Integrating Strategic Risk into Enterprise Risk Management (ERM)

Craig Krimbill
Senior Manager | Deloitte Advisory
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Welcome

Agenda

• Evolving enterprise risk management (ERM)
• Strategic risk
• What boards are asking?
• What executive management can do
Regulators, governments, analysts, and “the street” are paying much more attention to this particular management capability...

The proportion of significant losses in market value caused by each type of risk over the past decade:

- Strategic: [VALUE]
- Operating: [VALUE]
- Legal and compliance: [VALUE]
- Financial reporting: [VALUE]

The proportion auditors spent on each type:

- Strategic: 39%
- Operating: 11%
- Legal and compliance: 42%
- Financial reporting: 6%


Strategic risk was added to ERM

ERM is evolving...
ERM is transforming and moving to the forefront of organizations, executives and board of directors…fueled by:

- Worldwide financial instability and networked economy
- Increasing regulations
- Hyper-connected world with constant threat of accelerating disruption and amplified reputational risks
- Routine and novel crises resulting from man-made and natural disasters
- Amplified media attention to corporations, geo-political, and economic uncertainty
- Extended enterprise (offshoring, outsourcing, and shared services) accountability
- Shifting competitive and stakeholders’ landscape

Risk is everywhere—external and internal, interconnected, growing, and ever-changing—AND is essential to GROWTH

As a result many organizations are evolving their own ERM function

Managing Crises
Prepare, respond, and recover from issues, incidents, and crises to limit business disruptions, reputational damage, and value destruction

Managing Business Risks
Execute a consistent, pragmatic process to manage business unit risks while elevating risks with enterprise impact

Managing Strategic Risks
Proactively identify risks at the corporate level that undermine a company’s ability to achieve or maintain exceptional performance
What are strategic risks?

Strategic risks attack the basis for competitive advantage. They challenge the logic of strategic choices, threaten an organization’s competitive position, and as a result, they can undermine a firm’s ability to achieve or maintain exceptional performance.

Long-term success relative to competition, for example:
- Superior talent acquisition
- Better customer service
- Exceptional supply chain efficiency
- Competitive pricing
- Innovation
What are strategic risks?

They challenge the logic of strategic choices

Integrated set of choices that create sustainable advantage, for example:
- Where to play?
- How to win?
- How to organize?

What are strategic risks?

threaten an organization's competitive position

Favorable position relative to competitors, for example:
- Premium player
- Low-cost player
- Innovator
What are strategic risks?

and as a result, they can undermine a firm’s ability to achieve or maintain exceptional performance.

Outstanding long-term financial return, for example:
- Return on investment
- Return on assets
- Return on equity

Strategic risks can be calculated, imposed, or self-inflicted

Risks can be categorized by an organization’s ability to manage and receive value from them

- **Opportunities**
  - **Imposed risks**
    - Risks originating from uncontrollable and unavoidable external factors (e.g., catastrophes, and regulatory changes)
  - **Calculated risks**
    - Risks resulting from organization’s strategic and operational choices intended to generate value (e.g., new markets and products, adoption of new technology)
  - **Self-inflicted risks**
    - Risks resulting from day-to-day operations, decisions, and behaviors of constituencies (e.g., poor judgment and gaps in compliance)

- **Threats**
  - **Imposed risks**
  - **Calculated risks**
  - **Self-inflicted risks**

**Expected reward for risk** (value to an organization for taking on risks)

**Controllability** (ability of organization to minimize the uncertainties creating risks)
Why some companies fall prey to strategic risks

- Failing to align with planning process
- Failing to identify new and emerging risks
- Failing to confront cognitive and institutional biases
- Relying on historical data
- Not considering an outside perspective
- Failing to communicate

Cognitive biases are pervasive in our daily life

Anchoring, Anthropic bias, Attributional bias, Availability bias, Barnum effect, Base rate neglect, Behavioral confirmation, Belief perseverance, Bias blind spot, Clustering illusion, Confirmation bias, Conjunction fallacy, Contrast effect, Cultural bias, Dilution effect, Disconfirmation bias, Egocentric bias, Endowment effect, Experimenter’s regress, False consensus effect, Framing effect, Fundamental attribution error, Gambler’s fallacy, Group-serving bias, Group attribution error, Halo effect, Hindsight bias, Hostile media effect, Hyperbolic discounting, Illusion of control, Illusion of validity, Illusory correlation, Impact bias, Infrastructure bias, In-group bias, Just-world phenomenon, Kuleshove effect, Lake Wobegon effect, Logical fallacy, Loss aversion, Media bias, Memory bias, Mere exposure effect, Misinformation effect, Negativity effect, Negative perception of the color black, Notational bias, Out-group homogeneity bias, Overconfidence bias, Pathetic fallacy, Peak-end rule, Physical attractiveness stereotype, Planning fallacy, Picture superiority effect, Positivity effect, Preference reversal, Primacy effect, Priming Projection bias, Pseudo-certainty effect, Pseudo-opinion, Publication bias, Recency effect, Regression fallacy, Reporting bias, Risk-aversion, Rosy retrospection, Sample bias, Selection bias, Selective perception, Self-deception, Self-serving bias, Spacing effect, Statistical bias, Status quo bias, Sunk cost effects, Tunnel vision, Trait ascription bias, Valence effect
a. Thumbtacks in the box

b. Thumbtacks beside the box
c. Solution

What are boards asking?

- What are our risks beyond the “known” and how are we managing them?
- How prepared are we in the event of a crisis? How can we be best prepared for unforeseen crises?
- What’s our company’s real level of exposure to (cyber, financial, brand and reputation, and other types of) risks?
- How effective is our company at managing exposure within acceptable limits?
- What does “maturity” look like with regard to managing those risks?
- What are the questions we should be asking management about their risk exposures?
- How are our strategic choices changing the shape of risks encountered?
What are boards asking?

- What measures should we take to establish confidence in taking certain “rewarded risks” to pursue new value?
- What does true resiliency look like and how are leading companies aligning their organizations and board oversight?
- What types of processes should we have in place to ensure we understand and manage the risks that we are taking?
- How are we addressing the risks that could make the company obsolete?
- How do we evaluate, assess, and address strategic risks beyond an annual exercise or point in time activity? How do we ingrain that discipline into oversight?

So what practices are boards and executives asking for?

- Traditional ERM typically meets the basic risk needs: “business as usual” or operational risks
- Many boards and executives want dynamic risk insights (brand, reputation, emerging and strategic risks) for decision support
Evolving your risk management capabilities doesn’t have to occur all at once

As a result, effective risk management programs focus on both value protection and value creation

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**The Upside and Downside of Risk**

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<th>Manage risks to help create value (future growth)</th>
<th>Manage risks to help protect value (existing assets and capital)</th>
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<td><strong>Value</strong></td>
<td><strong>Rewarded risks</strong></td>
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