

Strategic Management - The Competitive Edge

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Lecture No. # 32

Other Strategic Issues -1

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Introduction

- Risk is a key strategic issue. Business is about risk, and the adage, “the bigger the risk, the greater the reward”, is still widely believed.
- Without risk there can be no reward. There may well be a normal distribution of risk and returns performance.
- The tree of modern risk management has its roots in a number of unrelated disciplines. Military risk analysis led to the evolution of operations research.



Welcome to this class, let us now look at strategic risk. What is meant by risk in this strategic context? This risk is a key strategic issue; in fact, I have dealt this strategic risk in chapter number 13 of my book, so you can go through that also. We will try to cover the salient points of this chapter in the few slides of this lecture.

Risk is a key strategic issue. Business is about risk, and the adage; “the bigger the risk, the greater the reward”, is still widely believed. That is if a person is willing to take higher risks, the rewards are likely to be substantially higher; this is the general feeling or the general belief in the business circles.

There is also a feeling that if you do not take any risk, there is no reward. So, an entrepreneur becomes successful or not successful depending on his risk-taking ability. The higher the risk taking ability, there is a good possibility that this entrepreneur will go greater heights or scale greater heights. In fact, there may well be a normal distribution

of risk and returns performance, so these are also one of the things - suppose you draw a distribution of risk and returns, you may end up with a normal curve.

Now, what is a tree of modern risk management? Where does it lie? It lies in a number of unrelated disciplines. So, how did it really start? If you start going backwards, you find that all the military operations dating back to World War 2, they led to the evolution of operations research. So, the **PERT** diagram, all the project management techniques then, the scheduling optimization, which followed later on, which was used by the manufacturing sector with hesitancy initially, now being adopted quite well by the manufacturing industry, then the different transportation logarithms, all those types of things, now which is being widely used. So, if you really look at it - the airline scheduling goes through an operations research model.

Now, given this type of scenario, where you look at risk as a strategic issue, management tends to think on the negative aspects of risk, that is, if you are in a business scenario, management tries to think, suppose this investment moves backwards, then, what will be the implications? **First, implications**; then second is - what is the likely spin-off implications **also**. First is, you may lose that investment in that particular project or whatever and second is - what is the type of spin-off? **Suppose, it gives a bad publicity for the company, then** it may result in many of the ongoing projects also getting a bad, sullen image, which is not really the one which the management wants. So, this is what the management looks at: one, is the capital allocation; then second is - what is the type of culture which is there in the organization? Is it capable of taking the risk? And suppose, it backfires, can the organization sustain and go forward still?

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Risk – A Strategic Issue

- Often the management focuses on the negative consequences rather than on such questions as,
 - How does risk affect capital allocation?
 - What risk-based information do we need?
 - How do we create a risk culture?
 - How do we ensure that our risk profile is commensurate with returns and shareholder risk appetites?
- A variety of tools have evolved to support companies in managing discrete types of risk.



So this is where you would say: often the management focuses on the negative consequences rather than on such questions as: how does risk affect capital allocation? What risk-based information do we need? How do we create a risk culture? How do we ensure that our risk profile is commensurate with returns and shareholder risk appetites? So, what is being told here is the proper method to address risk, is to answer or is to support these types of questions, instead of getting worked up over this risk phenomenon.

Now, the modern day business scenario is such that organizations are learning or trying to cope with risk; so, they are learning how to cope with risk, so in order to cope with this risk, they have evolved a wide variety of tools. So, a variety of tools have evolved to support companies in managing discrete types of risks. So that risk is evident; when that risk is evident, you have a tool defined to tackle this risk; so, this is where the organization is in a better position in the present business landscapes. So, compared to the **previous** few decades back, where organizations were not at all prepared to take this type of risk, in the sense that, suppose if the risk comes, the organization did not have a tool to counter this risk - this is what it is.

Now, you have got certain tools to counter this. Before we go to the tools, let us see how to define this risk management or this strategic risk.

