Can Strategic Risk Management Contribute to Enterprise Risk Management? A Strategic Management Perspective

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Can strategic risk management contribute to enterprise risk management? A strategic management perspective

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Introduction

Within the discipline of enterprise risk management (ERM), strategic risk management (SRM) has become a subject of increasing interest to practitioners and academics. To our knowledge, the term “strategic risk management” first appeared in the management literature in 1985 and 1986 (Jammine, 1985; Figenbaum & Thomas, 1986) and in the academic finance literature in 1990 (Rawls and Smithson, 1990), although early usage of the term did not clearly relate to later conceptions. The phrase has been in use even longer than ERM (Bromiley, McShane, Nair, and Rustambekov, 2014). Even with this longevity, the meaning of the term remains unclear, with confusion increasing with the advent
of ERM. For example, does SRM mean the management of a specific category of risks known as “strategic risks” (AICPCU, 2013) or does SRM mean strategic actions/responses taken to mitigate major uncertainties facing the enterprise? Can any type of risk potentially become a strategic risk, or are only certain types of risk strategic? Is SRM a separate type of risk management or a subset of ERM?

This chapter deals with these issues. Specifically, we adopt a strategic management perspective to examine: what “strategic” means in SRM; the relation between SRM and ERM; the issues associated with identifying a separate category of risks termed “strategic”; and the outlook for value creation by SRM. In a preview of our discussion, we conclude that SRM is a subset of ERM and that strategic risk is more usefully defined as applying to risks that have strategic importance rather than a specific kind of risk. We begin by defining strategic risks and SRM, and by examining the relations between SRM and ERM.

In several places, we will use banking examples to illustrate issues. We do this not because our discussion applies most directly to banks, but because we assume most readers will be relatively familiar with banking and bank lending. Furthermore, non-banking businesses vary so much that risk terminology and kinds of risks faced may not be interpretable for individuals from other industries. The issues illustrated apply equally well to non-banking organizations.

Defining strategic risk

Any discussion of SRM must address the usage of the term strategic risk. What SRM means depends on what dimension or dimensions we use to differentiate between strategic and other risks. Let us begin by considering some of the definitions of strategic risk and strategic risk management provided by professional bodies, scholars, and practitioners. Table 1 lists these definitions/descriptions.
The AICPCU states that “strategic risk arises from trends in the economy and society including changes in the economic, political, and competitive environments, as well as from demographic shifts” (AICPCU, 2013). Similarly, Slywotzky and Drzik (2005) define strategic risks as the array of external events and trends that can devastate a company’s growth trajectory and shareholder value. Slywotzky and Drzik (2005) identify seven major classes of strategic risk including industry, technology, brand, competitor, customer, project, and stagnation, and suggest countermeasures for each class of risk. In a similar fashion, Andersen and Schroder (2010) list several risk factors related to strategic risks: competitor moves, new regulations, political events, social changes, changing tastes, and new technologies.

These three definitions emphasize strategic risk as stemming from external factors. This creates two specific problems. First, internal factors can offer strategic risks just as well as external factors. Consider, for example, a drug company. Developing a new drug is clearly an internal issue, but a failure to foresee adverse side effects is a strategic risk in that it could bankrupt the company. Likewise, manufacturing a drug is an internal issue, but a serious quality failure is a strategic risk. In the banking industry, subprime lenders’ internal policy decisions to issue 100% loan to value mortgages to high risk individuals resulted in the bankruptcy of many such lenders.

Second, identifying trends in external factors as a source of strategic risks, as the AICPCU and Slywotzky and Drzik (2005) definitions do, is also problematic. While trends that management has not identified could pose risks, for well-informed managers, predictable known trends should pose little risk. It is the deviations from known trends that pose risks. That the baby boom generation is nearing retirement in the US, for example, is not a risk but rather a completely predictable pattern that may have positive or negative impacts on firms.
Another set of definitions emphasizes strategic in terms of achieving corporate objectives. Frigo and Anderson’s (2011) definition of SRM as a process for identifying, assessing, and managing risks and uncertainties, affected by internal and external events or scenarios, that could inhibit an organization’s ability to achieve its strategy and strategic objectives with the ultimate goal of creating and protecting shareholder and stakeholder value, overcomes the problems that stem from defining strategic risks solely in terms of external factors. By adding the goal of “creating and protecting shareholder and stakeholder value” to the definition, however, Frigo and Anderson (2011) create a new problem: that of assuming that the corporate goal is one of creating both shareholder and stakeholder value, when in reality, a massive debate exists over possible conflicts between shareholder and stakeholder value.

Paralleling Frigo and Anderson’s (2011) theme of creating value, the Risk and Insurance Management Society (RIMS), a professional association and standard-setting body, defines SRM as a business discipline that drives deliberation and action regarding uncertainties and untapped opportunities that affect an organization’s strategy and strategy execution (RIMS, 2011). The RIMS (2011) definition thus explicitly includes identification of opportunities whereas the others emphasize the traditional view of risk as something that hurts performance.

