11-2009

Strategic management of three critical levels of risk

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By Christine G. Springer

The financial crisis that erupted in 2007 revealed a major gap in the management systems of government and business. For the most part, governments focused on revenue growth, productivity, cost control and quality. There were many interrelated factors involved with the failures but two in particular stand out in my mind: a failure to explicitly account for risk when formulating organizational strategies and a failure to monitor and manage the risks that they had identified and assumed. Organizations face many different types of risk but often they can be categorized into three types based upon their predictability, controllability and management. Perhaps, most important to consider is the magnitude of the risk's consequences to the organization and the community served. For that reason, it is important for public managers to be aware of three levels of risk and how to manage them. Level 1, the lowest category, encompasses routine operational and compliance risks. Level 2, the middle category, represents strategy risks. Level 3 represents unknown, unknown risks.

Level 1 risks arise from errors in routine, standardized and predictable processes that expose the organization to substantial loss. These processes are often categorized as either strategic or vital. Vital processes include the maintenance and updating of financial accounting and tax systems, protecting important assets and information as well as ensuring information security, privacy, backup and disaster recovery. They also include internal controls that protect against fraud, negligence, legal and other regulatory liabilities. Any break down in these processes could expose the organization to financial and information losses as well as litigation. And even when the processes are performed perfectly, the organization can still fail in its strategy execution. Protecting against these risks usually involves extensive training of personnel and the establishment of standard operating procedures, creating internal controls which may include the segregation of duties and the empowering of an internal audit department to monitor operating processes so as to highlight defects and deviations in compliance. All of the risks at this level are known and avoidable. Therefore, risk management of these processes strives to achieve 100% compliance and zero defects.

Level 2 or strategy risks focus on sustaining the organization and its services into the future. That may involve acquiring and maintaining a competitive advantage over other government, non-profit and business organizations as well as the securing of superior financial returns and revenues. To do so always involves some risk. These risks can be straight-forward and easily quantifiable such as when a public utility accepts the risk of default when extending credit to customers or providing them with extra time to pay their utility bills. They can also be more speculative such as when a government develops an entirely new product line or service or enters into a new market. To manage these risks, I have found that it helps to identify the major plausible risks inherent in the strategy, attempt to mitigate or manage those risks and then continually monitor the risk exposure it has accepted in order to earn superior returns. Possible strategy risks include financial, reputation, environmental, human resources and information technology risk.

To manage strategy risks effectively, an organization needs to develop a framework for identifying, mitigating and systematically managing the risks to the organization's strategic objectives in an integrated and comprehensive manner. This may mean identifying the obstacles and barriers that could preclude the organization from reaching its goals as well as finding a way to measure progress toward targeted performance. As an example, if the objective is to develop technologically skilled workers, the organization may establish a metric to measure the percentage of workers rated as "very good" or "excellent" for their relevant skills, experience and knowledge of technology. Then the organization should look at what risk events threaten achieving the objective such as high turnover, retirements or ineffective training programs. Planning for and coping with Level 2 strategic risks requires that public managers identify the major risks to the strategy, establish an early warning risk assessment warn system to signal when adverse conditions are occurring and set priorities for funding that will prevent or mitigate the most likely and consequential of strategic risk events.

To be effective, risk management must be a priority for senior managers and time to discuss critical operational and strategy risks should be allocated monthly to a strategy review meeting that often is facilitated by risk professionals. Such periodic reviews ensure that executives regularly discuss the organization's risk exposure and assess how well they are mitigating the known risks to the strategy.

Level 3 risks are often described as the "unknown unknowns": the unpredictable, unprecedented occurrences that create existential risk. One could say that this kind of event was experienced by General Motors and Chrysler when oil prices doubled making their profitable product lines of large, fuel-inefficient vehicles unsellable to consumers. Neither company had planned or implemented a strategy that could generate positive cash flows in a world of high gasoline prices. While quantifiable models may have difficulty predicting the likelihood of these risks, managers can still plan for or mitigate them. For example, California is at risk along the San Andreas Fault for a Level 3 kind of an earthquake event. Scientists believe that such an event is plausible within the next several decades, but they cannot predict either the year it will occur or its magnitude. Nevertheless, citizens and communities can mitigate in advance the consequences of such an earthquake by constructing buildings that are earthquake resistant and by formulating emergency and disaster relief plans. Some organizations like Goldman Sachs and JP Morgan Chase do their Level 3 risk planning by conducting active discussions of unlikely events and their consequences. The meetings are referred to as tail-risk meetings because the likelihood of the events discussed are in the "tail" of the probability distribution. Such meetings help leadership teams determine whether the organization's strategy is sufficiently robust to survive the disruptions that might occur from "unknown, unknowns".

In the final analysis, risk management requires predicting events, particularly the unlikely ones that have never occurred. But despite the difficulty of risk management, public managers who avoid, de-emphasize or delegate it to another person or another time, do so at their own peril. Risk comes in many forms and combinations. Some risks like Level 1 risks are known and unavoidable. Public managers attempt to minimize their incidence through standard operating procedures, internal controls and internal audits. Other risks, like Level 2 risks, are inherent in the organization's strategy and they are accepted as a necessary part of superior performance. Finally, some risks are uncontrollable, external events that threaten the organization's very existence. Ultimately, risk management requires leadership especially when times are good and there are no clouds on the horizon. It is then that public managers must have the courage to be aware of the positive and negative consequences of an action and be prepared to turn down opportunities that expose the organization to excessive risk.