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Definition – Strategic Risk

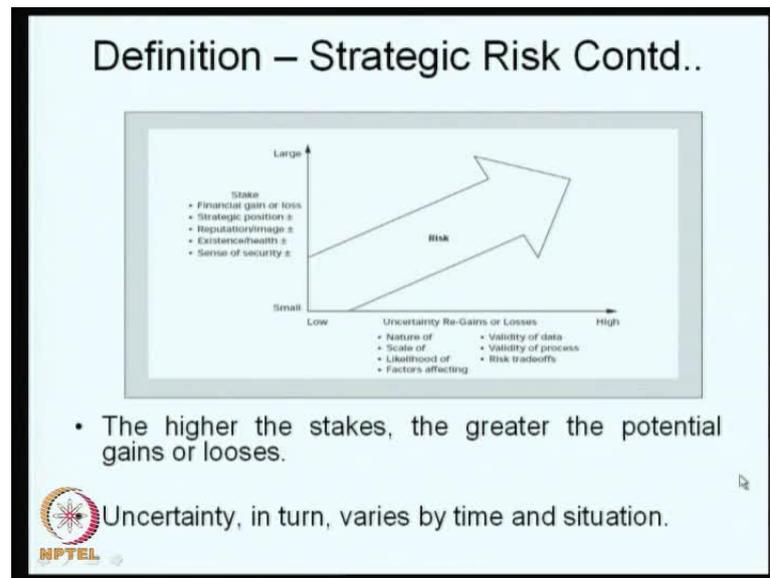
- Risk management is a strategic business process.
- The management needs to assess whether the company's business activities are consistent with its stated strategic objectives, and how risk management is linked to investment and growth decisions.
- Risk can be best understood in terms of its two main elements: Stake and Uncertainty.



This risk management is a strategic business process; so in other words, you are going through all the elements of strategic decision-making - kindly note that. The management needs to assess whether the company's business activities are consistent with its stated objectives, and how risk management is linked to investment and growth decisions.

So, the management has to do its financial homework properly and this is where the risk analysis team comes into play, and this risk analysis team will help in analyzing not only the risk that is involved, but by taking that risk how investment and growth decisions can be supported. Risks can be best understood in terms of two main elements: one is stake, another is uncertainty.

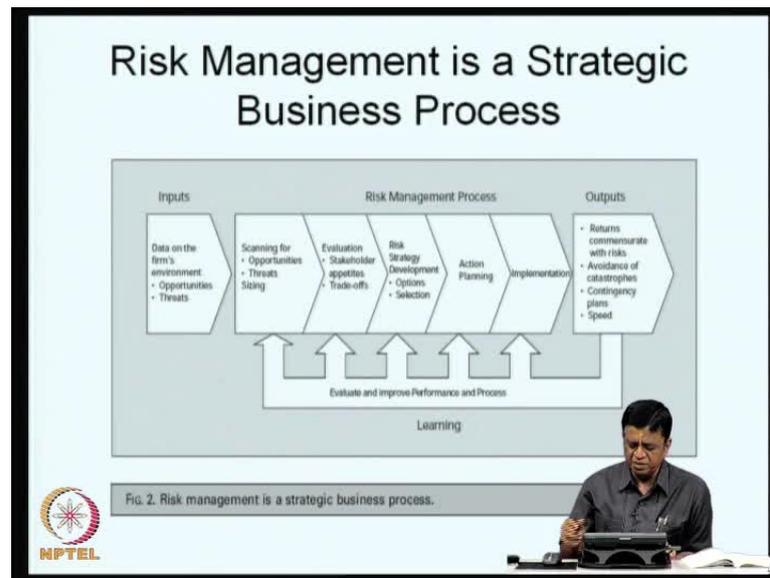
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What is this stake and uncertainty? This is explained by a diagram here. So, a stake, you can look at a stake in terms of whether it is a financial gain or loss, whether it is a strategic position gain or loss, whether it is a reputation stroke image gain or loss, then, existence or health of the organizations gain or loss, then sense of security - have you gained something from this risk or lost something - so again, gain or loss.

So, depending on this, you can put whether the gain is high or low, you can go from small to large. **Now the uncertainty - again the gains or losses**; so, what is the type of losses? If you really look at it, nature of these gains or losses, the scale of gains or losses, then the likelihood of this happening, then the factors affecting, then the validity of the data, the validity of the process and the risk tradeoffs. If you plot all these through indexed numbers, you are likely to get this type of an arrow for risk, that is, what is it that you are trying to see? If you see, the higher the stake, the higher is the uncertainty.

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So, all these are signified by these different types of index numbers. The higher the stakes, the greater the potential gains or losses. Uncertainty, in turn, varies by time and situation. So, depending on the time and situation you took the decision, there is a possibility that for this uncertainty, the gains or the losses will also change.