Kaplan and Mikes (2012) identify three types of risks: preventable, external, and strategy. Preventable risks and external risks are downside risks. Preventable risks are internal risks that the firm should eliminate cost effectively, typically using rules-based, internal audit methods. External risks (for example political risks and natural disasters) are not preventable; hence, the company should mitigate their impact, for example with lobbying and business continuity plans or by transferring the risks using insurance. Strategy risks, in contrast to preventable and external risks, are risks that the company consciously takes on with the goal of increasing firm value. Defining strategic risks as those the firm chooses to take on to increase firm value creates two problems. First, it makes a strategic risk depend on the firm’s thinking around undertaking that risk.
The firm that blithely does something without considering a potential problem does not face a strategic risk from that problem, while the firm that carefully considers a potential problem does. A firm that takes a given action to increase value has a strategic risk whereas another firm that does the same thing in the same circumstances with a different motive does not. Making what is a strategic risk dependent on firm motivation seems undesirable. Furthermore, many would assume that all risks the firm takes on are taken on consciously with the hope the risk will help the firm achieve its goals; this would make all risks strategic.

Second, the “take on to increase firm value” approach makes the definition of strategic risks dependent on the company’s reference point and intent. A firm intending to grow could define an external factor as risky while a firm trying to maintain the status quo might not. Paralleling the “it’s not a defect, it’s a feature” logic, this might be fine, but dramatically complicates the situation. What happens when a growth firm looks at the risk and, upon assuming it cannot grow, decides to revise its objectives? Has it eliminated the risk? This creates the potential for circularity, or what researchers refer to as the endogeneity problem. Clarke and Varma’s (1999) definition of SRM illustrates this problem. Clarke and Varma (1999) define SRM as an integrated risk management approach that allows companies to deliver consistently superior performance while proactively managing risks. This definition includes the desired output of SRM (consistently superior performance) as part of its definition. This is problematic because if a firm takes a given set of actions and succeeds it is SRM, but it takes the same actions and it fails it is not.

Furthermore, common usage of “strategic” depends to a substantial extent on the importance of the decision to the entity. For example, managers in an extremely large bank like Bank of America or Wells Fargo would not consider buying a small bank strategic. These large banks routinely purchase small banks to acquire their facilities and customer bases. However, these large banks would see acquiring another very large bank as strategic. Likewise, management might not view the launch of a
single product line extension as strategic, but would consider the launch of some major new products strategic. If management does not see a given decision as strategic, it seems hard to classify the risk associated with that decision as strategic and vice versa.

A strategic management approach to defining strategic risks

An alternative approach, more consistent with usage in strategic management, would see strategic as connoting important or key decisions of all types (Nutt and Wilson, 2010). Strategic decisions have the following characteristics: they are “elusive problems that are difficult to define precisely; require an understanding of the problem to find a viable solution; rarely have one best solution, but often a series of possible solutions; questions about trade-offs and priorities appear in the solutions; solution benefits are difficult to assess as to their effectiveness, in part because they lack a clear final end point against which effectiveness can be judged; other problems in the organization are connected to solutions for a focal problem; high levels of ambiguity and uncertainty are associated with solutions; realizing hoped for benefits has considerable risk; strategic decisions have competing interests that prompt key players to use political pressure to ensure that a choice aligns with their preferences” (Nutt and Wilson, 2010, p. 4). Strategic decisions differ from other decisions in that “once implemented, a strategic decision stipulates premises that guide the operational decisions that follow” (Nutt and Wilson, 2010, p. 4). Often, the highest level of management makes strategic decisions. In this approach, strategic aligns with the responsibilities normally ascribed to top management and boards of directors. Strategic risk then means the risk associated with factors that the company considers strategic.

Strategic risks defined in this fashion would include both the risks inherent in the company’s strategic decisions and the macro structural decisions that determine internal risk-taking. Whether one acquires another company or enters a new market falls in the first portion of the definition, namely, “the risks inherent in the company’s strategic decisions”. The parameters and structure under which
one manages the rest of the firm’s risk fall into the second. These parameters and structure set the
stage for subsequent decisions; they determine and constrain the kinds of operational decisions (and
their attendant risks) that organizational members would make while implementing the strategic
decision.

While not part of the definition, a fundamental question underpins the above
definition of strategic risk and indeed, any discussion of risk management in general. Does the firm
manage the risk because the risk per se is an issue or because the risk defined in terms of negative
potential outcomes can influence expected value? For strategic risks, the answer is we care about risks
because a bad outcome in this domain could have major implications for the continuing existence or
prosperity of the company. Strategic risks can result from a single major decision or a set of policies that
lead the firm to take a number of inappropriate small risks. This contrasts with operational risk
management decisions where we are not concerned with the risk per se, but rather with the impact of
the risk on the expected return level. A banking example may illustrate the difference.

Consider a retail bank. Whether the bank makes a significant acquisition, begins trading
derivatives, or starts making consumer loans are clearly strategic choices. The other portion of the
bank’s risk comes from the interaction of policies, procedures, and criteria that determine how the bank
engages in derivatives trading or what specific loans the bank makes. The composition of a bank’s entire
lending portfolio, for example, is an SRM problem; an excessively risky or undiversified portfolio can lead
the bank into bankruptcy. At the same time, a bank with a policy of not verifying borrowers’ credit
histories or addresses before issuing a loan and with a policy of making the loan process as easy for
customers as possible would face a strategic risk because the interaction of these two policies strongly
influences the loans the bank makes and its consequent loan portfolio.
The bank’s operational risk management problem, in contrast, comes in what loans to reject and what prices to offer potential borrowers of given risk levels. Here, the bank is not directly concerned with the negative consequences of a given loan. The problem is to appropriately price and select loans to achieve an appropriate expected return. Unlike strategic risks, the bank should not be concerned with risk per se, but rather should focus on the expected value. Thus, for an appropriately high interest rate, loans to individuals who have a relatively high probability of default can be profitable. At the same time, individuals may have very low default probability but may command such a low interest rate that lending to them is not profitable. Thus, at the operational level, the bank should be concerned largely with expected value of each loan, but at the firm or strategic level, the bank should be concerned with the possibility that either a single big loan or the portfolio of loans, and the set of policies or criteria the bank will use to make loans, will damage the organization significantly.

