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Managing Strategic Risk

Case study | two

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 organisations

This case study looks at a partnership between two larger providers operating across jurisdictions. The partnership is focused on a considerable growth opportunity which incorporates multiple areas of service delivery, including managing tenancies and properties, supporting clients, and developing new housing.

Key strategic risks identified by the organisations include financial, reputational and sovereign risk, as well as risks to systems and services in the context of rapid growth.

Key facts

	Number of properties	5,000+
	Staffing numbers	150+
	Operations in multiple locations	Yes
	Core social housing activities	» Managing tenancies » Managing properties » Supporting tenants » Asset management
	Other activities	» Developing properties » Community regeneration » Private sector leasing

Note: The key facts are the combined total for both organisations.

03 About the organisations' management of strategic risk

Forging partnerships

The main factors driving the establishment of this partnership included the complementarity of capabilities and the alignment of organisational values.

After the global financial crisis, one of the partners had taken the decision not to take on development risk in the short to medium term.

This organisation previously had an in-house property development program for some years. However, in analysing its development outcomes, the organisation found that it was able to purchase properties off the plan for the same price it could develop them. In addition, the organisation could gain a one per cent customer margin from its lender if it did not take on development risk – leading to a considerable financial benefit.

Other factors which led the initiating organisation to take a partnership approach to developing new properties included:

- difficulty in recruiting experienced development staff in the context of a relatively small and uncertain development pipeline
- efficiencies of scale available to larger developers
- increasing preference by government for providers to partner with private sector developers, particularly on large projects.

This is an example of the evolving approach to management of development risk by providers nationally and internationally. In many jurisdictions, medium to large providers have gone through a period of taking on development functions in-house, before reconsidering their approach in light of changing economic and political conditions.

One of the contributors to the success of the partnership has been the early identification of complementary skills and roles. The organisations have different areas of business focus, as well as different organisational skills, capacities and resources. They therefore each have a clear understanding of the value they bring to the growth opportunity, as well as their organisational limitations.

This complementarity, as well as the lack of competition between the organisations in other areas of operations, helps support collaborative working relationships and reduces risk to the partnership.

Before agreeing to work together on the growth opportunity, the organisations prepared a Memorandum of Understanding (MOU) which clearly defines the purpose of the partnership, project structure, funding sources and exit arrangements.

The roles of each organisation are carefully defined in the MOU. The leaders of both organisations believe that the creation of structured and documented roles within the MOU is critical – and would be even more important if there was a greater degree of competition between the organisations in other areas of operation.

Another key to success has been the maintenance of a close working relationship between the organisations – and particularly their leaders. The CEOs agreed that it has been important to put time into maintaining a strong and respectful working relationship, building on the shared values and considerable foundation of trust on which the partnership was established.

Aligning with strategic direction

The medium to long term direction of each organisation is set through a strategic plan approved by the Board. One organisation's strategic plan has a three year horizon and the other has a ten year timeframe.

The strategic plans of both organisations identify growth through partnership as a priority. This meant that when the opportunity to partner on the growth opportunity emerged, the organisations had confidence that it aligned with their strategic priorities and had been subject to risk analysis via the organisational strategic planning process.

Other key elements of the strategic plans of both organisations include the lack of a geographic limiter in the organisational vision or mission. While some providers specify the area in which they intend to work, these organisations do not limit their regions or jurisdictions of operation at the strategic level. They may target regions or jurisdictions for growth in their detailed strategic or business planning, but not limit themselves in their vision or mission.

Both organisations also include measurable goals within their strategic plans. This includes targets in key areas such as number of properties managed, debt repayment regimes and overall tenant satisfaction. The inclusion of key measures allows new opportunities to be rapidly assessed against each organisation's strategic direction and priorities.

For one of the organisations, the strategic plan is supported by rigorous stress testing. It includes financial analysis of a base option plus five growth scenarios. These scenarios model changes to a range of interrelated assumptions, such as:

» ratio of social to affordable housing in the portfolio
» debt repayment regimes
» income from fee for service operations and other revenue streams
» business expenses, including wages, rents and utilities.

