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On the board's agenda | US

Framing strategic risk in the boardroom

Accelerated economic cycles. Exponential technological advances. Increased competition. Changing customer demographics and preferences. Increased shareholder activism. New industry and regulatory requirements. Geopolitical uncertainty. The world is rapidly changing at an accelerating pace and these factors, along with many more, pose challenges to effective strategic risk thinking.

Despite the high stakes, identifying and managing strategic risks has been a difficult task. It is often unclear what to look for, signals to identify such risks are often weak, sources of information are not easily known as they are within other industries and geographies, and traditional tools and methods don't reliably detect what is "over the horizon." To add to the challenge, many companies have traditionally separated their risk and strategy functions and think of risk as more of a compliance responsibility rather than a dynamic tool for value creation, business performance management, and growth. And, while the strategy setting process has begun to factor in the many changes occurring in the world, risk management is still often considered to be a narrowly defined core activity.

For many companies, risk management remains process-oriented and siloed. Enterprise risk assessments are conducted but risk management activities, including monitoring, measuring, and reporting, may not be coordinated across the company. In this state, there is limited alignment of risks to strategies. Managed risk tends to have a more operational than strategic focus and risks tend to be addressed only after they occur. By focusing solely on mitigating risks and preventing the recurrence of a risk, companies face a slow-down in the decision-making process. We believe that companies that align strategy and risk are better served to allow for "Strategic Resiliency." Strategic resiliency is anticipating, knowing and acting on risks when introducing or executing new strategies in order to increase the chances of success in spite of uncertainty.

Creating a strategic risk "framework" to drive resiliency

Strategic resiliency is designed to strike the right balance between value creation and value protection. Applying a risk lens to strategy helps companies understand which risks provide opportunities for long-term value creation and which to protect against. To optimize value on a risk-weighted basis, companies should first make sure to have a strong enterprise risk management program as the foundation upon which to build (e.g., having a risk governance and reporting cadence, and standardizing and deploying enterprise-wide risk management processes with regard to operational, financial and compliance risks, developing risk responses, and mitigation plans).

To better integrate strategic thinking and risk awareness for more informed, value-based decision-making, management should think about a strategic framework that considers:

- How the company plans to innovate while identifying potential disruptors and strategic risks;
- Well-thought out scenarios designed to shed light on unexpected risks; and
- Mechanisms for monitoring triggers that allow the company to adjust strategies in an efficient manner.

Uncovering potentially disruptive or innovative strategic risks with little or no historic precedent generally requires a different approach than traditional risk discovery methodology and processes. In addition to preventing the recurrence of a risk, companies should also take the time to focus on "what's next." To help identify hidden and emerging risks and opportunities, companies need to think methodically about external factors (e.g., consumer behavior, new technologies, and regulatory environment) that could be sources of strategic surprise. Scenario planning is a time-tested tool that does this well.

Scenario planning can provide a company with strategic options and flexibility should the industry, the market or company face unexpected change. Scenarios should push companies to the edges, with management and the board collectively thinking outside the boundaries of the standard deviation. Appropriate scenario planning can allow companies to innovate or anticipate changes in order to optimize performance. Additionally, each scenario should focus on value in the face of potential disruption or other changes and how the company will sustain its competitive advantage and continued resilience. Scenario planning requires an understanding of how each scenario fares in light of risks and an understanding of the assumptions underlying each strategic alternative.

Leading indicators, triggers and other signals of strategic risks should be monitored to determine if management needs to adjust or adapt the original strategy to new circumstances. Management should apply judgment and expertise while deploying risk sensing technology, a system that scans the external environment for strategic risks or monitors current risks identified by utilizing data and text analytics and human intelligence. The use of big data to derive insight about risks can provide management with more relevant information to make agile and proactive strategic decisions in a timely matter and make shifts to the strategy.

To supplement scenario planning, companies should also consider applying a financial lens to potential strategic changes and conducting risk valuation modeling. For each scenario, the underlying circumstances should be assessed for various levels of uncertainty and risk, to yield a range of outcomes and the likelihood of each outcome. Companies can compare outcomes for each risk-adjusted alternative and select the alternative that provides the optimal risk/reward profile. This exercise can assist companies with determining levels of risk tolerance. The company outlines which strategic objectives are supported in taking risks and when putting strategic objectives into action, keeping within agreed-upon risk limits.

For all companies, the chances of an unexpected event occurring remains. Companies should consider formalizing a crisis response program and framework and be prepared to respond effectively. Having a vigorous, coordinated response to incidents can limit lost time, money, and customers, as well as damage to brand and reputation and the costs of recovery. Crisis response programs should also include steps to normalize operations, which may mean a change in strategy.

