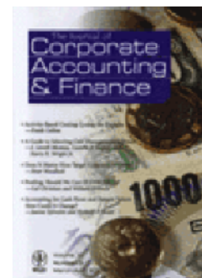
feature article



Missed Opportunities in Performance and Enterprise Risk Management

Bob Paladino, Larry Cuy, and Mark L. Frigo

Is your organization missing opportunities to incorporate enterprise risk management (ERM) into its strategic planning and strategy management processes? This article addresses how an organization can ensure that its strategic planning process considers risk and risk management. How well, in other words, do your ongoing performance management reports include ERM program concerns? And are your ERM and strategy management or balanced scorecard (BSC) processes operated together or separately?

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This article explores how fragmented linkages and lack of alignment among these processes can create risk. It also presents approaches for the integration of enterprise risk management (ERM) into the strategic planning and strategy management processes to provide comprehensive ERM/strategy management coverage and shares two winning case studies to provide direction for your future program design.

FIRST, WHAT IS A BALANCED SCORECARD?

We will use the balanced scorecard (BSC) as a normative reference to corporate performance management programs. But, you may ask, what is a BSC? Briefly, the BSC is a management framework that translates company strategy into objectives and measures across four perspectives:

- two perspectives consisting of primarily *lagging* indicators (financial and customer) and
- two perspectives consisting of primarily *leading* indicators (process and people).

We show an example of this framework later in the article; the four perspectives form the basis for "balanced" management (see Robert Kaplan and David Norton's best-selling book[1] for a more complete discussion). *Fortune* magazine reports that nearly 40 percent of Fortune 500 companies today have a BSC program to manage performance. This article reviews how the BSC and ERM frameworks together form a potent management framework that not only focuses on performance but also risk management.

WHAT IS ERM?

Bob Paladino, a subject-matter expert for the American Productivity and Quality Center's (APQC's) comprehensive ERM study, uses the APQC's definition: "ERM enables organizations to identify and manage all significant risks in an integrated way. ERM covers a broad portfolio of risk. Risk assessment is firmly rooted in an understanding of the business, its customers, and management's strategic objectives."[2]

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WHAT IS STRATEGIC RISK MANAGEMENT?

Mark L. Frigo has developed a systematic approach for identifying and managing strategic risks, which he has described as follows: "Strategic risk management needs to examine how well a business strategy will perform under different scenarios and events. It must look closely at scenarios where the strategy could perform so poorly that it could potentially result in significant losses, destruction of shareholder value, or a damaged corporate reputation. So, strategic risk can be defined in terms of the risk scenarios that could potentially lead to significant loss of shareholder value."[3]

As Frigo has noted:

> *Shareholder value risk* provides a high-level overview of risk and is driven by future growth and return on investment as reflected in the plans of the company and the company's perceived ability to execute on it. Anything that will impede growth and returns, including the risk of unethical activities of the company, should be considered in assessing shareholder value risk using the first tenet of Return-Driven Strategy, "Ethically Maximize Wealth." *Financial reporting risk* is driven by reporting irregularities in areas such as revenue recognition, which can result in restatements of financial reports and be devastating to shareholder value. *Governance risk* is driven by factors such as controls and governance capabilities. *Customer and market risk* is driven fundamentally by the extent to which a company's offerings fulfill otherwise unmet needs, and this provides protection against competition. *Operations risk* can be driven by any part of the value chain and often surfaces with the inability to deliver offerings, which is at the heart of Return Driven Strategy. *Innovation risk* is driven by the inability to change or create offerings that fulfill customer needs better than your competitors do. *Brand risk* includes the risk of brand erosion and damage to a company's reputation. *Partnering risk* is driven by the activities of your partners, from vendors to joint ventures, to other associations. *Supply chain risk* focuses on the increasing risk in outsourcing and global supply chains. *Employee engagement risk* is driven by the employment practices of the company. *R&D risk* is driven by the processes and pipeline of options for new offerings for future growth. *Communications risk* is driven by how well your company communicates internally and externally."[4]

High-performance companies show a pattern of innovation that balances focus and options in innovation pipelines, uses performance measures to monitor innovation, and learns quickly from innovation failures.

