What's Going To Kill Your Company?
How Boards Can Improve Strategic Risk Governance

By Neil Britten and Tom Coyne

A recent report from McKinsey noted that many companies are finding their risk management processes "inadequate for today's volatile and uncertain environment. One crucial gap is strategic risk management – understanding the critical enterprise-wide risks affecting the company's ability to reach its strategic aspirations." Based on our experience as directors, corporate officers, and consultants, we have frequently seen instances of this at the board level, where the principle responsibility for strategic risk governance lies. We believe there is a systematic approach boards can use to close this gap

Let's start with a very practical definition of strategic risk: it is any uncertainty that is hard to quantify, impossible to transfer, and can quickly kill your company. The number and severity of these risks have substantially increased over the past twenty years, as radical improvements in information and communication technology have resulted in much higher levels of connectedness, and produced equally large increases in complexity, non-linearity, and the speed of change. In today's world, skill in avoiding failure has become much more important to success, as it buys companies the time they often need to adapt their strategy to unforeseen circumstances.

We have observed that corporate failures due to strategic risks tend to arise from the most neglected quadrant in a typical SWOT analysis: the one where external threats interact with internal organizational weaknesses. We divide these external threats into four categories: threats to a company's right to operate; to the size, structure and growth of its served markets; to its value proposition to customers and competitive advantage; and to the economic viability of its business model. Organizational weaknesses include three fundamental failures: to anticipate these external threats, to accurately assess their potential impact, and/or to adequately adapt to them. In the simplest case, company failure results from a combination of one external threat and one internal weakness. However, most failures involve compound interactions between multiple threats and organizational shortcomings. This following table shows examples of different paths to company failure:

Examples of Strategic Risk Governance Failures*

	Failure to Anticipate	**Failure to Accurately Assess**	**Failure to Adapt**
Reputation/Right to Operate	• Owens-Illinois was surprised in 2010 by the sudden expropriation of its operations in Venezuela	• MTBE producers (e.g., Methanex) in 1990s failed to accurately asses the risk posed by leaking underground tanks at gasoline stations that eventually resulted in national ban on MTBE use in gasoline	• Oil and gas companies in New York (e.g., Norse Energy) failed to lease land in Pennsylvania, despite risk that NY would not lift its ban on hydraulic fracturing

	Failure to Anticipate	Failure to Accurately Assess	Failure to Adapt
Size of Market	• Crash of 2008 dramatically reduced size of housing and construction markets	• Laptop makers like HP and Dell failed to accurately assess implications of tablet introduction	• RIM failed to adapt to shrinkage of the corporate market for smartphones as it fused with the consumer market
Competitive Advantage	• Computer makers failed to anticipate Apple's use of design as a basis for competitive advantage	• Sony failed to accurately assess the significance of rising MP3 downloads from Napster	• Kodak failed to adapt to strategic risks posed by introduction of digital technologies
Profitability of Business Model	• Both General Motors and the City of Detroit failed to anticipate the future crippling cost of their defined benefit pension plan benefits	• Multiple companies in the news publishing and broadcasting industries failed to accurately asses the implications of the internet	• Blockbuster failed to adapt to the risk posed by the likely future introduction of online video streaming

** In practice, most failures likely include more than one organizational failure mode – i.e., they are compound failures.*

In carrying out their fiduciary duty to govern risk, boards face a fundamental challenge: human nature. The interaction of a number of tendencies that have been hard-wired into us by evolution practically guarantees that a management team will fail to anticipate, accurately assess, and/or effectively adapt to some of the strategic risks facing a company. Research has shown that people who rise to positions of leadership tend to be both overoptimistic (overestimating the most likely results of a strategy) and overconfident (underestimating the range of possible outcomes). These biases are further reinforced by our tendency to overweight information that confirms our existing views, and to underweight conflicting evidence. In a group, these individual tendencies are further reinforced by our desire to conform to the views of our peers (particularly when uncertainty is high), and to become increasingly overconfident as we interact with people whose views are similar to our own. All of these should be painfully familiar to experienced directors and executives.

Directors are often further hampered by company risk registers that overlook strategic risks, or, when they are included, inadequately assess the threat they pose.

So what is a board to do? Attempts to change human nature are likely to be far less effective than improving the attention paid to strategic risks in two core governance processes: setting direction and monitoring performance.

When evaluating strategy, boards can use a variety of techniques to improve their anticipation and assessment of potential strategic risks. For example, one of the most effective is a "pre-mortem." Following the presentation of a strategy, the chair can ask executive and non-executive directors to assume it is some point in the future, and the company has failed. Have them independently write down a list of reasons why this failure occurred, and what, in

retrospect, could have been done differently to avoid this outcome. What signs were missed? What actions were not taken? What initiatives were allowed to continue for too long? Collect and organize the results, then systematically discuss them. This almost always results in a far better understanding of the strategic risks facing a company.

In setting direction, boards should also focus on the steps a company is taking to adapt to strategic risks. Broadly, these fall into three categories. The first is simply avoiding them, by waiting for critical uncertainties to be resolved before acting, or by taking steps to reduce the chance that the worst outcomes will occur.

The second adaptation is well known: increasing physical, financial, and organizational resiliency to enable a company to avoid rapid failure by successfully absorbing the initial shock of a negative outcome for one or more strategic risks.

However, it is the third adaptation that is often the most important. In setting direction, boards should ensure that the company is making sufficient investments in a portfolio of ideas, experiments, and options that will likely rise in value under negative outcomes for one or more strategic risks. Culturally, this is often difficult, as this portfolio is based on outcomes for strategic risks that are different from the key assumptions that underlie the company's strategy. Board support for this portfolio – and the people who work on it -- is therefore critical.

Effective monitoring of early warning indicators or "risk triggers" is another important element of strategic risk governance. Our rule of thumb is that it takes twice as much evidence to change an opinion as it did to originally form it. Human nature makes it unlikely that management will recognize that adverse outcomes are developing until this process is well underway. Boards can take two steps to better detect these changes when there is still wide scope for action. The first is to conduct regular reviews of the "weak signals" – the near misses, small surprises, and anomalous data -- that often give early warning of impending negative outcomes, but are too often dismissed by management teams. The second is to engage an outside group to routinely report to the Board on information that is not consistent with the base case assumptions in a company's strategy, in much the same way that the defense and intelligence communities often make use of "red team" and other competitive analysis techniques.

In sum, while strategic risk governance is a growing challenge for many boards, with the right board capabilities and support, there are straightforward steps they can take to successfully meet it.

Neil Britten and Tom Coyne are the founders of Britten Coyne Partners, which advises directors and boards on strategic risk governance. They each have over thirty years of global experience as corporate directors, officers, and consultants.

Contact:
nbritten@brittencoyne.com
tcoyne@brittencoyne.com
www.brittencoyne.com
http://www.linkedin.com/company/britten-coyne-partners