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Managing Strategic Risk

Case study | one

Prepared for NSW Federation of Housing Associations and NSW Registrar of Community Housing

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01 About the project

The NSW Registrar of Community Housing (the Registrar) and NSW Federation of Housing Associations (the Federation) engaged Elton Consulting to prepare a series of in-depth case studies of community housing organisations' experience with managing strategic risk. This report was commissioned under the NSW Community Housing Industry Development Strategy 2013/14-2015/16. The Strategy is a partnership between the NSW Federation of Housing Associations and the Department of Family and Community Services and aims to enhance the industry's ability to respond to the challenges and opportunities of the emerging environment. This project extends and complements the Managing Strategic Risk Stage 1 Report, also jointly commissioned by the Registrar and Federation in 2014. The Stage 1 Report documented the perceptions of providers and critical stakeholders regarding contemporary strategic risk practices in the sector.

About the case studies

The case studies explore key issues emerging from the Stage 1 Report, including:

- approaches to managing risk arising from changing government policy
- appreciation of the risk inherent in existing community housing business models
- approaches to managing risk to culture, purpose and values, for example, resulting from growth
- the Board's stewardship role in managing strategic risk
- experiences with managing financial risks
- approaches to decisions about organisational structure
- appreciation of the role of business diversification as a strategic risk, as well as a risk mitigation technique.

Participating case study organisations were selected on the basis of a recent history of growth and diversification, or a recent reshaping of the organisation in readiness for growth and diversification. Further information about each organisation and the reasons for their selection is contained in each case study. The case studies include overseas providers.

The case studies have been prepared using the current risk management strategy and reporting framework of participating organisations, as well as relevant documents including Board papers, Audit and Risk Committee papers, and strategic and financial plans.

CEOs of case study organisations were interviewed twice to canvass their experiences and perspectives on the key issues, and to explore matters arising from the review of their documents. The first interviews were approximately two hours in length and were in depth and discussion-style. The second interviews were shorter and more targeted, focusing on topics which benefitted from further exploration or confirmation.

All materials received from participating organisations have remained confidential, and case studies have been de-identified.

About strategic risk management

Risk refers to the effect of uncertainty on an organisation achieving its strategic objectives and maintaining its long-term viability and reputation. Risk management is an integral component of good organisational strategy. At an operational level, the purpose of risk management is to minimise the impacts of potential threats to achieving an organisation's objectives, and to enable it to take advantage of opportunities. At a strategic level, risk management is essential for sustaining the organisation's purpose and for creating value for shareholders and stakeholders.

To manage strategic risks effectively, organisations must first consciously take an approach to risk. They must anticipate risks and opportunities, understand the character of the risks, and determine their risk appetite. They must also appreciate that the drivers of risk tend to operate in an interconnected way, which means they must be monitored and managed in combination.

Risk management must be integrated into all levels of an organisation's processes. In particular, the management of strategic risks must be embedded in business and strategic planning, as it forms an integral component of decision making. A risk management framework should ideally be subject to iterative and continual monitoring and review. This aims to ensure that the risk management approach continues to remain relevant and is able to inform decision making as the organisation's operating environment changes.

The International Risk Management Standard AS/NZS ISO 31000, published in November 2009, provides the benchmark for good practice risk management. The standard outlines risk management architecture, comprising core principles and a related risk framework and process. While the risk framework and process are important for effectively identifying and managing operational risks, it is the 11 principles which most directly address the question of strategic risks. As articulated in the ISO 31000 principles, risk management:

» creates value
» integral part of organisational processes
» part of decision making
» explicitly addresses uncertainty
» systematic, structured and timely
» based on the best available information
» tailored
» takes human and cultural factors into account
» transparent and inclusive
» dynamic, iterative and responsive to change
» facilitates continual improvement and enhancement of the organisation.

These principles assist organisations to navigate their operating environments, with all their inherent and ever-changing uncertainties and potential opportunities. Linking strategic risk management to the aim of creating and protecting value allows an organisation to get the most out of its business strategy and to understand closely both its business model and its stakeholders. In order to understand the risks to an organisation's business strategy, the organisation must first understand and be able to articulate the key elements of that strategy. Strategic risk management helps organisations to make strong decisions at the executive and governance level, by making explicit the level of risk the organisation is prepared to take in executing its business strategy. Equally, strategic risk management makes explicit the level of risk which is actually being taken, and allows this to be evaluated.