Importantly, stress testing is used by this organisation to initiate robust discussions by the Board. The Board has come to expect and value stress testing to support the preparation of the strategic plan and project planning associated with key growth opportunities. It thoroughly interrogates the assumptions on which the scenarios are based, leading to dynamic discussions between the Board and senior management.

The organisation has also extended the practice of stress testing to its project management staff. Project leads are expected to develop potential scenarios as part of project plans. Assumptions which underpin the scenarios are reviewed by the CEO before being debated and tested by the Audit, Risk and Governance Committee and, ultimately, the Board.

Cultivating readiness

To be able to rapidly take advantage of emerging opportunities, contemporary community housing providers often need to be nimble and responsive. The clear identification of growth through partnership as a strategic priority has assisted these organisations to cultivate a culture of readiness. One of the organisations has a dedicated business unit to search for and evaluate opportunities, as well as prepare tender responses.

The ability to move swiftly on opportunities is also enabled through clear delegations.

One of the organisations has a detailed delegations policy as a key part of its strategic risk management framework, which aligns delegations with activities based on their likely risk. The policy enables the CEO and other key staff to authorise expenditure and execute contracts up to certain values. Importantly, the CEO also has delegated authority to sign funding, tender and other submissions which do not incur financial or legal obligations. The opportunity and associated organisational response is then put to the next available Board meeting for discussion, including of associated risks. Once projects reach the stage of binding decision making, they must be agreed by the Board.

While it is not required by the delegations policy, the CEO of this organisation also discusses emerging opportunities with the Chair of the Board as part of their weekly meeting and seeks verbal approval to proceed with the submission. The close working relationship between the Chair and the CEO complements the formalised delegations policy and ensures the Chair is informed about, and actively engaged in, early decision making on time constrained projects.

As an additional safeguard, the delegations policy requires that management provide a list of significant documents that have been executed or signed by the organisation to each Board meeting. Significant documents are defined as including any new contract above a certain value, as well as any document that may significantly affect the reputation of the organisation, no matter what its value. The delegations policy therefore allows the organisation both to respond rapidly to emerging opportunities while retaining appropriate Board oversight of financial, legal and reputational risk.

In addition, both organisations use Special Board meetings where necessary to provide appropriate oversight of strategic risk while enabling the organisation to respond to project and other opportunities within limited timeframes. Special Board meetings are called by the Chair, typically on the advice or request of the CEO.

When considering the partnership and associated growth opportunity, both organisations held Special Board meetings at key stages. The CEOs each described these as critical moments in assessing the balance of risk and reward created by the partnership and the project.

Undertaking due diligence

Before entering into the partnership, the initiating organisation had commenced an arrangement with an alternate partner. The due diligence process undertaken on the potential partner incorporated high level analysis of a range of matters, such as cash flow and debt. While this due diligence process raised some potential areas of concern, the initiating organisation did not have sufficient time to complete a detailed due diligence process. It order to manage risk without losing the opportunity, the organisation included a clause in the initial partnership agreement which enabled the substitution of either partner.

Following a more detailed due diligence process, which raised further concerns, the organisation activated the substitution clause. A number of important lessons were learned from this process, including the importance of undertaking early, detailed and independent due diligence wherever possible. The process also reinforced the importance of including a substitution clause in partnership agreements.

When it came to establishing the ultimately successful partnership, both organisations ensured they undertook comprehensive 'deep dive' due diligence processes. These processes included:

- careful assessment of financial risks, including financial advice from specialist consultants
- financial modelling, including sensitivity analysis
- legal advice, including on the best partnership structure and associated tax implications
- land use planning advice from specialist planners.

Both organisations identified the ability to source good consultants, and to build ongoing relationships with trusted private sector advisors, as an important contributor to due diligence processes to support growth.

One of the organisations also investigated the capacity of the information technology systems of their potential partner, having identified this as a potential risk in previous partnerships.

The partner organisation was able to demonstrate that it has appropriate information technology systems to support growth. Key elements of its approach to information technology include:

- early take up of a new system, which meant the organisation was able to secure access to a sophisticated system at an early adopter price
- scalable system design, able to cater for a portfolio size many times greater than the targeted growth opportunity
- direct employment of a systems architect, who can customise the system as needed and thus reduce dependence on expensive modifications undertaken by the provider
- a comprehensive change management program, including ongoing training of staff.