This approach of defining strategic risk as the risks inherent in a company’s strategic decisions and in the macro structural decisions that determine internal risk taking makes the definition of strategic risk dependent on the usage within a given company. From a research standpoint, this creates problems. Specifically, how can we differentiate between strategic and non-strategic risks? Potentially, could any type of risk be a strategic risk? One answer would be no—if every risk is strategic, then nothing is. Power (2004) argues that the proliferation of risk management techniques to encompass a multitude of decisions (termed “the risk management of everything”) has a detrimental effect. The “risk management of everything” may extend the risk management logic from areas in which it works effectively to areas in which we have no idea whether it works effectively. Researchers in strategic management have dealt with this problem of differentiating strategic decisions from others by studying decisions that appear to be strategic for most corporations – mergers, divestitures, corporate outlays on R&D or capital expenditures, etc. This set of decisions will probably be smaller than the set of decisions any specific company sees as strategic.
While definitions can have better and less functional features, they remain essentially arbitrary.

By taking a strategic management perspective to examine SRM, we lean toward a strategic management approach that views strategic risk as risk associated with factors that the company would consider strategic. Organizations already have made some allocation of decision responsibility to the top for what is often termed strategy or strategic decisions. To define strategic risk such that strategic risks do not generally apply to strategic decisions opens immense opportunities for confusion.

This also aligns with a legal allocation responsibility to top management and boards. Top management and the board have responsibility for the major strategic choices of the company. When it comes to risk, they have a responsibility to assess or make sure someone assesses appropriately the risks of their decisions and that they consider such assessments. They also have responsibility for the aggregate supervision of risk management processes and controls in their companies. United States corporate law assigns these responsibilities to top management and corporate boards.

Both corporate practice and law define certain activities as strategic and demanding of attention from top management and the board of directors. To define strategic risk as risk associated with such activities (including major systems choices), simply aligns usage with prior usage of strategic rather than developing a new definition of strategic in strategic risk that differs from usage of strategic elsewhere in management. Any definition of strategic risk that does not align with the risk of strategic choices seems destined to create confusion.

How does SRM relate to ERM?

We next turn to the relation between SRM and ERM. Understanding this relation requires an understanding of the history of ERM. ERM evolved from traditional risk management (TRM) (Bromiley, McShane, Nair, and Rustambekov, 2014 and Nair, Rustambekov, McShane, and Fainshmidt 2014). TRM was originally insurance management for hazard risks and operational actions related to
safety issues. Vestiges of the “insurance and risk management” approach continue to appear in the names for educational programs, organizational units, and journals. Following the development of the options pricing model in the early 1970s, TRM expanded to involve financial risk management, which, however, developed in a separate silo from managing hazards.

In the late 1990s, the concept of ERM arose from TRM. Two main features distinguished ERM from TRM. First, in ERM, the firm should manage all risks—not just hazard and financial risks, but also operational and strategic risks. Second, the firm should see these risks as portfolios spanning functional or organizational divisions, not silos where different groups independently handle different risks. Under ERM, the management of “all” risks inherently includes strategic risks, consolidated across functions and organizational units, and leaning towards risk management at the strategic level of the organization. ERM rhetoric has implicitly, and often explicitly, included managing strategic risks as part of ERM.

Several authors have taken this view. Louisot and Ketchum (2014), for example, criticizes efforts to establish SRM as a new discipline as unnecessary and deriving from ERM implementations not living up to the ERM philosophy of managing all risks in a portfolio. Skipper and Kwon (2008) describes risk management as an evolution that starts with hazard risk management, then adds some operations risk management (such as safety training), then financial risk, and finally reaches full integration with the addition of strategic risk. Bromiley et al. (2014) lists more than 20 definitions/descriptions of ERM found in both the academic and practitioner literatures between 1995 and 2011. Most of the definitions/descriptions indicate that ERM should manage all risks and some of the more recent ones imply a close relation between ERM and the achievement of strategic objectives. We could thus view SRM as part of the next generation of ERM (ERM 2.0) that has reached its conceptual potential to include strategic risks. Indeed, one could argue that ERM cannot be
“enterprise” risk management if it ignores the risks that could influence the entire organization (or enterprise).

This then raises the question of why some have promoted SRM as a discipline separate from ERM. Part of the answer may lie in turf battles among different risk management silos in both the corporate and academic worlds. The rise of ERM has increased the power of whatever function controls ERM. In many companies, internal audit oversees the ERM process although a Chief Risk Officer (CRO), typically reporting to the CFO or CEO, often has overall responsibility. Many companies have not assigned responsibility for SRM to any specific group. Consequently, SRM could change the power relations within organizations. It also could generate a substantial amount of consulting as organizations that implemented ERM now need to pay consultants to help them implement SRM. In the academic world, silos have remained intact even as research on ERM demands cross-disciplinary collaboration.