For example, innovation risk is an area where many companies may have a blind spot. High-performance companies show a pattern of innovation that balances focus and options in innovation pipelines, uses performance measures to monitor innovation, and learns quickly from innovation failures.[5] A study by McKinsey & Company discusses how high-performing innovators manage innovation risk.[6]

Risk management should also consider the upside of risk, as discussed by Adrian Slywotzky in his book *The Upside of Risk: The 7 Strategies for Turning Big Threats Into Growth Breakthroughs.*[7] For example, Target sidestepped the competitive threat from Wal-Mart by focusing on a customer segment different from Wal-Mart's—and achieved profitable growth opportunities in the process. Samsung, as another example, faced serious brand erosion and commoditization risk, so it turned its attention to build on product innovation, speed to market, and a strong brand to turn a position of weakness into a position of market strength.

Risk management should consider risk to intangible as well as tangible assets. As Frigo has noted: "Risk can include loss of tangible assets, which we find on the balance sheet, and it can also mean the potential loss of one of the company's most valuable assets—its reputation. Ultimately, strategic risk management and ERM need to be

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connected with the potential impact on shareholder value."[8] The area of reputation risk has been discussed by Eccles, Inquest, and Schatz.[9]

WHERE ARE THE GAPS BETWEEN ERM AND BSC PROGRAMS TODAY?

How comprehensive or discrete are your definitions of BSC and ERM? This question is analogous to the proverbial blind men and the elephant; their descriptions depend upon what part of the elephant each is touching.

- Does your chief financial officer define risk narrowly in terms of reductions in insurance premiums while your BSC reports transaction processing cost per check from near sourcing (for example)? What, if anything, do these two measures have in common? Nothing. These BSC and ERM definitions and measures are all too common but lack alignment and are incomplete. Author Bob Paladino states, "Integrating ERM and BSC thinking results in a more meaningful set of considerations, consider the following questions that concurrently focus on both performance and risk being discussed by a telecom client. Have we considered the risk profiles of our credit terms by customer group? Have we factored in customer lifetime value? How well do we align signature authority with positions levels, for example could a local manager with $50,000 signature authority commit the organization to a multimillion-dollar lease?"
- Has your chief information officer defined ERM program risk as a disaster recovery plan while your BSC program simplistically measures (for example) information systems uptime? These ERM and BSC programs are not going to protect your company against a multitude of other risks. For example, what about hackers invading and snatching information? How have you protected customer information? What is your password policy? How do you secure laptop content? Does your BSC track how many releases behind you are on major applications?
- Has your procurement officer "certified" vendors while, separately, your BSC captures procurement savings earned? Has your ERM program dealt with vendor concentration risk? Why does your company have only single suppliers for key products? Have you provisioned for supply-chain interruptions now that your suppliers are global?

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BSC leaders in many organizations do not talk with those responsible for ERM. Not too surprisingly, the timing of the BSC and ERM processes is not synchronized or integrated. For example, is development of the annual strategic plan an event held at a desirable offsite destination? How far down the organization are strategic plan objectives communicated? How well are strategies translated into BSC measures to enable proactive management? Do these questions apply equally to your ERM program? Do your ERM and BSC programs include customer, process, people, and risk management measures?

Do these depictions sound too familiar? These are a few examples that underscore how poorly organizations define risk, and these gaps get exposed at the worst possible times. If you have not defined your ERM and BSC programs in an integrated manner, how can you plan for, measure, and ultimately manage risk and performance? How can you optimize these relationships without all the integral components? By now, you have probably concluded, as we have, that separate ERM and BSC programs fail to optimize value to the organization, and often many operations, business, and other risks are missed by both programs.

HOW DO YOU CLOSE THE GAPS?

Research shows that leading companies have integrated their risk management programs into their strategic planning and performance management/BSC

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programs. Bob Paladino, advisor to two comprehensive APQC ERM projects noted earlier, shares this insight: "A defining characteristic of the best practice ERM organizations is their ability to define and integrate strategic planning and BSCs with their ERM programs to not only mitigate risk but also drive outstanding business results."

Globally recognized ERM expert Dr. William G. Shenkir provides further evidence of the shortcomings of many programs, "Traditionally, companies have managed risk implicitly in silos." However, management in a growing number of organizations recognizes that this approach is no longer an effective way to manage the myriad forms of risk they face."[10] He adds, "In the strategy and risk-focused organization that uses the BSC … integrating the performance management system with the ERM is an essential step in any performance management process."