The principles draw attention to uncertainty: to probabilities and consequences which cannot be known; on events which are outside the organisation's control and estimation; on the potential for catastrophic risks which may pose a threat to the ongoing existence of an organisation or an entire industry. Strategic risk management does not require that all unknowns are made known, only that the uncertainty inherent in the operating environment is identified as much as possible, so that it can become an explicit part of decision making. One way for an organisation to address uncertainty is to identify the assumptions it is making, and to subject those assumptions to stress testing and/or scenario analysis. The latter involves modelling the impact on the organisation of an adverse event such as a development partner bankruptcy or more dramatically a second global financial crisis.

All risk management approaches need to be able to adapt to changing circumstances. This is even more critical at the level of strategic risk management, which aims to support business decisions in dynamic and complex environments.

This project applies the principles of ISO 31000 to inform the desired approach to strategic risk management in the community housing context.

02 About the organisation

This case study focuses on a larger provider with a history of business growth in multiple geographic areas. Growth has been achieved through a mix of management transfers as well as design and construction of new properties and property procurement.

Key strategic risks identified by the organisation include: not delivering new growth due to limited government tenders and unclear or changing government policies; the risks associated with ongoing debt finance; and the challenges associated with recruiting and retaining staff.

Key facts

Number of properties	6,000+
Staffing numbers	550+
Operations in multiple locations	Yes
Core social housing activities	» Managing tenancies » Managing properties
Other activities	» Developing properties » Homelessness services » Training and employment services

03 About the organisation's management of strategic risk

Undertaking due diligence

The organisation has a strong focus on generating and pursuing business opportunities. This includes the extension of existing services and programs into new locations, either independently or in conjunction with local organisations. It also includes the delivery of new types of services and programs. This focus on expansion requires the organisation to implement processes and practices for evaluating new business opportunities: in order for the organisation to make sound decisions about whether, and how, to proceed, the strategic risks associated with any proposed business venture must be identified and managed.

The organisation has implemented significant due diligence processes including a full feasibility study for any potential location for business expansion. The study may take two or three years to complete, and includes a review of:

- demographic factors – including current and projection population statistics and key breakdowns
- economic and social factors – including employment trends and income inequality statistics
- government policy – local housing policy, availability of housing subsidies, tax and other relevant policy settings
- housing market – including housing supply and demand
- projected start up costs for the organisation to establish a presence in the location
- financial forecasts for indicative projects – on top of projected start up costs.

The purpose of the feasibility study is to identify risks methodically, isolate any critical gaps in knowledge and seek further information where available. This process assists the organisation to make explicit the risks inherent in the decision, and not to be overly influenced by information which is readily available. Feasibility studies may be conducted in multiple locations simultaneously, to assist the organisation to evaluate options.

By establishing a format for the feasibility study, the organisation is less likely to overlook information gaps, as the process is structured around questions for which answers need to be identified. Lack of information is not in itself a reason to abandon a proposed business venture: aiming for 100 percent knowledge is unrealistic. However, areas where information is unavailable, or changeable, or subject to multiple interpretations signal areas of potential strategic risk, to which the organisation must choose how to respond.

The organisation carries out stress testing of key metrics, as part of its due diligence processes. Typically this includes:

- interest rate variations
- property valuations
- timeframes for new properties coming on line
- revenue projections across the portfolio.

The organisation also establishes key criteria for evaluating whether or not to proceed with an opportunity. The criteria are set out in advance of the feasibility study, which helps to ensure an objective assessment of the proposal. For example, when the organisation considers a transfer opportunity, it considers whether:

- tenants will have improved housing amenity as a result of the transfer
- the organisation will be able to benefit tenants through community engagement
- the organisation will be able to grow its property numbers
- there are financial or reputational risks associated with engaging in the transfer opportunity
- there are opportunity costs, such as reduced capacity to respond to other tenders.

The practices implemented by this organisation demonstrate a robust approach to investigating opportunities, which equips the organisation to make sound decisions based on evidence.