The appearance of SRM as separate from ERM also reflects that ERM research and practice have been slow to include strategic risks. Indeed, the main purpose of Bromiley et al. (2014) was to stimulate ERM research by management scholars on these types of risk for which other disciplines are not suited. Given the difficulties in defining and identifying strategic risks that we discussed earlier, however, the question comes up as to why we should bother or care to delineate SRM as a part of ERM. There are both several explanations for this and reasons why it may be desirable. We examine these in the next section.

Why bother with SRM?
The categorization of risks into categories such as strategic, financial, operational, etc. has both potential benefits and drawbacks. On the upside, risk categories are useful for grouping risks to determine processes and responsibilities. At an individual level, sorting risks into broad categories or groups overcomes some of the time and attention related constraints facing managers (Cyert and March, 1963) by directing managers’ attention towards certain types of risk and helping them decide what to do about these risks (Damodaran, 2008). Grouping coincides with specialization that allows greater expertise; the skills necessary to manage factory safety and related insurance issues differ greatly from the skills necessary to manage currency exchange and other financial transactions. At the senior levels of the firm, sorting risks into categories can free a board to focus on broader strategy issues facing the firm instead of focusing on the risks facing each individual division (Protiviti, 2014).

At the organizational level, grouping risks helps assign responsibility and allocate resources for managing these risks. The expertise benefits noted above means that risk categories could lead to more accurate budgeting and reporting. Further, the risks differ fundamentally across many different categories of risks; financial risks, for example, are distinctly different from operational risks for many firms. Bundling disparate risks together (rather than treating them as belonging to distinct categories) can create analytical confusion over what tools or frameworks to apply and what benchmarks to use to evaluate the extent to which it has mitigated each type of risk.

On the downside, risk categories may constrain managerial thinking about risk and encourage the treatment of risk in silos. This, in turn, may prevent the organization from identifying a common cause underlying different types of risk, or the interactions among different types of risk (Bharathy and McShane, 2014). Organizations that use risk categories as a means of risk identification may also neglect important sources of risk. Furthermore, the portfolio benefits from ERM require the aggregation of risks across categories.
Practically, whether risk categorizations help or hinder the ERM prescription that organizations treat risks as a portfolio remains problematic. While the benefits of aggregating risks are unquestionable, it is hard to treat risks as a portfolio in the financial sense when different systems define and attempt to manage different kinds of risks. Portfolio treatment assumes a common metric for risk and understanding of correlations among risks. Let us examine why it may be difficult to achieve these. Think about how firms evaluate risks, and more specifically, the extent to which conventional risk management tools apply in particular domains. To apply conventional risk management tools, we need good estimates of the probabilities of potential outcomes. Often, this means we have to deal with domains in which we have substantial experience. To the extent that certain groups have been lent to historically, the retail bank we discussed earlier can draw on long histories of lending experience (both its own and that of other organizations) in assessing the risk of lending to particular groups. In contrast, for some strategic and operational categories we cannot apply conventional risk management tools because we cannot estimate variances or covariances. This was part of the problem in the subprime debacle. Because no one had ever loaned to this particular category of borrower under these terms, history did not provide appropriate data on which to assess the long-term risk of such loans.

While data problems are generally more challenging for strategic than operational risks, often objective data does not exist for operational risk management either. In many organizations, managers assess operational risks on scales of 1 to 5 because management cannot see how to assess real probabilities at reasonable cost. The available data clearly depend on a variety of factors, both externally and internally determined. The lower the probability of an event, the more data we need to estimate the probability accurately, but risk management usually tries to lower the frequency of negative events.
Now consider how most organizations evaluate strategic risks. As we note above, conventional risk management tools often do not apply to these kinds of risks because of difficulties related to data collection. As a substitute, organizations usually rely on qualitative methods (e.g., scoring methods where managers rate the likelihood and impact of various risks) to estimate these risks. We know of no validated techniques for the analysis of a portfolio that combines quantitative and qualitative risk estimations. Lacking such validated tools, portfolio-based decisions could be worse than traditional practices. Hubbard (2009), in fact, goes further and terms qualitative risk assessments “worse than useless” because individuals interpret qualitative descriptions differently resulting in inconsistent use of scales. Even if we mitigate this concern by carefully standardizing the meaning of the descriptions and ensuring that the users understand the scales, we still face the fundamental problem that we lack validated tools to estimate the risk of a portfolio based on a combination of qualitative and quantitative risk assessments.

Even in the rare instances where historical data on strategic risks exists, strategic decisions often differ within categories such that historical averages may not be very helpful. This appears, for instance, in the literature on acquisitions where the average return from acquiring another company may be slightly negative, but almost half the companies have positive returns from acquisitions.

A further complication comes from the ERM idea that a firm should think of risks it can handle efficiently as a potential source of value. We noted the difficulties of analyzing portfolios where we only have qualitative risk assessments on some of the risks. The potential for gains from risk management further complicates the analysis. As a practical matter, it is unclear how many companies are ready to manage coherently enterprise risk that incorporates both concern for downside risks and exploitation of risk-based opportunities.

Often, assessing and evaluating strategic risks rests on managerial judgment. However, there are good reasons to question managerial judgment in risk assessment. People have
enormous difficulty learning to assess and deal effectively with risky events. An entire division of psychology termed behavioral decision theory is devoted to how people deviate from the prescriptive models in handling uncertainty and risk. This does not mean people cannot be trained to some extent to assess risk better, but that training will be domain specific. For example, meteorologists may be reasonably well calibrated so that when they say a 50% chance of rain, it on average rains half the time (Sjörberg, 1979). This does not mean, however, that meteorologists are any better at assessing other forms of risk than anyone else. Likewise, someone could be good at handicapping horses at the track, but not necessarily good at handling other kinds of risk.