The next part of this article provides our reader practitioners with more detailed insights into three key enabling processes:

1. Strategic planning,
2. ERM, and
3. The BSC strategy management.

Judging from the preponderance of strategic planning, ERM, and BSC functions in organizations, it appears that their value is recognized. However, it was not very long ago that only strategic planning existed in organizations. At that time, the only explicit consideration of risk would typically be when management evaluated "weaknesses" and "threats" during the strengths, weaknesses, opportunities, and threats (SWOT) analysis. In the late 1980s and early 1990s, it was recognized that one of the greatest risks of a strategic plan is that strategies in the plan are never implemented, let alone executed. As a result, approaches and methods such as the BSC intended to close the gap between the strategic plan and strategy management were developed. During a similar time frame, corporate risk management or ERM processes began to develop, which attempted to better identify, assess, and manage risk in the organizations. As the 2008 credit crisis demonstrated, even banks considered the most sophisticated failed to adequately strategically manage their mortgage portfolios and were bankrupted by failed public policies of loaning to consumers with no income or no income verification. Hundreds of billions of government money are now being used to recapitalize these fallen titans.

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Exhibit 1 depicts these three organization processes, including their purpose and scope, time frames, organizational drivers/owners, and expected outcomes.

The purposes of these processes vary widely, though each attempts to provide value to the organizations by enhancing its decision making and overall value. All processes apply to the entire organization or can be targeted at certain areas. Each of the processes involves an analytical process and is generally data-intensive.

The strategic plan covers a discrete period (e.g., the five-year plan) and is generally followed by development of certain measures to monitor and measure its implementation. Monitoring implementation of the strategic plan is generally the responsibility of corporate performance management. In formulating measures, it is likely that some measures are carried over from plan to plan if they are believed to provide continued value. Unlike the strategic plan and BSC, ERM is generally ongoing and open-ended. More recently, strategy formulation and strategic planning in some organizations has become more of a continuous process, or strategic plans are reviewed and refreshed more frequently than every three years.

It should be noted that each of these processes results in a narrowing of the scope or a prioritizing of the organization's focus. It would be reasonable to believe that there are inherent risk considerations being weighted in determining the expected outcomes. Organizations where this is absent are likely to result in an unmanageable level of strategies, risks, and performance measures. It is very likely that the data used for key performance indicators (KPIs) and key risk indicators (KRIs) is similar, if not overlapping, while the owners of the KPIs and the KRIs are often different and in unrelated areas of the organization.

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Exhibit 1

Comparison of Organizational Processes

	1. Strategic Planning	***2. Enterprise Risk Management (ERM)***	***3. Balanced Scorecard (BSC)/Strategy Management***
Purpose and scope of the process	Analysis of internal and external environments, organizational strengths, weaknesses, and threats leading to mission, vision, and strategic objectives for the organization	Assesses existing and emerging risks, devises organizational risk tolerance, and identifies effective risk management strategies	Develops criteria for effective performance, including leading and lagging performance indicators and drivers of intended strategic outcomes to execute strategies
Time frames	Typically three to five years with periodic review; more organizations have adopted rolling plans	Ongoing with periodic reporting	Measures and targets established annually, with results reported at regular intervals generally within a year
Organizational drivers and owners	Driven by senior management but evolving to a combined top-down, bottom-up approach	Driven by board of directors and/or senior management with input from business-area experts often based on perceived industry or organizational risks	Driven by senior management, the financial function or a business unit
Expected outcome	Articulates management's vision for success, including strategies expected to move closer to achieving the vision	Integrated business process that identifies, assesses, and better manages risks to the organization	Collaborative identification of key objectives, measures, and targets that provide decision support to management's efforts to achieve its strategies and address gaps in performance

Senior management often drives strategic planning, and the process is usually discrete, often using ad hoc teams to support the process. Accountability for success measures and execution of the strategic plan is often the responsibility of a performance management area. This area is charged with working with business functions to help measure, monitor, and report on progress in the business areas on strategic objectives. It is natural for this area to seek quantitatively oriented analysts, and some are within the financial management functions.