Proving the concept

Through its experience of expansion over many years, the organisation has a well developed appreciation that new areas of business take time to explore, time to develop and time to mature. The establishment of operations in a new location may begin slowly, with a focus on fostering engagement with local communities and key organisations, identifying partners and brokering working relationships, and developing a deeper understanding of the opportunities and challenges. Following the exploration stage, the organisation may decide not to proceed, or may decide to trial initiatives or bid for short term contracts to develop the business area, before the business matures into a more stable operation. The Board deliberately sets conservative expectations about the timeframe for maturation.

For a new business venture, this process may take five or even ten years. During this period, the initiative may appear to be a tiny and peripheral part of the organisation's activities. In reporting to the Board, the organisation's executive ensures that such initiatives remain on the radar, as they have a strategic importance which may far exceed their current operational or financial impact.

Even when major new business ventures are approved, the organisation has learned not to expect financial success in the short term. This acknowledgement requires a particular approach to strategic risk management, where investment in new businesses is restricted to pre-determined levels, in order to control the level of financial exposure.

In order to help manage the risks around new business ventures, the organisation establishes performance indicators to evaluate a new project's success, including specific performance indicators for the start up phase. This approach focuses on measuring progress towards longer term goals, via reasonable short and medium term indicators. For example, to monitor projects involving the transfer of properties, the organisation may use the following short term indicators:

- level of rental income against budget
- number of new staff employed against budget
- value of maintenance delivered against budget.

For the same project, medium term indicators may include:

- vacancy rates against organisation-wide benchmarks
- tenant satisfaction levels against baseline
- community development projects commenced
- value of property upgrades delivered against budget.

Long term indicators may include:

- property values against baseline
- community wellbeing against external benchmarks
- level of demand from applicants to move into the area.

The organisation applies a similar approach to manage risks in other business ventures, such as property development projects. Project plans include specified 'stop points', where the project will be subject to review. Failure to meet timelines or other key indicators may result in the organisation withdrawing from the project, or taking corrective action to resolve problems before proceeding.

Forging partnerships

The organisation considers itself to have a partnership approach. It focuses on delivering services and programs in collaboration with local organisations, and on facilitating grassroots organisations to increase their level of activity. While somewhat less formal that other due diligence processes, the identification of suitable local partners is a key component in managing the risk of pursuing an opportunity.

Partnering helps manage the risk of new business. By working with organisations which are already in the location, or already have the expertise, the organisation avoids the need to learn 'on the job'. It also allows the organisation to move quickly, by working with an organisation with existing capability rather than employing new staff and developing capability internally. Critically, this offers the organisation the opportunity to carry out projects without having to expand into non core business areas. For example, the organisation has identified the need to provide specialised furniture as part of some development projects. Rather than establishing a new line of business, the organisation partners with an acknowledged expert. Similarly, the organisation prefers to partner with specialist support providers, rather than to develop an in house capability to provide support services.

In addition, the organisation sees part of its role as providing a platform to allow grassroots organisations to build capacity and expand their activities. Partnering thereby allows the organisation to fulfil its purpose in a lower risk manner.

Containing financial risk

The organisation has a reputation for fearless pursuit of growth, including:

» high profile expansion into locations where other community housing providers already operate
» development of business ventures in new locations
» consideration of mergers with other providers.

Perhaps somewhat against this reputation, the organisation perceives that the risk involved in the pursuit of new business opportunities is carefully quarantined to a very small proportion of the organisation's finances.

According to the CEO, the vast majority of the organisation's financial resources are committed to existing business operations, which are carefully controlled by the organisation and closely monitored by regulatory arrangements and contracts with lenders. Less than three percent of the organisation's financial resources are available to fund innovation or expansion. This effectively contains the financial risk of new business opportunities. Should a business venture fail, the project or service would be affected but not the organisation as a whole.

This approach is endorsed by the Board, which sees careful monitoring of financial matters as a critical part of its role. In addition, the Board tasks the Audit and Risk Committee with monitoring the organisation's financial controls and risk management arrangements. The Chief Financial Officer is also tasked with managing risks associated with borrowings, through monitoring movement in interest rates and property valuations, and reporting on financial ratios. Deliberate containment of financial risk to a small proportion of the organisation's finances indicates good practice within the sector.