**People have difficulty learning to assess risks accurately.** To learn to do something effectively, it helps to do it, see the outcome, and repeat, but in learning to assess risk this often does not suffice. Meteorologists do not learn strictly by trial and error, but rather learn scoring rules and other research-based short cuts to improve prediction. Managers face many situations even if they wanted to do the analysis, the situations themselves do not structure the data and the world in a way that would enhance or facilitate learning.

For example, take something as simple as a bank making loans to companies. The individual loan officer makes a loan. In assessing the borrower’s risk, the bank cares whether some modest or not so modest proportion of the loans goes bad over the next five years. For example, with a low risk assessment, 2% failures might be a good outcome and 10% a very bad outcome. Often, however, loan officers’ risk assessments suffer from systematic biases (McNamara & Bromiley, 1997, 1999). Ideally, the loan officer would learn the association of borrower characteristics with differences in actual probabilities, but many organizations do not even systematically feedback outcomes to those who make probabilistic assessments. For example, lenders who make loans do not necessarily know what happened to those loans two, three, four, and five years later. Even if they do have the data, unless the
loan officer undertakes systematic statistical analyses, the loan officer is unlikely to be able to learn the relations between specific levels of borrower characteristics and specific loan default probabilities. The immense majority of lenders do not even know the statistical techniques necessary to estimate such relations. Even more generally, we suspect many ERM implementations do not systematically analyze the accuracy of risk assessments.

When the choice is not random (and we hope our bank is not lending completely randomly), assessing the impact of a choice on an outcome presents significant statistical problems. Indeed, a rapidly developing area of econometrics and statistics is devoted to developing tools to analyze the impact of treatments when the treatments are not randomly applied (see, for instance, Stata (2013)). Where we want to understand the impact of an action on an outcome and the action is not random, naïve analyses of data can be terribly misleading.

Consider now the issues associated with estimating strategic risks, whether assessing the probabilities associated with outcomes of specific major choices (e.g., an acquisition or new product launch) or assessing the probabilities associated with outcomes of internal control choices (e.g., level of flexibility given to division managers allocating resources). Here the problem is much worse than for our lender. A given individual only observes a very small set of comparable choices, and in many cases only one. Very few managers see a statistically viable sample of acquisitions. Likewise, they see a very limited set of internal control choices and almost never observe what would have happened if they made different choices. In such situations, there is no reason to believe that the individual will become skilled at assessing the probabilities of different outcomes given specific choices.

Some might argue that firms select managers on their ability to assess and manage risk so we can assume they can do so effectively. However, few if any firms actually have managers stipulate risk assessments and use a comparison of outcomes to such assessments in judging managers. In many
companies for many important decisions, managers do not even write down risk assessments. Many firms punish managers who take risks that turn out badly, but this is very different from judging whether the managers can assess a range of risk probabilities accurately.

To summarize, we have argued that the primary distinction between strategic and other risks is that strategic risks deal with strategic issues. We also note that strategic risks generally imply risks large enough that the firm should care about the risk per se whereas for operational risks the focus should be on expected values. Furthermore, the firm seldom has good data on which to assess strategic risks. Whether managing strategic risk in an ERM framework will benefit firms remains an open empirical question. In the next section, we expand on why SRM may be valuable to firms, and how long it may provide value.

**Will the Value of SRM and ERM Diminish Over Time?**

A strategic view of SRM raises the question whether it can provide competitive advantage. Strategy scholars concern themselves with whether a given set of activities will help the firm perform better than its competitors and whether that better performance is fleeting or sustainable.

The resource based view (RBV) of the firm presents a popular approach in strategic management to explain how firms create value and generate sustained competitive advantage (Barney, 1986; Peteraf, 1993). In essence, the RBV proposes that only rare, valuable, and hard-to-imitate and substitute resources or capabilities can give firms persistent competitive advantage.

SRM and ERM are capabilities that may protect and create value by allowing firms to improve performance by reducing the negative impact of unanticipated events, as well as anticipating how changes in environmental or internal conditions could create opportunities for value creation that other
firms may miss. However, as more firms begin to use SRM, it will no longer be particularly rare. The standardization of SRM in the form of steps or processes outlined by consultants or organizations (such as RIMS) may mean that SRM should not even be particularly hard to imitate. In this case, will SRM still create value?

To answer this question, we turn to some recent research on firm practices. Based on a vast quantity of empirical evidence from a variety of management fields, Bromiley and Rau (2014) argue that even publicly available practices can create value for firms. RBV assumes that the majority of firms in an industry show “normal” returns, with a few firms showing above normal returns; the presence of rare, valuable, etc. resources within these firms explains their above normal performance. Even a cursory examination of the distribution of returns in most industries, however, reveals a wide distribution of returns. Many firms perform below average, some close to average, and a few show truly superior performance. Bromiley and Rau (2014) suggest that firms that perform below or slightly above average can improve their performance if they adopt practices that have created value in other firms – in this case, SRM.

Before we turn to assessing the actual value creation potential and outlook for SRM, perhaps the first question we need to ask is whether the broader practice of ERM as practiced actually delivers. Schrand and Unal (1998) and McShane, Zhang, and Cox (2012), for example, finds evidence of risk allocation by banks and insurance companies where these institutions appear to transfer risks in which they have no comparative information advantage so that they can take on more risk in areas where they do have an advantage or core competence. However, the academic literature on ERM is not chockablock with studies showing ERM per se reduces risk let alone improves financial performance¹.

