CUTTER CONSORTIUM

Executive Summary

Risk Management and the Strategy Process

by Ken Doughty and Craig Terry

Business Technology Strategies
Executive Summary Vol. 16, No. 1

The global financial crisis (GFC) provided a once-in-a-generation opportunity to develop support among key decision makers that a strategic view of risk management actually does matter. Post-GFC views of risk management increasingly seek to embed the analysis and understanding of risk within the strategy process. After all, strategy is about taking risk. The challenge then becomes: how do we control this risk taking?

For many organizations, risk management tends to be something tacked on at the end of a strategic planning cycle rather than an integral part of the process. One may often hear a CRO claiming that he or she has a "seat at the table" within the strategic management process. The reality is that the CRO may have the seat, but risk is not taken into consideration until after the strategy has been substantially determined.

For risk management processes to be fully embedded within those of strategy creation, boards and management need to have both an intimate knowledge of the concepts of risk and an understanding of how organizations create strategy. Organizations are diverse. Each will have its own methods of strategy development depending on such variables as size, maturity, culture, technologies, industry sector, economic environment, and so on. In the accompanying *Executive Report*, we explore these methods. Due to this diversity, organizations need to understand the following:

- The risk attitudes of key stakeholders as the starting point by which risk capacity, risk criteria, and, importantly, risk policy can be developed and then used as the major guide within the strategy creation process
- The varying models of strategy development used within different environmental contexts and how risk management needs to be relevant to the context
- The inherent problems within each major type of strategy development process model

STAKEHOLDERS AND DEVELOPMENT OF RISK POLICY

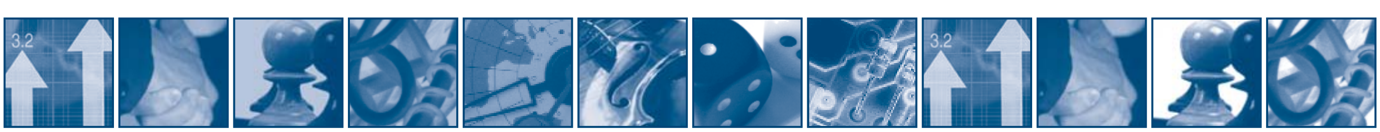
Stakeholders provide resources that they put at risk; they have "skin in the game" — provided they get something in return. For example, the customer risks buying the wrong product; the shareholder risks losing its investment; governments risk losing support; employees risk losing their jobs or risk wasting time if their careers don't develop in an acceptable way. All stakeholders are themselves taking some level of risk when providing "support" to the organization.

The key questions to ask in any organization are:

- What value do we need to deliver to each of our key stakeholders in return for the resources and support supplied by these stakeholders?
- How much risk is the stakeholder prepared to take in providing this support?

Risk then, at this level of the organization's search for strategic purpose, views the risk attitudes of each stakeholder. This in turn helps the organization define:

- The "capacity" of the organization to take risk, as it is the stakeholders who provide this continuing capacity (e.g., shareholders provide equity capital; bankers provide debt capital; employees provide human capital and skills; customers their loyalty)
- The specific risk criteria of acceptability, or otherwise, of strategic activity applicable to each stakeholder
- The risk policies that will guide the organization throughout its strategic decision-making processes based on these criteria



In this way, a risk assessment becomes an inherent part of identifying what "risk-adjusted" value needs to be created for each stakeholder and hence what strategies need to be ultimately pursued in delivering this value.

MODELS OF STRATEGY DEVELOPMENT

Having identified risk policy, the organization then needs to understand what environmental context it operates in, as this impacts the processes to create strategy. Differing risk management processes need to be embedded within whatever method the organization employs.

Within the classical management concept of formal, planned views of strategy development — that is, strategy by "design" — a foundation assumption is that knowledge resides at the top of organization. Other assumptions about the functioning of this model include that careful analysis makes it possible to predict and forecast the future and that the organization can use its existing resources, or indeed change its structures and processes in a planned way, in order to match external environmental challenges.

In more unstable or uncertain external environments, knowledge and structural hierarchies within the organization need to be designed in order to generate a degree of "learning." Strategy is uncertain because the environment is uncertain. Thus, the organization should develop strategy in a more incremental, experimental, and "learning by doing" approach — since strategy in fact "emerges."

In both models, the design of risk management processes and the approach taken by senior management to define its risk appetite will be significantly different and needs to be understood. In the design model, risk management itself will likely be highly formalized to match the formal strategy approaches inherent within this model. In the emergent model, alternative means of risk management need to be employed as the formal checkpoints and milestones of the design approach will not be available. Risk management itself needs to be in a "learning" mode; the concept of culture becomes important in this context.

The incremental nature of the emergent approach can make it an effective change management framework. Change is more easily implemented as the culture more readily allows this change compared to the sometimes bold, top-down change typical of the design approach. But herein resides the danger!

The culture of the organization can end up getting in the way of required change. The organization ends up "drifting" and doesn't actually change enough to keep up with a changing environment. When this is finally recognized by the organization (if at all), sometimes it is too late, or, the amount of change required is so great that it introduces its own risks and costs.

All strategy models will have their own risks. Emergent approaches don't always allow enough change. In contrast, design approaches may try to introduce bold new strategies that are gross oversimplifications of what is ultimately a complex world. Regardless, boards and management must address this complexity. The framework discussed in the report will help organizations:

- Identify those strategies and the consequent risks that are acceptable to stakeholders in risk-adjusted value terms
- Understand how different risk processes need to be embedded within environmentally different strategy processes
- Acknowledge the potentially risk-creating weaknesses of the strategy process itself

Business Technology Strategies Practice

FOR MORE INFORMATION

For more information on Cutter Consortium's Business Technology Strategies practice, led by Practice Director Ron Blitstein, and other services, contact: Tel: +1 781 648 8700; Fax: +1 781 648 8707; Email: sales@cutter.com.

 Print ISSN: 1530-3470 (*Executive Report*, *Executive Summary*, and *Executive Update*); online/electronic ISSN: 1554-7086. (The Business Technology Strategies practice also includes ISSN 1554-7035, 1554-7043, 1551-6261, 1554-7094, 1529-4870, and 1554-7051.)