Now, how can you view this risk management as a strategic business process? I have presented here, a diagram - what are the inputs for this diagram? You are looking at the firm's environment. What do we understand by the firm's environment? You are looking at the opportunities and the threads which are facing the firm. How does the risk management process, itself, work? It scans for opportunities and threats; so, by scanning for opportunities and threats, what does the organization gain or what is the type of insight it gains, it is able to size the risk and that is called sizing the risk. What is the type of risk element that is involved in this type of decision?

Now this evaluation of the risk is has to be done with respect to the stakeholder, then the stakeholder appetites - that is what we said earlier - what is the culture of the organization? Is it prone to taking risks? This is where this culture becomes extremely important. If it is a public sector, the ability of the public sector to venture into a risky arena is always low, due to the type of constraints in which it has to operate.

Whereas, the private sector is always at an advantageous position with respect to this particular aspect of risk, that is, it is capable of taking **the risk and this** is how, it has been proven also.

Look at all the software firms which have made it big in the Indian context, they have taken risk. Whenever they have taken risk and whenever they have executed the projects abroad, this risk element was very high, whether the project will be successful or not successful, and suppose, it is not successful, not only the losses from the project - how will the image get dented of the organization? All these things had to be taking into account; so in other words, the tradeoffs in this whole scenario and the software firms which took this risk - if you really look at big firms like Infosys or Wipro or TCS, you have a risk analysis wing itself with respect to different projects, and all this risk analysis wing in all these companies, they go through a thorough analysis - it may involve operations research, it may involve optimization, it may involve (many times) game theory also, all these things **come** into play.

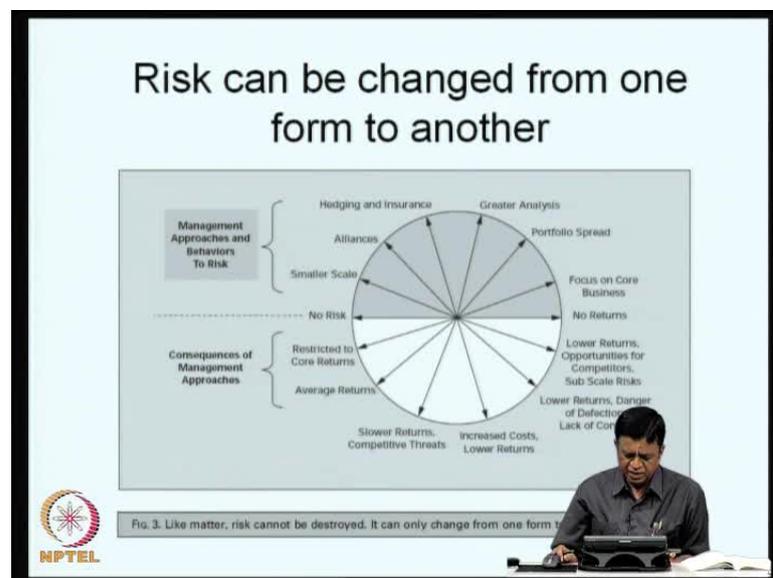
Suppose we do something, what will be the competitor's move? So the risk analysis wing has to look at different scenarios. In other words, they should build the scenarios and present it to the management. Suppose, scenario-1 happens, this is a type of outcome that you can expect. Suppose it is scenario 2, or scenario 3, then the outcomes are likely to be this. Now, what is the risk associated with scenario-1, scenario-2, scenario-3, everything has to be spelt out to the top management.

So, now, after this, the risk strategy development process takes place. So, what are the options that are available to the top management, and which is the one to be selected, how could you select this? Then having done this, the next stage is action planning. So, you have selected this particular strategic risk, now implement this - this is a risk which the organization is taking. So, when you implement this, what are the types of outputs that you are likely to get, the returns you are going to measure, whether it is commensurate with the risks that the organization took and suppose, if it is not commensurate, let us say, then what will the risk analysis team try to do? It will try to find out whether they can avoid this catastrophes, that is going down the hill very badly, so a very steep fall, they would say like to see whether it can be avoided. How can you avoid this? By this risk analysis wing in all these organization, looking at this type of scenario, they would have prepared some contingency plans, and the speed with which

this contingency plans are implemented or put into place, it will tell you how much of this risk is getting mitigated. Now, all this will lead you to different arrows which are shown here, where it says evaluate and improve performance and process.

So, this is where you can say, you went through this whole strategic business process with respect to risk management and you gained so much of so many insights into this. And these insights into this whole risk management process can help you to face the next risk better; so this what it comes to.