¹ For a review of the mixed findings on the relation between ERM and firm performance, see McShane, Nair, and Rustambekov (2011) and Eckles, Hoyt, and Miller (2014).
It may seem obvious that using ERM to manage risk will result in better risk management and better corporate performance, but it is not that simple. First, a firm that really cares about controlling risk might reduce the firm’s risk level regardless of the techniques it uses. Put differently, the desire to reduce risk might result in firms adopting ERM and reducing risk even if ERM had no impact on risk whatsoever. Second, ERM is not free. ERM usually requires significant amounts of management time (often taken from other duties) and the real costs may be much greater than the dollar cost of management time. Whether ERM, overall, benefits the company depends on the relative impact of the improvement in risk management vs. the potential damage of having less management time paid to other concerns like operations.

The literature on safety raises an even more troubling possibility. Some academics on safety claim that making cars safer simply results in drivers driving more dangerously. These academics argue that drivers want a particular level of risk and if improvements in the car or the road remove that risk, they will drive in a more risky manner to compensate. In a corporate setting, would a top management that believed it had excellent internal risk management processes take more strategic risk than one less confident in its internal risk management? Would those risks on average have positive expected value? We do not have evidence for these, inherently empirical questions. In the end, we simply do not have a substantial literature demonstrating that ERM (let alone SRM) as practiced in most companies has the desired impacts. Clearly, this is an important area for future research.

Even if we assume that ERM and SRM could positively affect a company, the extent to which a firm realizes these benefits may vary for a few reasons. While many organizations have offered guidance on implementing ERM, there remains enormous variation in how firms actually implement ERM. However, the problem is not just standardizing ERM (and by extension SRM), but
whether we can standardize them on extremely desirable models – and whether firms can implement these models correctly and consistently.

The example of TQM is instructive. TQM is risk reduction. Measuring quality as the inverse of error rates meant high quality equals low risk. Probability of errors is just another risk measure. Thus, in one sense, operational risk management is like TQM in that it tries to reduce operational probabilities of errors/failures.

TQM was extremely popular in the late 1900s. While many firms that used TQM did find an increase in the level of product quality across many product categories (Hendricks and Singhal, 1997), many other firms that did TQM didn’t see a significant improvement in performance and often quit using it (Staw and Epstein, 2000). Whether this is because they did not do it long enough or they did not do it for long because it was not working is unclear (Hendricks and Singhal, 1999).

Even whether a firm can estimate the risk impact of ERM or SRM is questionable. To assess the risk impact of ERM or SRM, we need to estimate the difference in riskiness of outcomes with and without ERM/SRM. In addition to the statistical problems noted above, at the corporate level, we often are concerned with relatively low probability events like financial distress during a recession. Historically, the frequency of recessions is less than every 10 years. Assessing a probabilistic outcome generally requires more than one or two relevant observations. Few managers will see any assessment that takes ten years or more as timely or relevant.

We should also worry that, like TQM, SRM and ERM may be fads. With fads, large numbers of firms adopt the practice, but many drop it when it fails to produce obvious, immediate results. Those that do persist are likely to have seriously implemented the practice and developed skills in its use. In
the persisting population, ERM and SRM may become more technical (and therefore less susceptible to
the opinions of generalists), improving their contributions to firm performance (David and Strang, 2006).

Even firms that adopt an extremely desirable model of SRM (and implement it both correctly and consistently) may find that SRM does not create value. Consider, for example, the effects of organizational characteristics -- in particular, organizational structure – on the outcomes of a practice. A central idea in Andersen and Schroder (2010) is that the management of strategic risks needs a different organization structure than that required for managing hazard, financial and operational risks. Specifically, SRM needs central risk monitoring at the senior manager level to understand interdependencies between risks. At the same time, SRM also needs a dispersed awareness of risks at all levels of the organization. Dispersed awareness allows employees at the middle and lower levels of the organization to monitor risks and feed that information back up to the higher levels of the organization, thereby enabling senior managers to become aware of trends and emerging risks and opportunities. Dispersed awareness of risks can best be achieved with a loosely coupled, decentralized structure. Overall, therefore, SRM requires an ambidextrous structure, combining central risk monitoring with decentralization. Effective management of non-strategic risks, on the other hand, requires a more centralized and uniform structure (in the form of internal control, accounting systems, etc.). An organization with an existing ERM system that would like to implement SRM cannot do so just by introducing new SRM related routines; it also has to change its structure simultaneously, from a centralized one to an ambidextrous one. Given the notorious difficulty of this latter task, an organization that attempts to add SRM to its existing ERM system without a corresponding change in structure may find that, ironically, the very presence of ERM limits the value the firm will be obtain from the adoption of SRM.
Conclusion

In this article, we proposed a definition of SRM and examined its relation to ERM. We see the practice of SRM as having the potential to contribute to the field of ERM and to create value for firms. At the same time, however we see the need for substantial advances both in research and practice before SRM can achieve its potential.
References


http://www.standardandpoors.com/ratings/articles/en/us/?assetID=1245193859443
Table 1: Definitions/Descriptions/Discussions of Strategic Risk and Strategic Risk Management

