspended production. By September, the overall production of the Japanese car manufacturing industry had fallen nearly 25 percent. Nissan's dipped less than 4 percent.[9]

According to PwC and the MIT Forum,[10] the keys to success are a proactive approach to strategic risk management and a focus on "identifying risks as early as possible, actively analyzing these risks, planning countermeasures and rapidly implementing them." Further, Nissan had an extensive "continuous readiness plan encompassing its suppliers that included an earthquake emergency response plan, a business continuity plan and disaster simulation training." By the end of the year, Nissan's production was up more than 9 percent, while the industry's had fallen by more than 9 percent. In this case, strategic risk management proved to be a significant and quantifiable competitive advantage.

This is not to say that these impressive achievements are entirely attributable to strategic risk management (though in Nissan's case they certainly seem to be). However, the correlations are simply too great and the examples too many. The record is clear: Risk management has paid off at a wide variety of companies.

5. Overcoming the Barriers

Some observers may look upon these results and assume that strategic risk management is hugely expensive. After all, these are highly trained and experienced analysts modeling and testing scenarios. But costs get lower as the maturity curve gets higher. Aon's 2010 Global Enterprise Risk Management Survey found that among advanced ERM teams (those which possess highly developed abilities to identify, analyze, manage, report and monitor risks across the organization), 78 percent were moderately to very successful in reducing the total cost of risks.[11] In other words, strategic risk management pays.

KPMG has found that ERM programs actually reduce costs, including hedging and insurance costs, by identifying risk exposures, offsets and various redundancies and inefficiencies. One company saw a bond

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[8] Kristina Narvaez, "Value Creation Through Enterprise Risk Management," webinar, 2013, http://www.erm-strategies.com/blog/wp-content/uploads/2013/07/Value-Creation-Through-Enterprise-Risk-Management.pdf.

[9] PricewaterhouseCoopers and the MIT Forum for Supply Chain Innovation, "Making the Right Risk Decisions to Strengthen Operations Performance," Global Supply Chain and Risk Management Survey, 2013, https://www.pwc.com/gx/en/operations-consulting-services/pdf/pwc-and-the-mit-forum-for-supply-chain-innovation_making-the-right-risk-decisions-to-strengthen-operations-performance_st-13-0060.pdf.

[10] Ibid.

[11] Aon, "Global Enterprise Risk Management Survey," 2010, http://www.aon.com/attachments/2010_Global_ERM_Survey.pdf.

rating change from A to A− as a result of its weak ERM program, with an increase in new-issue interest rates from 0.2 percent to 0.4 percent. That equates to $200,000 to $400,000 in additional interest expense each year on a $100 million bond issue.[12]

McKinsey has also highlighted capital market perceptions of the value of ERM in the insurance industry. Looking at Standard & Poor ratings as the basis for ERM value, McKinsey found that insurers with a higher rating during the 2008–10 financial crisis experienced less volatile returns on equity and more stable stock prices compared to firms with lower ratings. The report concluded: “Better risk management preserves equity value especially during periods of stress.”[13]

The same report also highlighted the unique challenges of building extensive strategic risk management within insurance:

> Insurers fail to apply ERM effectively because they regard risk pooling or risk transfer as the “bread and butter” of their business. Several successful insurance companies that have underinvested in a centralized ERM function argue that risk management is a core business skill.[14]

While risk evaluation and analysis is certainly at the heart of the insurance enterprise, actuaries in particular should avoid the misconception that strategic risks are like the others they model and weigh for a living.

Any firm undertaking a strategic risk management approach must recognize that it’s not easy, as confirmed by a range of industry research. Deloitte’s ninth Global Risk Management Survey indicated that 55 percent of companies find defining risk appetite for strategic risks extremely or very challenging. A mere 20 percent of companies surveyed calculate economic capital to assess risk-adjusted performance and allocate capital for strategic risks.[15]

Further, it appears that strategic risks are not fully understood. Many organizations have trouble determining the value of strategic risks and how to properly manage those risks. Due to the expected increase in importance, this is an area that will require more organizational focus in the future.

Even for insurers with mature ERM programs, organizational issues are a critical risk. Internal politics must be acknowledged as a barrier. Limited transparency across internal business units and functions is a real problem, and it’s obviously difficult to challenge the deep thinking of senior leaders, with their long tenure and track records of accomplishments, about their baseline strategic assumptions—

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[12] KPMG, “Placing a Value on Enterprise Risk Management,” 2009, http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/documents/Placing-Value-ERM-201003.pdf.

[13] McKinsey & Company, “From Compliance to Value Creation: The Journey to Effective Enterprise Risk Management for Insurers,” February 2014, http://www.mckinsey.com/~/media/McKinsey/dotcom/client_service/Financial Services/Latest thinking/Insurance/From_compliance_to_value_creation.ashx.