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This risk is there in any form of business, but there may be some changes from one form to another, whether it is hedging and insurance or alliances, smaller scale, greater analysis, portfolio spread, focus on core business, no risk to no returns, then you have at the bottom of this circle, the consequences of management approaches.

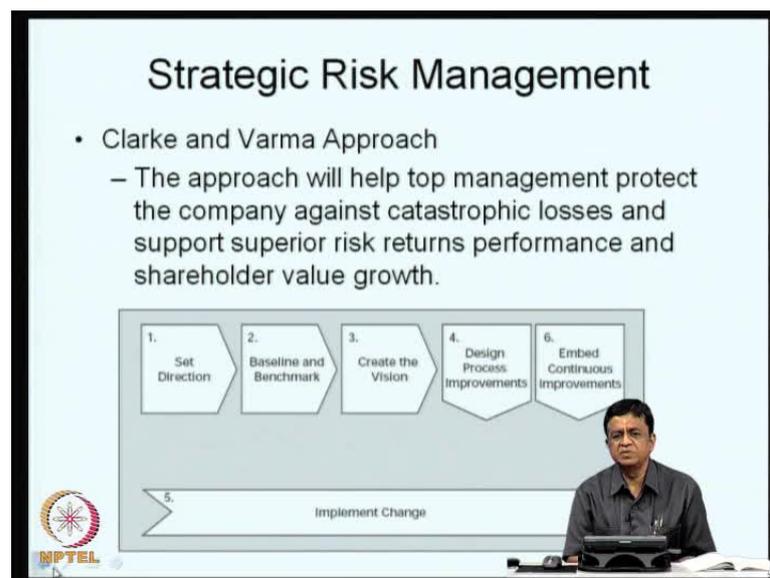
In a typical sense, this circle represents, one - the management approaches and the behaviors to risk and two - what are the consequences of this management approaches. The top half of the circle gives you the management approaches, then the bottom half of this circle gives you what is the consequence of all this approaches. Some of the consequences can be restricted to core returns, average returns, then slower returns, competitive threats, increased cost, lower returns, then lower returns, opportunities for

competitors, subscale risks or lower returns, danger of defection, lack of control, all these can happen.

So, we are looking at different projects, different portfolios, different investments, and different market sectors; that is, you are looking at different sectors - can be small scale industry, insurance or your. So, in order to mitigate this risk, you may enter into alliance with different players - all those types of things; so, you may like to hedge some stocks or some projects; so, all these types of things; then, you may go for insurance cover - all these things can happen in a business setting. So, this is the way risk can change from one form to another, but it cannot be destroyed.

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Then the fifth is the implementing this change at the bottom then, if you go to the sixth one - embed continuous improvements. So, first four, you start working on the first four blocks, then the organization implements change, and then embed these continuous improvements throughout. So, this is the way organizations should work against this risk or try to look at risk.

Now I will read from this particular book - my book only - on what is this setting the direction? That is the first four blocks. What do you mean by setting the direction? Set direction means the step focuses on developing and understanding of the companies, and

its stakeholders risk concerns, and an identifying the major areas of risks such as operations, enterprise, events and market risks. The key objective is to identify and aggregate the risks facing the enterprise and the risk issues, perceived by the management and stakeholders.

So, this setting the direction is an important key. So, this important key is again explained by one more diagram - this diagram is not - you can go to my own book only, this is given to you on page 212, where you look at the operational control risk, then the project risk, then the transaction risk, then the systems risk, all that contributing to what is called the enterprise risk. The enterprise risk can come down to event risk, the reputation risk, the legal and the regulatory risk, then the disaster risk, and the political risk. The counter party risk could be the credit risk or the discontinuity of demand and supply. Some of the examples are given - it can be demands or equity price risk, or interest rate risk, or foreign exchange risk, or liquidity risk, or port concentration risk, and the correlation risk.

Now, come to the second block that is the base line and benchmark. What does that mean? Here, the team evaluates the risk and returns and the appetites of investors and other stakeholders, to quantify major risk elements and priorities, analyze risk drivers and map current processes, it is important to quantify the risks. For some risks such as financial related risk, this may appear to be a relatively simple exercise. For operational risks, such as safety or technology quantification often requires making assumptions. We have found that using multi-disciplinary teams, involving those actually on the ground, gives superior results to using assumptions generated by corporate, by planners, at the corporate headquarters.