<table>
<thead>
<tr>
<th>Source</th>
<th>Description</th>
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<tr>
<td>Baird and Thomas (1985)</td>
<td><strong>Strategic risk-taking</strong>: Corporate strategic moves that cause returns to vary, that involve venturing into the unknown, and that may result in corporate ruin – moves for which the outcomes and probabilities may be only partially known and where hard-to define goals may not be met.</td>
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<tr>
<td>Figenbaum, and Thomas (1986).</td>
<td>Argued that while the market-based measure is important from a &quot;financial markets&quot; perspective, the accounting based measure (or &quot;total risk&quot;) is valuable from a strategic risk management perspective.</td>
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<tr>
<td>Miller and Bromiley (1990)</td>
<td>Defined risks in three categories: income stream, stock returns, and strategic risks. They measured strategic risks as debt-to-equity ratio, capital intensity and R&amp;D intensity.</td>
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<td>Rawls and Smithson (1990).</td>
<td>Discussed management of strategic exposures facing firms: exposure to changes in foreign exchange rates, interest rates, or commodity prices that affect firm market value—that is the present value of the expected future cash flows.</td>
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<tr>
<td>Miller (1992)</td>
<td>Discussed strategic moves that can potentially mitigate the risks associated with uncertainties. Uncertainty means the unpredictability of environmental or organizational variables that impact corporate performance or the inadequacy of information about these variables.</td>
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<td>Collins and Ruefli (1992)</td>
<td>Developed a unique ordinal measure of strategic risk, as opposed to most other measures that are cardinal.</td>
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<td>Clarke and Varma (1999)</td>
<td>Discusses an integrated strategic risk management approach allows companies to consistently deliver superior performance while proactively managing risks. Risk management is a strategic business process, but is often treated tactically and piecemeal.</td>
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<tr>
<td>Chatterjee, Lubatkin, Lyon, &amp; Schulze, (1999).</td>
<td>Discuss three types of risk: tactical, normative and strategic risk. Tactical risk is rooted primarily in information asymmetries, strategic risk in imperfections in the resource and output markets, and normative risk in the forces that underlie institutional norms.</td>
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<tr>
<td>Roberts, Wallace, and McClure (2003)</td>
<td><strong>Strategic risk management</strong> identifies, monitors, and manages the risk profile of the organization. \n<strong>Strategic risk</strong> relates to risk at the corporate level, and it affects the development and implementation of an organization’s strategy.</td>
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<tr>
<td>Lam (2003) p 229</td>
<td><strong>Business risk</strong> is the risk of adopting the wrong business strategy, or failing to execute the right strategy.</td>
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<td>Committee of European Banking</td>
<td><strong>Strategic risk</strong> is the current or prospective risk to earnings and capital arising from changes in the business environment and from adverse business decisions, improper implementation of decisions or lack of responsiveness to changes in the business</td>
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<tr>
<td>Author(s) and Year</td>
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<tr>
<td>Slywotzky and Drzik (2005)</td>
<td><strong>Strategic risk</strong> is the array of external events and trends that can devastate a company's growth trajectory and shareholder value.</td>
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<td>Chapman (2006) p224-225</td>
<td><strong>Strategy risk</strong> is risk associated with the initial strategy selection, execution or modification over time, resulting in a lack of achievement of overall objectives.</td>
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<td>Sehn (2006)</td>
<td><strong>Strategic risk management</strong> is a process designed to keep both the risks associated with doing business and the costs to a minimum. Strategic risk management is a planning and management tool to minimize the cost of risk and the cost of doing business.</td>
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<tr>
<td>Crouhy, Galai, Mark (2006) p 32 and 33</td>
<td><strong>Strategic risk</strong> refers to the risk of significant investments for which there is high uncertainty about success and profitability.</td>
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<tr>
<td>Standard and Poor’s (2007)</td>
<td><strong>Strategic risk management</strong> is the process that an insurer uses to incorporate the ideas of risk, risk management, and return for risk into the corporate strategic decision-making processes. Risk capital is usually a key concept in these processes. Standard &amp; Poor’s analysis of SRM starts with understanding the risk profile of the insurer and getting management to explain the reasons for recent changes in the risk profile and the changes it expects to make in future.</td>
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<tr>
<td>Hampton (2009) p127-129.</td>
<td><strong>Strategic risk</strong> is the positive or negative impact of risk on an organization. <strong>Strategic risk management</strong> encompasses all activities intended to identify risks, solve problems, adapt to change and successfully execute plans. It includes goals and strategies, resources, organizational structure, capabilities of people, systems, and risk identification.</td>
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<td>Andersen and Schroder (2010) p77</td>
<td><strong>Strategic risk factors</strong> may include major competitor moves, product innovations, process improvements, new business designs, technology leaps, all which constitute exposures that can be difficult to identify in advance and hard to quantify. Main focus of ERM has been on downside exposures (hazard, financial, and operational). The inclusion of strategic risk management has added a focus on opportunities.</td>
</tr>
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</table>
| Fraser and Simkins (2010) p 510 | **Strategic risks** group includes external and internal risk factors. The external factors essentially refer to the likelihood that industry, economy, legal, and regulatory changes and competitors will cause the breakdown of operations or variability in the firm’s earnings. The internal factors risk related to the likelihood that the firm’s reputation, strategic focus, patent and trademark types of company specific risk factors will cause variability in the revenues or net earnings of the firm. **Operational risks** are the cause-effect related pressures on the revenues and net earnings of the firm resulting from the supply-chain discontinuities, customer satisfaction, cycle time, manufacturing processes (process risks); which others may be