The impetus for risk management often starts with the board of directors' concerns over fiduciary responsibilities. With the support of senior management, this process broadens and seeks to identify and better manage existing and emerging risks throughout the organization. Often the ERM and the customer relationship management (CRM) functions are separate functions in the organization, yet they are likely to develop metrics and measures, monitor ongoing performance, and create reports that require actions from a

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business or senior management to address an emerging problem. Each of these processes attempts to ensure that the organization focuses on the "right" things, whether it's a particular strategy, risk, or performance gap. Opportunities exist to break down any real or perceived barriers between these areas and collaborate on sharing data and business intelligence. A rich and ongoing dialogue between these areas can lead to better lines of defense against organizational failure and more of an "end-to-end" process that incorporates strategic planning, risk management, and also performance management. Conversely, it is also beneficial to have some degree of independent thinking and analysis from each area to avoid unhealthy "group think."

Strategic Risk Management at High-Performance Companies

Effective strategic risk management should provide a way for identifying and evaluating how a wide range of possible events and scenarios will affect a business's strategy execution, including the impact on the assets and shareholder value of the company. The integration of the BSC and ERM Return Driven Strategy framework has been shown to be a useful framework for this.[11] It represents the best practices of high-performance companies in managing the threats and opportunities in risk. The research on high-performance companies can provide valuable insights about risk management. High-performance companies are vigilant to forces of change, and they manage risks and opportunities better than other companies. The integrated BSC/ERM Return Driven Strategy framework approach provides a way to evaluate the strategic risks of a company from the perspectives of shareholder value risk, financial reporting risk, governance risk, customer and market risk, operations risk, innovation risk, brand risk, partnering risk, supply-chain risk, employee engagement risk, research and development (R&D) risk, and communications risk. It also provides a useful framework for understanding the cause-and-effect linkages in critical risk scenarios and explains how those scenarios would play out in the business strategy and impact profitability, growth, and shareholder value.[12]

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BEST PRACTICE CASE COMPANIES INTEGRATING BSC AND ERM/BSC

We explore two primary case studies: the Federal Reserve Bank of Cleveland and the Independent Health Association of Buffalo, New York. Both organizations are managing myriad risks using approaches that tie ERM and BSC programs.

Case 1: Federal Reserve Bank of Cleveland

The Federal Reserve Bank (FRB) of Cleveland was established in 1914 as one of the 12 regional reserve banks that, along with the Board of Governors in Washington, D.C., comprise the Federal Reserve System. The Bank's main office took up residence in its current home in the heart of downtown Cleveland in 1923. The Federal Reserve Bank of Cleveland serves the Fourth Federal Reserve District, which comprises Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. The FRB of Cleveland has efforts to integrate these core processes:

- *Strategic Planning:* The strategic plan covers three years, and the BSC is used to implement strategies and monitor performance.
- *Risk Management:* A formal enterprise risk management function was established in 2004 and began with an education program on how to identify, assess, and manage risk. Each function is charged with the responsibility of identifying and managing risks. A risk management committee was established to review functional and enterprisewide risk.
- *Performance Management/BSC:* The bank has used the BSC process since the mid-1990s. The bank currently has a corporate BSC along with functional BSCs to manage performance and help to achieve strategic objectives. The BSCs include risk factors from the risk management process above. Results on the corporate BSC are made available to all employees and reported to the board of directors on a quarterly basis.

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As with past strategic objectives, corporate and functional BSCs were created in 2003 to help implement a strategic plan covering 2004–2006. Major strategies consisted of operational excellence, external focus, and leadership in thought and deed. While tactics and actions supporting operational excellence were effectively assisted through the balanced scorecard, the strategies of external focus and leadership and thought and deed proved more difficult to measure and monitor. Management determined that the same three strategic objectives would be used in a new three-year strategic plan.

INTEGRATING RISK INTO STRATEGIC PLANNING

Successful ERM in strategic planning seeks to maximize shareholder value when setting strategic goals by finding a balance between performance goals and targets and related risks. As management evaluates various strategic alternatives designed to reach performance goals, it includes related risks across each alternative in that evaluation process to determine whether the potential returns are commensurate with the associated risks that each alternative brings. Considering risk during strategy planning provides an ability to seize risk opportunities. In other situations, ERM may identify risk opportunities that may create potential increased returns to the enterprise. If risks are ignored in strategy, risk opportunities may be overlooked.