In other words, what is being suggested is, come to ground 0; that is the markets, come to the market level, then you are in a better position to analyze this scenario, the business landscape. Risk processes and risk performance are benchmarked against global best practice. This global best practice on any type of risk, whether it is project risk or financial risk or transaction risk or operations risk, we have a global database now that is organizations have been able to get a global database and bench mark themselves against this.

It is usually essential to go beyond the immediately obvious competitors and to compare other industries where business best practice lies. So, look at something beyond - do not just look at one or two circles only, you should be able to go further. A value at risk approach is often used, this calculates the probability of loss on a financial portfolio rather than the probability of losing the entire portfolio, this is what we earlier said - the risk analysis team should be able to have contingency plans, if required. Why should you have contingency plans? This contingency plans are to avoid the catastrophe for the organization. Then in the step-3, what does this creating the vision mean? So, just looking at the army, let us say for detecting any enemy aircraft and vehicles, the management - the vision of management - should be to scan the environment and to identify quantitative and qualitative opportunities and threats and to determine the most attractive appropriate response, depending on the stakeholders risk sensitivity.

Kindly note all this risk, it in fact, came from the war scenario, the ability of party one preparing to take the risk against the enemy, and the enemy in turn, counter responding to this. A risk management vision is created comprising the three components of measuring, managing, and monitoring risk.

The management may develop appropriate strategies. What are the types of strategies you can develop? Decrease the stakeholders through sharing the risks and rewards, with co-investors, suppliers and customers. Decrease the stake through sharing the risk and rewards with co-investors, suppliers and customers. How does it help? It may reduce the uncertainty through bringing in partners with data and who can control risk drivers; it can also prepare country scenario and contingency plans, focus on core-business or spread its risks through a range of businesses and geographies - this is the third one.

The fourth one, that is, the designing process improvements - what does that mean? Based on the data gathered in the earlier steps, the management decides on the most appropriate improvement options.

It can include designing processes, documenting policies, then tighter process management and parallel processing, that is, to remedy the decision delays, then it can use a risk plus or minus returns matrix to evaluate the overall risk position of projects; so whether it is going up or coming down, then the risk matrix is used to decide where does each strategic business unit lie with respect to the risk, whether it is low or high and

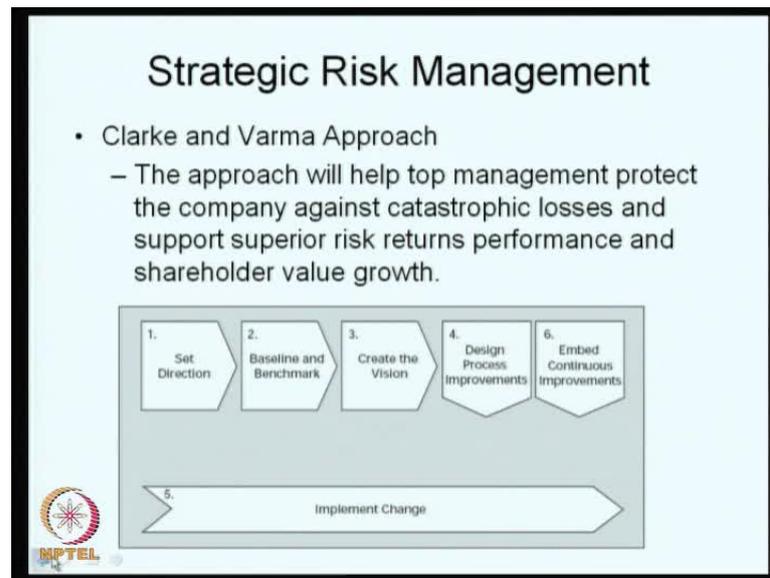
where should it depending on where does it lie, you can take an appropriate strategic response.

This can then be plotted against expected returns. The designing of process changes occurs in four areas, then first strategy and policy changes need to be made, a clear risk management strategy must be articulated by top management in the visioning phase. And this is converted to a risk management policy document, and training plan in the design phase and it is important to ensure that the overall business policies are supported by the risk management policy.

An example, a growth focused business objective will not work while maintaining a minimal risk tolerance as seeking growth, will inevitably lead to undertaking enhanced risk. So, the policy manual outlines the risk objectives, tolerance levels, acceptable procedures, and then the specific risk-related accountability and risk measurement, and reporting guidelines. Once the risk process is finalized, management endorsement and commitment is needed to provide a mandate for the risk management program.

