

The alignment challenge

How strategic is your ERM program?



Overview

We believe that Enterprise Risk Management (ERM) programs focused on and consistently aligned with strategic priorities and initiatives provide the greatest benefits to organizations. Strategic priorities often change over time, and if risk management activities do not address these changes, associated efforts can become reactive, misaligned and compliance-focused rather than supportive of strategic decision-making.

Additionally, assessments may cover a wide spectrum of low impact risks, which although important, become unnecessary noise in the prioritization process. Compounding the challenge is the tendency for assessments to focus on current or historical issues rather than the future – and to short-change strategic issues if risk management program initiatives are managed independently.

This article articulates the challenges and provides actual client examples of how to align strategies with risk management activities. Several actions can refocus ERM programs to better integrate risk management activities with strategic priorities.

Challenges to Maintaining a Strategic Focus

In an environment where organizations have limited resources and attention to apply to risk management, ERM program success can be judged by the ability to narrow management's focus quickly to the few, most important issues. Three major challenges to maintaining a strategic focus in ERM programs are:

1. Constant Change – Strategic priorities are constantly changing to address external issues, trends and events and the internal capabilities to respond to business challenges. Therefore, risk management information, including risk appetite and tolerances, can quickly become misaligned and outdated unless routinely updated to reflect the current and future business environment.

2. Organization & Risk Ownership – When dealing with risks highly aligned to strategy, complex governance and organizational issues, questions often arise as to “who owns the risks”, “who should review the risk plans” and “what forum is best for discussing risk mitigation strategies.” Even though significant progress has been made over the last decade in raising risk awareness, the ERM programs are often organizationally separate from and not integrated with strategic decision-making and strategic planning. For example, organizations often have both strategy discussions and initiatives and separate risk management discussions and initiatives, but there is limited integration between the two. Risk-based strategy alignment, on the other hand, provides a structured approach to ensure that risks and risk mitigation are key elements in strategy discussions. The focus on alignment is intended to reduce redundant strategic and risk management activities and eliminate gaps between objectives, strategic initiatives, risks and risk management plans.

3. Risk Complexity – The largest challenge to maintaining a strategic focus within ERM programs is the natural tendency to focus on the “easy stuff” and develop a granular focus on issues where companies are most comfortable. Strategic issues are often seen as too big to fit the “one-risk, one-owner, one-approach” tactical methodology applied within many ERM frameworks. In an environment with limited resources and management attention, the unintended consequence is that strategic issues sometimes get short-changed. Strategic issues are often more structurally complex and can involve many areas of the organization to effectively address and mitigate. The structural complexity for strategic issues is often driven by complex inter-relationships between multiple internal and external

risks. These complexities often escape simple risk assessments and require more sophisticated analytics including detailed risk driver analysis, capabilities assessment, risk scenarios and simulations, and risk measurement for individual and aggregate risks.

A Narrow Focus Doesn't Mean Missing Emerging Issues

Focusing on a few things does not mean that action planning, monitoring and reporting activities take a holiday. Risk monitoring and reporting activities should continue for the organization's current risks as well as emerging risks which could become part of the organization's risk profile over time. The whole process resembles a pyramid with the few strategic issues at the top executive level and the business owners, risk management and planning organizations focused on the details below that level.

When significant risk events occur, they are typically combinations of smaller issues which cascade into something large. The analysis of the combination of factors can be quite complex and requires a deep understanding of business information and risk management techniques such as risk measurement and scenario analysis.

Questions

- What are the organization's strategic objectives? What are the strategic initiatives?
- How do you align identified risks and the strategic objectives and goals within the organization?
- Is a structured framework and approach used to integrate risk management into strategy discussion? How?
- Are risks identified, assessed and addressed for each strategic initiative?
- Have risk assessment participants highlighted and prioritized strategic issues facing the organization?
- Is risk management language used when discussing strategies?
- Are there one set of organization initiatives or separate initiatives for strategies and enterprise risks?

Immediate Actions to Make ERM Programs More Strategically Focused

A good starting point is to pose two questions – What are the strategic objectives? What are the strategic initiatives? The answers to the two simple questions can be used to map the strategic objectives and initiatives to the organization's risk profile. We often find that existing strategic initiatives and risk plans are not aligned with and not focused on “top of mind” issues for Boards and senior management teams. Gaps between objectives and plans and misalignment of strategic and risk initiatives are a primary reason for failed strategies.

We recommend close coordination between the ERM program leader, the senior management team and planning groups to facilitate the sharing of critical business and risk management information across the organization. ERM is by definition focused on strategic issues so this is a natural fit. Ongoing communication between the ERM group and planning groups can support short-term alignment between the strategies and risks, and longer-term alignment of risk management activities with the planning and governance calendar.

The key to success is clear communication of risk management program intentions and plans. Improved risk management capabilities can be a powerful catalyst for better decision-making, but can be somewhat threatening if not rolled-out properly. We often find limited knowledge within business areas of existing ERM program activities or planned development of risk management capabilities. If we think through the major ERM program areas – governance, assessment, analytics, and monitoring and reporting – there are many ways to integrate risk management into strategic decision-making.

A Common Language – It is best to first address how business issues are described. This includes terminology for strategic objectives and related strategies, and how operational activities and plans are related to strategies. Risk management terminology should address risk assessment concepts such as risks, risk causes, risk consequences, and risk impact and likelihood, risk exposure, and management capability. Specific risk impacts such as financial, operational and reputational should be clearly understood. Lastly, risk analytic methodologies such as risk scenarios, simulation analysis and risk measurement should be used as tools to integrate with business processes.