[14] Ibid.

[15] Deloitte, “Operating in the New Normal: Increased Regulation and Heightened Expectations,” Global Risk Management Survey, 9th ed., 2015, https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/risk/dtt-en-wp-global-risk-management-survey9-20052015.pdf.

especially if the conversations happen at the board level. For all these reasons, companies need a rigorous process for strategic risk management, inclusive of critical communication and consensus building.

Again, for actuaries, this "soft stuff" can often seem very difficult, but it is critical to facilitating the development of high levels of risk intelligence across the organization, where everyone recognizes the careful evaluation of risks as part of their day jobs.

The opportunities for improvement are great. According to EY's 2015 Global Governance, Risk and Compliance Survey of 2,000 board audit committee members, senior executives, and assurance and compliance executives, 85 percent of respondents indicated that opportunities exist in their organizations to improve the link between risk and business performance. A full 77 percent indicated their organizations limit the ability to adjust business strategy to the changing risk landscape because the organization's risks are viewed annually instead of continuously.[16]

6. Operationalizing SRM: Putting Strategy Into Practice

The key is to go deeper than industry standard frameworks, such as the 2004 Committee of Sponsoring Organizations of the Treadway Committee (COSO) ERM Framework. In fact, the COSO ERM Framework is being rewritten to link more closely to organizational strategy to address the unique risk profiles that most companies face. Insurers considering expanding into underpenetrated markets—in Southeast Asia, for example, or sub-Saharan Africa—would need to thoroughly evaluate a range of geopolitical risks (the stability of electoral systems, the maturity of political institutions, the integrity of regulators), as well as the demographic and socioeconomic trends (population growth and an expanding middle class).

Even within demographic data, there may be gray areas. Consider the millennial generation and its relationship to insurance. This cohort is marrying later, living at home longer and switching jobs more often than previous generations. Millennials appear generally less inclined to purchase life insurance products, and they don't assume that they will buy policies from traditional carriers (especially if those carriers cannot effectively engage and communicate in the social and digital channels millennials prefer).

For actuaries trained on the rather more black-and-white numbers in mortality tables, evaluating and assessing these less tangible factors can seem a daunting task. Within the strategic realm, however, techniques such as structured scenario analysis and probability monitoring can be applied to reduce the uncertainty of success of the overall business strategy. At its core, that's what strategic risk management is all about.

Again, the goal is not to set up barriers or add more protections, but rather to embed strategic risk awareness and principles into both the design and implementation of the strategy. Remember: Vehicles

[16] Ernst & Young, "There's No Reward Without Risk," Global Governance, Risk and Compliance Survey, 2015, http://www.ey.com/Publication/vwLUAssets/theres-no-reward-without-risk-EYs-global-governance-risk-and-compliance-survey-2015/$FILE/theres-no-reward-without-risk-EYs-global-governance-risk-and-compliance-survey-2015.pdf.

are able to reach their destinations sooner and more safely *because* of—not *despite*—brakes, traffic signals and lane buffers. When it comes to high-performance automobiles, even test drivers wear safety gear and test tracks have cushioned bumpers because their presence is necessary to help these vehicles achieve their peak performance.

7. Measuring and Monitoring

Risk indicators should be viewed like other important business metrics and captured within an actively monitored dashboard. Optimally, the strategic risk indicators are diverse, with several that may be closely overseen by the chief financial officer, and a few for the chief marketing officer, chief operating officer and other senior leaders. While the right indicators will vary by company, common examples include:

- Capital allocations
- Market share
- Key revenue drivers
- Profitability
- Cost/expense management
- Security resiliency
- Customer satisfaction
- Employee engagement

The dashboard should also provide notifications when predetermined upper or lower limits are reached (or breached) so that the information is shared, appropriate levels of discussions ensue, and necessary actions are taken before the next meeting of the risk or operational committee is scheduled.

8. Learning From the Past

Insurers can learn from their recent experience in implementing ORSA and meeting the demands of other regulatory initiatives. There is business value for those firms that look beyond the lowest common denominator of compliance, and focus their ORSA efforts toward building out more robust and disciplined decision-support processes. Similarly, there is little doubt that banks that took a similarly broad, long-term and value-oriented approach to their stress-testing requirements are reaping the benefits today.

9. Conclusion

The many examples cited throughout the paper—including those from the insurance industry—demonstrate that the time for broader adoption of strategic risk management has come. Indeed, as insurers invest more heavily in ERM generally, there is a clear foundation for further focusing ERM teams on the strategic and high-value aspects of ERM. In other words, it's time for insurers to get more strategic about their approach to risk management.