While the financial risk of new business ventures may be carefully contained, there is the potential for the organisation's reputation, and consequently its capacity to do business in the future, to be damaged by a high profile failure. The Board reviews a wide range of reputational risks in the organisation's risk reporting, including:

» community resistance to proposed property development projects
» negative media coverage, traditional and social
» reduced tenant satisfaction levels.

Diversifying the business

The organisation acknowledges that government support for community housing varies over time and between jurisdictions, subject to changing political and administrative priorities. In this context, the organisation has taken the view that operating within a single jurisdiction is riskier than operating across several.

By spreading the organisation's business activities, prospects for continued growth and expansion are improved, rendering the organisation more stable. It also helps mitigate the potential loss of key personnel, which is identified as a critical risk area.

The organisation's commitment to diversification reaches beyond geography. Its expansion has been largely characterised by incremental increases, so that it now manages over 120 separate service contracts. These include traditional property and tenancy management services, property development projects, homelessness services, community development projects and training services. The organisation acknowledges that the fragmented nature of its contracts poses operational risks. However, overall the organisation considers diversification in income streams and types of business to be a prudent approach for managing strategic risk.

Aligning with strategic direction

A key element of the organisation's process for evaluating opportunities is its mission statement. Potential new areas of business, whether new projects or initiatives or the possibility of expansion into new jurisdictions, are interrogated using the mission statement as a primary guide for whether to pursue the opportunity further. The question: 'Would this help us fulfil our mission?' is posed explicitly, rather than left as an assumption.

As the Board takes the view that it is the guardian of the 'soul' of the organisation, responsible for ensuring that all areas of operation fulfil the organisation's vision and purpose, this question is explicit in Board deliberations about business opportunities and activities. In addition, a wide range of staff across the organisation use the vision and purpose to assess whether, and how, to take up opportunities. For example, if a new project entails both housing management and support for tenants, staff may refer to the organisation's purpose in choosing to partner rather than pursue the opportunity alone.

Following an extensive feasibility study, the organisation decided not to pursue an opportunity to deliver a specific housing program. While embarking on the program would have made a contribution towards the organisation's growth targets, the Board and CEO determined that the program would not have created good living environments for low income people. The organisation declined to pursue the opportunity on the grounds that it did not align with the organisation's core purpose as expressed in its mission statement.

Where a new initiative falls outside the organisation's purpose, but nevertheless demonstrates potential value, the organisation is prompted to consider expansion of its purpose. This is done through a deliberate, explicit process, to avoid the danger of inadvertent 'mission creep'.

Staffing new initiatives

The organisation has at times experienced difficulties with identifying, recruiting and retaining appropriate staff for senior positions, to lead new areas of business. This has led to an increasingly explicit acknowledgement of the importance of staffing and culture.

The processes and practices adopted by the organisation include:

- investing CEO time and effort in identifying and recruiting suitable senior staff, especially the leaders of new areas of business
- a focus on recruiting staff on values rather than focusing primarily on technical skills, to ensure their commitment to the organisation's vision and their personal qualities of tenacity and patience
- an explicit acknowledgement that new areas of business will require additional staffing, and including this in the budget for the investment stage so that staff are recruited as early as possible – the first risk identified in the organisation's Risk Management Strategy is the risk relating to new areas of business, and one of the key risk management techniques is to resource new business with the right quantity and quality of skilled staff
- an acknowledgement that new business requires not only sufficient frontline staff but also sufficient management resources – this includes senior line management as well as appropriate time for the organisation's executive to dedicate to oversight
- building a consistent culture throughout the organisation, despite its highly dispersed areas of operation – staff are encouraged to relocate between offices where possible, induction for new staff includes spending time with staff from a variety of operational areas, and a deliberate program of decentralising the organisation to strengthen each office with senior staff is being implemented.

Nevertheless, a 'key person risk' remains. In each area in which the organisation operates there are one or more vital individuals without whom the organisation would lack important corporate or industry knowledge, skills or credibility. The business strategy for each area of operations relies heavily on the long term drive and commitment of its leader, and the organisation is highly dispersed geographically.

This means that it is difficult for the organisation to implement sufficiently strong succession plans or to cover for changes of key personnel.

Cultivating readiness

A key insight from industries which have undergone rapid expansion is that scale brings complexity. As these organisations grow, they become new and more complex types of organisations.