In other words, the management has to approve this risk, that is it has to say, it has give its nod, “Okay, go ahead with this”, taking this strategic risk. The management also needs to review the organization structure that will be used to support risk management. Centralized risk management options tend to work for a controller company, has evidenced by many financial institutions, and a decentralized risk management model, tends to work for a portfolio management/ manager company. Depending on the risk vision, the design changes relating to the formation of risk committees or councils. Then, risk measurement is the other area where you have to keep on monitoring the changes that are required.

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So, effective tools to proactively assist in monitoring and managing risks **have to be incorporated, have to be crafted, they incorporated**. The overall picture could be something like a design process improvement, depending on the type of risk involved, and this can help you in overall risk monitoring. So, whether it is a country, or a project, or a credit trading operating, or environmental risks; each of these risks, there can be a dashboard approach, that is, the risk analysis team provides the top management on the drawing board.

What is the type of risk that is involved with respect to each of the scenarios? In other words, in half an hour, the board can go through all these risks and opportunities faced by the corporation in considerable depth, it can go through all this and then say - take this particular course of action, it can also include changes to IT infrastructure as well. Do not ever be thinking that all this is concerning only manufacturing; it can also be concerning the IT infrastructure, the internal controls and also the operating guidelines

The step-5 is where you start implementing the change. So, this is what we call in **the management terminology where “the rubber meets the road”**; so, this is what it means. So, **in all strategic** as in all strategic processes, successful implementation is the key to ensuring long term success of any risk management program.

How do you try to achieve this? Focus on two things - one is the people, the second is the process. What do we mean by the people? Take the commitment of the senior management and employees towards the strategic risk initiative that you have taken. Then, what about the next things which you have to look at? Form these working teams which are responsible for the enterprise wide change effort. So, form working teams. Then, this where you have the corporate staff, you have the risk experts in areas, you also have the process champions and the line managers. So, in other words, the idea is to have a team of key decision-makers from across the enterprise.

So, drawn the experience of all these people, to have good teams. With respect to process implementation - how does it work? It must be understood with respect to process implementation, it is the organization is better off taking one step at a time. Do not jump the gun.

So, the first focus should be on the core risk areas, that was defined in the base line or the benchmark phase, then the implementation - this implementation stage is where you formulate a common language to cope with this risk, that is, the common risk language which can be understood by the entire organization, entire enterprise.

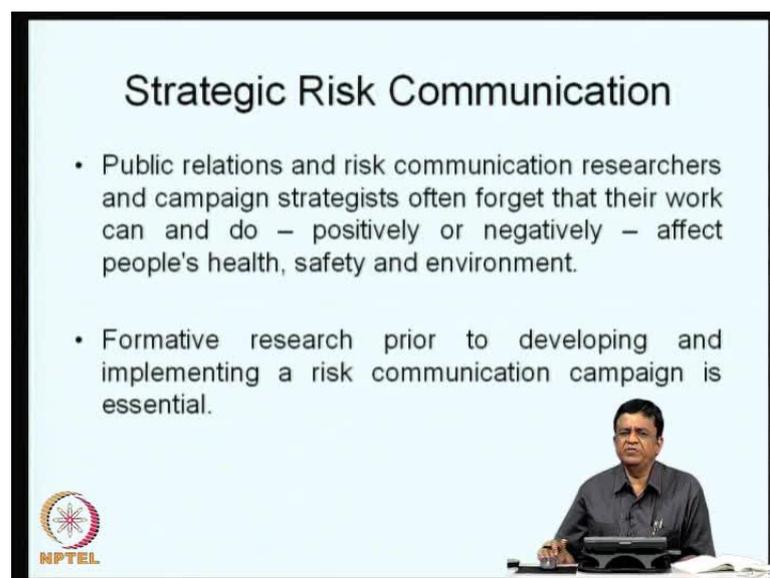
So, in other words, you have designed a risk management process. This risk management process armed with these strong people, that is, all these working teams and a realistic implementation schedule, it will help in ensuring that implementation succeeds and penetrates the entire organization. In order to make things better or to be current, you roll out training and communication programs as well. So, whenever you are doing these types of risk management exercises, keep the training and communication program modules **also** ready. Given a requirement, you should be able to put this into action, that is, the working teams should be prepared to put these modules into action.