Role of the board as a strategic differentiator

The primary role of the board is to collaborate with management in overseeing the process of creating long-term shareholder value. Although total shareholder return ("TSR") is an important performance metric, the quest for TSR, or other performance metric a company may employ, needs to be risk-adjusted based on the potential impact of specific risks, both individually and collectively, and the risk appetite and preferences of investors.

The board should be very engaged in advising, challenging, and guiding management and ultimately in signing off on the company's strategy. With the heightened focus on innovation and disruption, activists demanding performance, and a growing list of external risk factors, boards are being called upon to play a more active role in strategic planning. Additionally, investors are looking more and more to engage (within Regulation Fair Disclosure) on how the board has been involved in the strategy process when talking with company management. (Refer to sidebar)

> "We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation. Additionally, because boards have a critical role to play in strategic planning, we believe CEOs should explicitly affirm that their boards have reviewed those plans."

Larry Fink, CEO, Blackrock

Over the course of the year, the {board} agenda should consider including and focusing on:

- Creation of shareholder value, with a focus on the long term. This means encouraging the sort of long-term thinking owners of a private company might bring to their strategic discussions, including investments that may not pay off in the short run.
- Major strategic issues (including material mergers and acquisitions and major capital commitments) and long-term strategy, including thorough consideration of operational and financial plans, quantitative and qualitative key performance indicators, and assessment of organic and inorganic growth, among others.
- The board should receive a balanced assessment on strategic fit, risks and valuation in connection with material mergers and acquisitions. The board should consider establishing an ad hoc Transaction Committee if significant board time is otherwise required to consider a material merger or acquisition. If the company's stock is to be used in such a transaction, the board should carefully assess the company's valuation relative to the valuation implied in the acquisition. The objective is to properly evaluate the value of what you are giving vs. the value of what you are getting.
- Significant risks, including reputational risks. The board should not be reflexively risk averse; it should seek the proper calibration of risk and reward as it focuses on the long-term interests of the company's shareholders.

—The Commonsense Corporate Governance Principles

Boards can start by seeking to ensure that there is a connection between the risk and strategy functions. Boards should play a role in developing a strategically resilient company by constructively challenging management to determine if the most relevant strategic risks and uncertainties have been identified and the potential impacts considered. Boards should understand the scenarios put forth, and challenge and advise on the underlying assumptions incorporated. Once agreed upon, the board should continually monitor the execution of the strategy and the risk/return results in light of overall risk appetite and defined milestones.

To help optimize risk-weighted value, boards should understand the effects risks may have on short- and long-term strategies, how those risks are being addressed, and how changes in the external environment may influence the business. Directors should draw upon and share their professional experiences and expertise in advising and challenging management's strategic decisions and the related risks. As a result of the board's role in providing significant and relevant perspective and input on strategy, board composition continues to be a critical focus to ensure that the board collectively possesses the right skillsets needed to allow for more robust engagement on risk-related strategy. Boards should continually review and assess the skills and expertise resident on the board compared to those needed to advise on the strategy set forth, and address any gaps.

Another important role for the board is to help set the tone to lead the way on transparency and accountability for the company. With heightened activist investor activity, there is a spotlight on potential areas that may trigger activist interest, for example, high cash balances, dividend policies, underperforming assets, and stagnant earnings per share, to name a few. By regularly reviewing the short and long-term strategic plans and related strategic risks through an activist lens, the board can challenge management to evaluate where vulnerabilities exist in the strategy and put a plan in place to be prepared to act or adjust accordingly.

The business environment is rapidly changing, and companies that continually innovate, stay ahead of the risk of disruption, and take advantage of strategic risk (and the opportunities they can signal) may lead the way. Boards, as a diverse group of highly experienced individuals who can provide an "outside–in" view and broader perspectives, can be essential partners in achieving strategic resiliency with management.

Questions for directors to ask:

01. Has the board engaged with management in a deep-dive, brainstorming session on strategy?
02. Does the board have ongoing conversations with management about the strategy? Are strategy discussions frequently built into board agenda topics throughout the year?
03. Have strategic risks been identified by management and has the board provided input?
04. What mechanisms does management have in place for risk sensing and monitoring risks that could result in a shift in strategy?
05. Is the strategy flexible enough to allow for a shift?
06. Does the strategy identify the company vulnerabilities?
07. Is the board confident that management has the right information to make high-stakes decisions?
08. Does the board have the right composition to effectively advise on the strategy?
09. Does the board know who is ready to lead if strategic risks are not managed? Is the company prepared for a crisis?

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