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<td>Economist Intelligence Unit (2010)</td>
<td><strong>Strategic risks</strong> are those that pose a threat to a company’s ability to set and execute its overall strategy. <strong>Strategic risk management</strong> encompasses the interdisciplinary intersection of strategic planning, risk management and strategy execution in managing risks and seizing opportunities, not only for protection against losses, but for reducing uncertainties and seizing opportunities, thus enabling better performance in achieving the organization’s objectives and greater resilience in an uncertain environment.</td>
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<tr>
<td>RIMS (2011)</td>
<td><strong>Strategic risk management</strong> is a business discipline that drives deliberation and action regarding uncertainties and untapped opportunities that affect an organization’s strategy and strategy execution.</td>
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<tr>
<td>Sim Segal (2011) p 117 and 118</td>
<td><strong>Strategic risks</strong> are a category of risks related to unexpected changes in key elements of strategy formulation or execution. This is highly variable by company and must be customized.</td>
</tr>
<tr>
<td>Frigo and Anderson (2011)</td>
<td><strong>Strategic risk management</strong> is a process for identifying, assessing and managing risks and uncertainties, affected by internal and external events or scenarios, that could inhibit an organization’s ability to achieve its strategy and strategic objectives with the ultimate goal of creating and protecting shareholder and stakeholder value. It is a primary component and necessary foundation of Enterprise Risk Management.</td>
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</table>
| Kaplan and Mikes (2012)                      | Three categories of risk:  
**Strategy risks** are risks taken for superior strategic return.  
**Preventable risks** arise from within the organization, are controllable and ought to be eliminated or avoided.  
**External risks** arise from events outside the company and are beyond its influence or control. |
<p>| Tonello (2012)                              | <strong>Strategic risks</strong> are those risks that are most consequential to the organization’s ability to execute its strategies and achieve its business objectives. These are the risk exposures that can ultimately affect shareholder value or the viability of the organization. <strong>Strategic risk management</strong> is the process of identifying, assessing and managing the risk in the organization’s business strategy—including taking swift action when risk is actually realized. Strategic risk management is an area that merits the time and attention of executive management and the board of directors. |
| Mohammed and Sykes (2013)                    | <strong>Strategic risks</strong> can be defined as the uncertainties and untapped opportunities embedded in your strategic intent and how well they are executed. As such, they are key matters for the board and impinge on the whole business, rather than just an isolated unit. <strong>Strategic risk management</strong> is your organisation’s response to these uncertainties and opportunities. It involves a clear understanding of corporate strategy, the risks in adopting it and the risks in executing it. |
| AICPCU                                      | Four risk categories: |</p>
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<td>(2013)</td>
<td>Strategic risks arise from trends in the economy and society, including changes in the economic, political, and competitive environments, as well as from demographic shifts. Operational risk: Arises from people, processes, and controls. Financial risk: Arises from the effect of market forces on financial assets or liabilities. Hazard risk: arises from property, liability, or personnel loss exposures. Strategic risk management is not intended to be an alternative to ERM, but to provide a higher level perspective for the organization’s leaders.</td>
</tr>
<tr>
<td>Deloitte (2013a)</td>
<td>Four types of risk: Strategic risks are risks that affect or are created by an organization’s business strategy and strategic objectives. Operational risks are major risks that affect an organization’s ability to execute its strategic plan. Financial risks include areas such as financial reporting, valuation, market, liquidity, and credit risks. Compliance risks relate to legal and regulatory compliance.</td>
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<tr>
<td>Deloitte (2013b)</td>
<td>Strategic risks are risks that have a major effect on a company’s business strategy decisions, or are created by those decisions. So they tend to have a larger and more widespread impact than the other types of risk that businesses have traditionally focused on, in areas such as operations, finance and compliance.</td>
</tr>
<tr>
<td>Standard and Poor’s (2013)</td>
<td>Strategic risk management is the process through which insurers facilitate the optimization of risk-adjusted returns, starting with a view of the required risk capital and a well-defined process for allocating capital among different products, lines of business, and risk factors. The strategic risk management subfactor assesses the insurer’s program to optimize risk-adjusted returns and to evaluate and prioritize strategic options on a level playing field.</td>
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<tr>
<td>Andersen, Garvey, and Roggi (2014), p24 and p51</td>
<td>Strategic risk management (SRM) is an extension of the ERM concept and a way to emphasize the importance of managing operational and strategic risk factors to achieve longer-term corporate objectives. The SRM approach is involved in identifying, measuring, and handling both pure and financial risks but also takes a special interest in speculative strategic risks with particular concerns for proactive risk taking initiatives. Strategic risks are characterized by high uncertainty and predictability for which there is little concrete data and include economic risks, competitor risks, political risks, social trends, new technologies, and innovations.</td>
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<tr>
<td>Louisot and Ketcham (2014) p105</td>
<td>Strategic risks are risks that impact the organization’s ability to achieve its broader goals and objectives, such as risks to market position or reputation, or the risk that a business plan to which major resources and effort are committed will ultimately not be successful due to lack of acceptance in the market place. Strategic risk is sometimes referred to as the risk associated with “doing the right thing.” Strategic risk management is a critical component ultimately driving enterprise risk management. Strategic risk is associated with adopting or not adopting the correct strategy for the organization in the first place, or once adopting, not adapting the chosen strategy in response to competition or other forces. Strategic risk management</td>
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contemplates the integration of strategic planning, the setting of organizational objectives and the identification of “risk” with the organization’s enterprise risk management program.