In addition, in an unpredictable operating environment with low visibility of potential growth opportunities, businesses often need to maintain readiness to respond and an ability to scale up and down rapidly. Most strategic risks are external to an organisation, and relate to possible future events. In this context, the key task for managing strategic risk is not to make a firm decision where none may be necessary, but to cultivate a high level of awareness of the strategic environment and to remain nimble.

The organisation has responded to this need by preparing readiness plans which focus on the key practical implications of growth. In considering growth or expansion into new business areas, or contemplating reduction in funding for particular services, the organisation anticipates:

- a range of potential staffing structures
- the impact on the organisation of an increase or decrease in staff numbers
- staff skills, including the potential for specialised teams to meet identified needs
- the cost of establishing and running additional offices
- alternative approaches to managing maintenance with potential portfolios of various sizes, geographic distributions and configurations.

These plans assist the organisation to consider the impact of realistic scenarios, in order to maximise its readiness to respond.

Setting risk appetite

The organisation has a high appetite for risk, as evidenced by its willingness to take on types of housing services often considered too difficult by other organisations, and by its willingness to invest in new areas of business which may take many years to demonstrate any return.

In its published corporate governance statement, the Board is explicit that part of its role is to set the risk profile of the organisation. It expresses this primarily through its delegations: the CEO and other members of the executive are authorised to exercise their judgement within clearly defined financial limits. The limits differ for capital projects and operational projects. The introduction of an entirely new line of business would be brought to the Board, no matter how minor the financial implications. The CEO is expected to maintain a close understanding of the organisation's overall financial position and potential reputational exposure, and to use this as a reference point when exercising judgement.

As a further control, the Board establishes clear budgets for each part of the business.

Implementing internal controls

Several years ago the organisation experienced a ‘near miss’ event, with a suite of property developments falling significantly behind contract. The organisation diagnosed the problem as one of insufficient internal project management capability: to take advantage of large scale opportunities the organisation’s development business had expanded very rapidly. The success of the organisation in winning tenders and developing new business put pressure on its existing capacity, which did not keep pace with growth. In effect, operational risks had become major strategic risks, potentially endangering the financial viability and reputation of the whole organisation.

To mitigate occurrence of similar risks in future, the organisation implemented a project management approach across its business: everything the organisation does is now treated as a project, and managed using PRINCE2. PRINCE2 is a highly structured project management methodology, which is used across public and private sector organisations. It requires a disciplined approach to planning, budgeting, resourcing and monitoring projects. It incorporates risk identification and management at the project level, which can be articulated to strategic level risks if appropriate.

In adopting PRINCE2, the organisation restructured to establish a project management team, to lead this approach across all business activities. A large number of senior staff received specialised training, and the project management approach has flowed through the organisation’s culture.

The project management approach also encompasses formal review of projects through a project closure report, which includes a review of 'lessons learned', including for successful projects. By implementing this for each project, the organisation has embedded in its processes the opportunity to identify risks to which there may have been exposure, even if the risk did not eventuate, and to improve future risk management.

For example, a project closure report for a medium scale property development project would review the performance of the project against its identified objectives. These would include the cost, revenue and valuation assumptions incorporated in the original business case, as well as timeframes and other objectives such as consolidation of working relationships with key partners or funding bodies. The report would also provide a written analysis of key learnings, for example the:

» relative level of confidence in working with the same project partners on future developments
» impact of short submission timeframes on the design process
» amount of management time required for negotiation of variations.

Attending to reputation

The organisation has logged a wide range of reputation risks, with a number considered sufficiently high priority to be reported up from the Audit and Risk Committee to the Board. A suite of strategies are implemented to mitigate these risks, including communications/ media strategies, a specific social media policy and social media delegations, and community engagement activities especially in relation to property developments.

In addition, the organisation seeks to generate positive media as part of its strategic risk management. Instead of using the media to promote specific projects or initiatives, the organisation's approach is to focus on grassroots engagement via local media, to build community knowledge, trust and goodwill towards the organisation. The organisation appreciates that its pursuit of growth and business diversification may at some point place its reputation at risk. For example, a new business venture may fail, or may subject to high profile criticism. From a reputational point of view, the organisation seeks to manage this risk not by refusing to take on new or higher risk projects, but by ensuring that its reputation is sufficiently strong to survive public criticism in the event of a negative outcome.