RISK-BASED STRATEGIC PLANNING AND MANAGEMENT

In formulating the corporate BSC for 2006–2009, a "risk-based approach" was used in developing the corporate BSC. The intention was that this would better focus the BSC on objectives with higher inherent risk. Strategic themes, objectives, and targets that were expected to be more difficult to measure and achieve predominated the new scorecard. Using a risk-based approach, it was determined that those objectives and targets that were likely to be achieved in the planning period were either moved to a dashboard or left for individual functions to monitor and achieve. While this resulted in a more narrowly focused BSC, it is more likely to produce results in those strategies than a less risk-based scorecard, which would be more comprehensive and include all major strategies regardless of their risk.

Major strategies consisted of operational excellence, external focus, and leadership in thought and deed.

The current BSC, as with previous ones, is reported on quarterly; the close relationship between the risk management, strategic planning, and performance management areas is expected to result in more effectively achieving goals of the organization. It is interesting to note that a review of BSCs from the past ten years of the bank revealed numerous examples of using the BSC to manage risk. Examples include continuous monitoring of employee satisfaction and their ability to serve customers through random e-mail surveys and monitoring a host of "can't fail" major projects (on schedule, within budget, and meeting expectations) over the years.

Case 2: Independent Health Association, a High-Performing HMO

The Independent Health Association (IHA) is a health management organization (HMO) serving the greater Buffalo, New York, market. The IHA's strategy has been very successful and underscores the integration of ERM and BSC programs without sacrificing the quality of health care.

HMOs, by their very nature, underwrite and manage a wide array of risks inherent in their product offerings. That is, the IHA was named one of the top ten commercial health plans in the nation and the highest-ranked plan in western New York for the second consecutive year by *U.S. News and World Report* and the National Committee for Quality Assurance (NCQA) in its rankings of "America's Best Health Plans 2006." "These rankings should be of great interest to local employers and consumers as they consider their health care options for 2007, because they represent the most objective and reliable information available within the industry for assessing the value that health plans provide for their members," said Dr. Michael W. Cropp, president and CEO of Independent Health.

RISK-BASED STRATEGIC PLANNING AND MANAGEMENT

Chief Operating Officer (COO) Carol M. Cassell comments on the importance of

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their strategy management program:

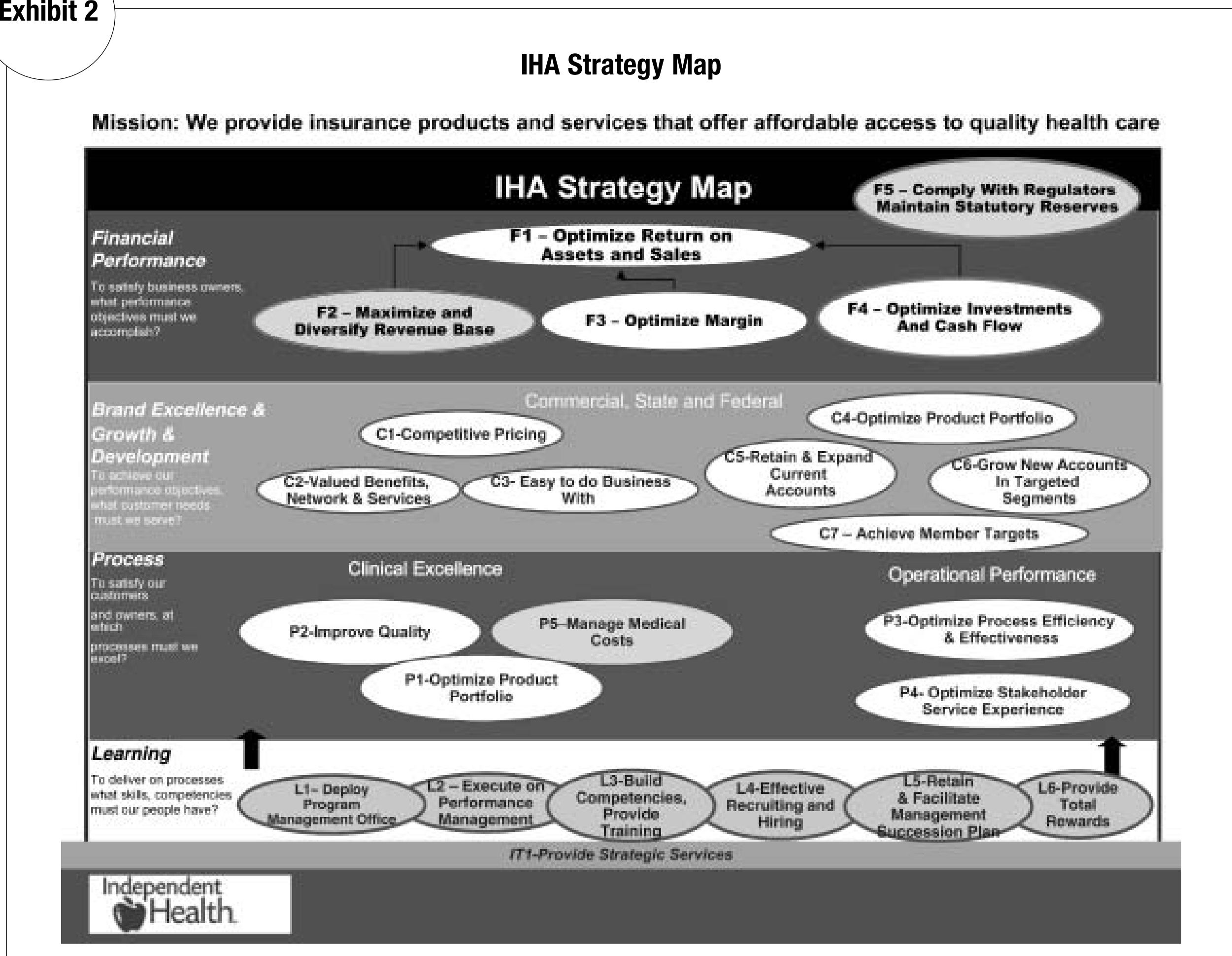
> Key to making a difference with our customers and achieving the related success is providing clarity to the organization in execution of our growth and quality strategies. This requires delivering on our values of passion, caring, and respect with collaboration and accountability across our product, sales, medical management, network, pharmacy, underwriting, service, operations, and support teams. We have partnered with author Bob Paladino to assist us in enhancing the clarity of our strategic direction to the workforce through defining our BSC Office, refreshing and cascading our Performance Scorecard and addressing risk to focus and align our employee base on financial, brand excellence, internal process and employee dimension objectives, measures and initiatives. Our industry is dynamic and having the ability to set targets, monitor performance, and adjust proactively to our members and customers needs is an essential component of managing our strategy and making a difference for our customers.

IHA ENTERPRISE RISK MANAGEMENT AND THE BALANCED SCORECARD: BRINGING IT ALL TOGETHER

IHA CFO Mark Johnson, recognizing the value of partnering with the CEO Dr. Cropp and COO Carol M. Cassell, designed his ERM program by integrating with the strategic planning and BSC programs. You will notice that the IHA's strategy map (Exhibit 2)

Exhibit 2

IHA Strategy Map



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leverages the BSC framework with strategic objectives across four perspectives to enable ongoing management. The IHA has integrated its ERM risks into the BSC concurrently managing both risk and performance. Several objectives relate to different ERM risk factors to manage:

- Objective F5, "Maintain Statutory Reserves," sharpens the focus on the relationship between underwriting medical risk and reserve requirements for meeting payouts from premiums to satisfy medical claims.
- Objective F2, "Maximize and Diversify Revenue," provides a strategic focus on the concentration revenue risk by customer segment and by health care program offered.
- Objective P5, "Manage Medical Costs," provides employees with visibility into explicit customer health profiles ranging from "healthy" to "high risk" and how to proactively reduce their health risk factors. An example would be the nursing intervention for members with a high risk of diabetes providing health care memberships or healthier diets and lifestyles.

With clarity and visibility, the IHA executive team can manage trade-offs between and among these factors. The IHA may review the relationships and trade-offs among raising premium revenue, reserve ratios, and medical payments expenses. Alternatively, the IHA could trade off investments in IT performance-related projects and security-related projects.

CONCLUSION

Organizations as diverse in nature as a regional Federal Reserve Bank and the IHA have recognized the value of integrating the processes and relationships among strategic planning, ERM, and the BSC to more strategically integrate and manage risk and better achieve business strategy.

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