Now, what does this sixth step - that is, embedding continuous improvements - what does it involve? So, as you might have seen, this entire risk management looks like a journey, a continuous journey. A continuous journey always looks for continuous improvements. So, you took one decision with respect to one project, that is, risk decision; so, the second project you may take a different type of decision; **then**, what do you mean by that? The planning can be different; so, the results are monitored against the plans, then the risk review programs, in that sense, needs to be institutionalized, and

then you have to track the best practices processes, and then update the procedures. So the idea is to see that all these results in continuous improvements. In all these, what is involved? You are looking at returns, and how do you measure these returns? These returns are measured against market expectations. So, the idea of all the entire exercise of this strategic risk management for the organization is to develop good risk managers. So, an organization should be able to develop through this strategic risk management process.

Good risk managers who can guide the organization, whatever might be the project the organization may be taking, the portfolio changes which may be called for all these; so, these people should be able to guide the organization through this whole thing - exercise.

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The slide features a light blue background with a black border. At the top center, the title "Strategic Risk Communication" is displayed in a bold, black, sans-serif font. Below the title, there are two bullet points, each starting with a black dot. The first bullet point reads: "Public relations and risk communication researchers and campaign strategists often forget that their work can and do – positively or negatively – affect people's health, safety and environment." The second bullet point reads: "Formative research prior to developing and implementing a risk communication campaign is essential." In the bottom right corner of the slide, there is a small video inset showing a man with dark hair, wearing a dark shirt, sitting at a desk with a microphone and papers. In the bottom left corner of the slide, there is a circular logo with a starburst pattern and the text "NPTEL" below it.

Now, given this type of a scenario, communication becomes extremely important. So, the strategic risk communication becomes an important block in this whole process. These public relations or risk researchers and campaign strategists, often forget that their work can and do positively or negatively, affect the people's health, safety and environment, that is, not only the people, by that, we are looking at the organization also. Formative research prior to developing and implementing a risk communication campaign is essential; so, do not communicate too much or do not communicate too little; everything has to be perfectly done. This is the type of communication exercise which the risk managers have to indulge in with respect to an organization.

Now, what have we really looked at? We have looked at, in the present business landscape, in which organizations are operating, they have to take risks. The higher the risk, the rewards are also likely to be higher, but the organizations have to learn how to manage this risk better. So, in order to manage this risk, what was presented was a model for this risk management. So, that model consisted of six blocks or six stages, and these six stages were explained. We have emphasized the role of communication in this entire process.

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The slide is titled "Looking Ahead" and features three bullet points. The first bullet point discusses the need for a delicate balance between risk communication and technical information. The second bullet point emphasizes the need for a comprehensive understanding of strategic risk and the use of an integrated risk management methodology. The third bullet point states that the development of strategic risk management can maximize shareholder value. The NPTEL logo is visible in the bottom left corner, and a small inset image of a man speaking is in the bottom right corner.

Looking Ahead

- There is a need to achieve a delicate balance among the risk communication efforts and technical information availability.
- A comprehensive understanding of strategic risk is required. An integrated risk management methodology must be used for identifying and evaluating risk.
- Development of strategic risk management can maximize shareholder value.

NPTEL

Now, what is the type of scenario which you can look ahead? The scenario which we can look ahead, given this type of input with respect to risk is there is a need to achieve a delicate balance among the risk communication efforts and technical information available. You **have got one on one** side - the technical information, on the other side - how much how of it should be communicated through the organization? So, you have to strike a balance, and this can always be a delicate exercise.

The second one is a comprehensive understanding of strategic risk is required. So, whenever you take a decision with respect to strategic risk, the organization has to understand fully - what are the different elements which are involved; so, that requires, what is called an integrated risk management methodology; the organization should be able to develop this. This should be used for identifying and evaluating risk, that is, a

comprehensive understanding of strategic risk is required, an integrated risk management methodology must be used for identifying and evaluating risk.

What is a third type of scenario which you can visualize? Given this type of a framework, if you can analyze, if you can develop, that is, a risk management team, suppose, it can develop strategic risk management models that can maximize shareholder value; so, **they can come out with** if they can come out with strategic risk management models which can maximize shareholder value, it can benefit the organization immensely in the type of competitive business landscape they are operating in - especially the IT sector. So, this is where this strategic risk and the efforts of the risk management teams to mitigate or the catastrophes that might come through, becomes vital for the organization.

So, we will stop here and we will continue in the next class. Thank you