Risk Inventory – The organization’s risk inventory should reflect the current business environment and strategic challenges identified by senior management. Additionally, the language used to describe risks should be as specific to the organization as possible. For instance, rather than referring to geopolitical risk in generic terms, the risk might better be described in terms addressing specific business uncertainties in a particular geographic area.

Additionally, it is important to not confuse the strategic risk with the underlying risk drivers and risk consequences. For instance, using the geopolitical risk example, if a strategic objective exists to expand business in a given geography, the risk may be described as changes in customer demand in the geography, a risk driver might be political unrest, and the consequences may include reduced sales.

Risk Assessment Criteria & Prioritization – Unfortunately, many organizations see a simple risk assessment as the end product of the risk management process. We believe that the most important element in the risk assessment process is the prioritization of risks and analysis of capabilities to drive the development of risk-based strategies.

The risk assessment prioritization criteria should be reviewed to ensure that the scales reflect a combination of financial, operational, reputational, and other industry specific impact factors relevant to meeting strategic objectives. Additionally, the scales when applied to the risk inventory should result in no more than five to ten risks being ranked high enough to deserve executive attention. The management of these risks should be viewed as critical to achieving strategic objectives.

Although it is valuable to focus on the “big risks”, it is equally important to utilize an approach which focuses on gaps between risk exposure and management capabilities. An honest appraisal of management capabilities can make the tone of risk mitigation plans more positive by focusing on tangible ways to enable risk taking by improving specific capabilities including people, processes, technology, policies, analytics, reporting and organization. Using this approach can focus risk management discussions on *how much risk to take* rather than a simple focus on risk reduction.

Risk Plan Development – A risk plan is not a “plan to have a plan”. Plans should clearly articulate the risks, underlying causes, potential consequences, interrelated risks and how they relate to strategic objectives and current strategic initiatives. This base-line of information is critical to choosing the appropriate time-bound steps to effectively manage the risks and support additional risk analysis.

Post-Assessment Integration – The output of a risk assessment process is often a risk plan which is somewhat similar, but different from strategic initiative plans developed separately. This can result in ongoing difficulties aligning the information and burdening the business with too many priorities and too few resources. The best solution is to integrate risk management language, content and

methodologies into the planning processes to enable close alignment and a single integrated set of management initiatives. If that is not possible in the short-term, the strategic plans should feed the enterprise risk assessment.

Sharing between ERM and Planning Functions – The ERM program and the planning groups should share risk assessment information, the planning calendar and templates, and risk analysis methodologies and output. Risk analysis information can directly support capital allocation discussions during the capital planning processes.

Communication and Training – This is an opportunity to reinforce desired risk management behaviors and build an open and transparent risk culture. Often risk management communication and training is geared towards narrow goals for the risk management function such as accurate completion of risk assessments or reinforcing concepts such as risk identification. The focus should shift over time from “what should be done” to “how to integrate risk management information and capabilities into decision-making.”

Risk Analysis – The analysis tools provided by an ERM program should help businesses develop a deep understanding of how individual and aggregate risks affect strategic objectives. Businesses should understand the combinations of risk issues, trends and events which pose a threat to the organization. The risk relationships can sometimes be straightforward, but often require recognition of underlying risk causes and potential consequences.

Monitoring and Reporting – Lastly, the monitoring and reporting of risks and risk plans should provide a clear linkage between strategic objectives, strategic initiatives and the risk profile. Risk reports should be shared with the business, planning and risk management functions.

Example – Risk Management & Strategic Plan Alignment

A large health insurance company conducted a comprehensive strategic planning process and developed a two year strategic plan with four pillar objectives and supporting initiatives for each objective. Approximately three months after the plan was approved and being implemented, the CEO of the organization decided to conduct a corporate level risk assessment.

Through a series of interviews with the senior management team, the top risks to the achievement of the strategic objectives were identified and validated with executive management. The risks were aligned with the appropriate strategic objective(s) and a facilitated risk assessment workshop was conducted with the top company executives. The risks were then prioritized according to their impact, likelihood, and current management capabilities. A subset of the top risks with the largest gaps between risk exposure and current management capabilities were thoroughly vetted and discussed.

To the surprise of the executive team, none of the strategic initiatives previously approved and launched were addressing these top risks. The company then revamped and realigned the strategic and risk initiatives ultimately leading to the successful achievement of the strategic objectives with minimal surprises.

The Value Proposition for Strategic Alignment

Most organizations want to make risk assessment processes more strategically relevant and reduce “organizational surprises”. The key to success often comes down to demonstrating the value by applying key risk management capabilities to a current strategic challenge. We suggest starting with a single strategic issue and applying risk management methodologies to develop a deep understanding of the issue. This simple action may identify gaps in risk ownership and improve the overall likelihood of the strategy’s success.

An additional benefit from strategic alignment is enhancing risk awareness and understanding among the management team for opportunities to integrate risk management into strategic decision-making. Strategic alignment can improve understanding of current risk management capabilities, resources and processes, which can lead to efficiencies through the consolidation of risk assessments and analysis, risk and strategic initiative action plans, and aggregate risk reporting.

Potential Benefits from Strategically Focused ERM

- A standardized risk assessment methodology and criteria enabling consistent application across the organization to support strategy discussions
- A better understanding of current risk management capabilities, resources and processes to support the achievement of strategic objectives and goals
- A forward-looking risk profile aligned with strategic goals and objectives
- A better understanding and articulation of business uncertainties and strategies to reduce “organizational surprises” and increase confidence of achieving goals and objectives
- An understanding among the management team of opportunities to integrate risk management into business decision-making

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