As well as managing an area of potential risk, the organisation's focus on information technology eventually became one of the competitive advantages of the partnership.

Containing financial risk

The two organisations undertook considerable planning to maximise the likelihood of a successful outcome to both the project and the partnership.

As an important risk management strategy, these two organisations also planned for the potential failure of the project and the partnership. The MOU developed at the beginning of the partnership contains arrangements for the replacement of either partner if they fail to perform their role. It also contains arrangements for the wind up of the project at, or at any stage prior to, the scheduled end of the project.

The MOU also describes the legal structure for the partnership, which is designed to ensure that the assets of the partner organisations, as well as their funding sources, are ring fenced.

In initial discussions, it was proposed that all of the costs associated with the growth opportunity be put on the balance sheet of one of the partners. However, it was eventually agreed to establish a special purpose vehicle (SPV) separated from both operations in order to share strategic risk, while also containing financial risk. The SPV also protects the assets of the organisations in different jurisdictions.

The MOU ensures that neither organisation will be required to guarantee loans or provide funding directly to the joint venture. This effectively quarantines the financial risk of the project, meaning that failure would affect the project, but not the financial viability of the organisations as a whole. It also quarantines the organisations from warranties and limits liability.

The SPV is a registered charity owned jointly and equally by the two partners. It is governed by a Board with four directors from one organisation and three directors from the other organisation. The charter of the SPV requires that strategic decisions of the Board be made unanimously.

Considering sovereign risk

The management of sovereign risk including changes to government policies and funding arrangements has proved one of the biggest challenges for this partnership. One of the ways the organisations have managed this risk is to develop a detailed model for sharing risk with government as part of their initial response to the growth opportunity. This model was accepted by government and included in the latter stages of the project procurement process.

The other key strategy the partners have used to manage sovereign risk is to build strong working relationships with government officers. This includes a wide range of communications and engagement activities, such as phone calls, emails, digital messaging and formal and informal meetings. Persistence has proven to be important in maintaining these relationships, and has enabled the two organisations to work with their government partners to identify and resolve potential issues as early as possible.

Other strategies the partners have identified to assist in managing sovereign risk include:

» maintaining a strong focus on outcomes for tenants
» developing a clear understanding with government on the way in which tenant engagement would operate and the areas tenant feedback would, and would not, be appropriately able to influence
» having very senior government representatives at the table for negotiations wherever possible
» communicating and engaging with both the government and the opposition, so that both are well informed about a particular project or approach.

Attending to reputation

Building and maintaining strong relationships with stakeholders is also one of the primary strategies the organisations use to manage reputational risk. In particular, one of the organisations takes a purposeful approach to relationship building by reaching out to key public and private sector influencers.

The organisation focuses on creating and regularly following up on relationships with stakeholders – preferably face-to-face, but also via a range of formal and informal communications mechanisms. This includes keeping in touch and maintaining relationships even when there are no emerging issues or problems to resolve.

If issues arise, this strong network of relationships enables the organisation to work directly with influencers to understand their perspectives and provide confidence that potential problems are being appropriately handled. While much of this liaison is undertaken by the CEO directly, the internal team is also well briefed and able to respond to any emerging issues. At critical times, the organisation also uses a dedicated government relations specialist to help manage reputational risk.

Setting risk appetite

In one organisation, risk appetite is set for each of their identified risk management categories: strategic, operational, financial, legal and reputational. While this organisation has taken up some major growth opportunities, it perceives itself as being highly constrained by its financial and legal obligations, as well as its commitment to tenants and the conditions of registration. This organisation is only able to put at potential risk income from fee-for-service operations, which accounts for a very small proportion of its income. The organisation's risk appetite is therefore described as low or very low in each of its risk management categories. For the same reasons, its risk appetite is also very stable.

The other organisation takes the approach of documenting the key determinants of its risk appetite, which are broadly related to its:

» strategic objectives
» financial performance
» organisational culture
» health and safety of staff and contractors
» brand and reputation
» management skill and experience.

It also reviews its risk appetite on a project by project basis, considering each project on a individually and in the context of the organisation's overall performance.

Implementing internal controls

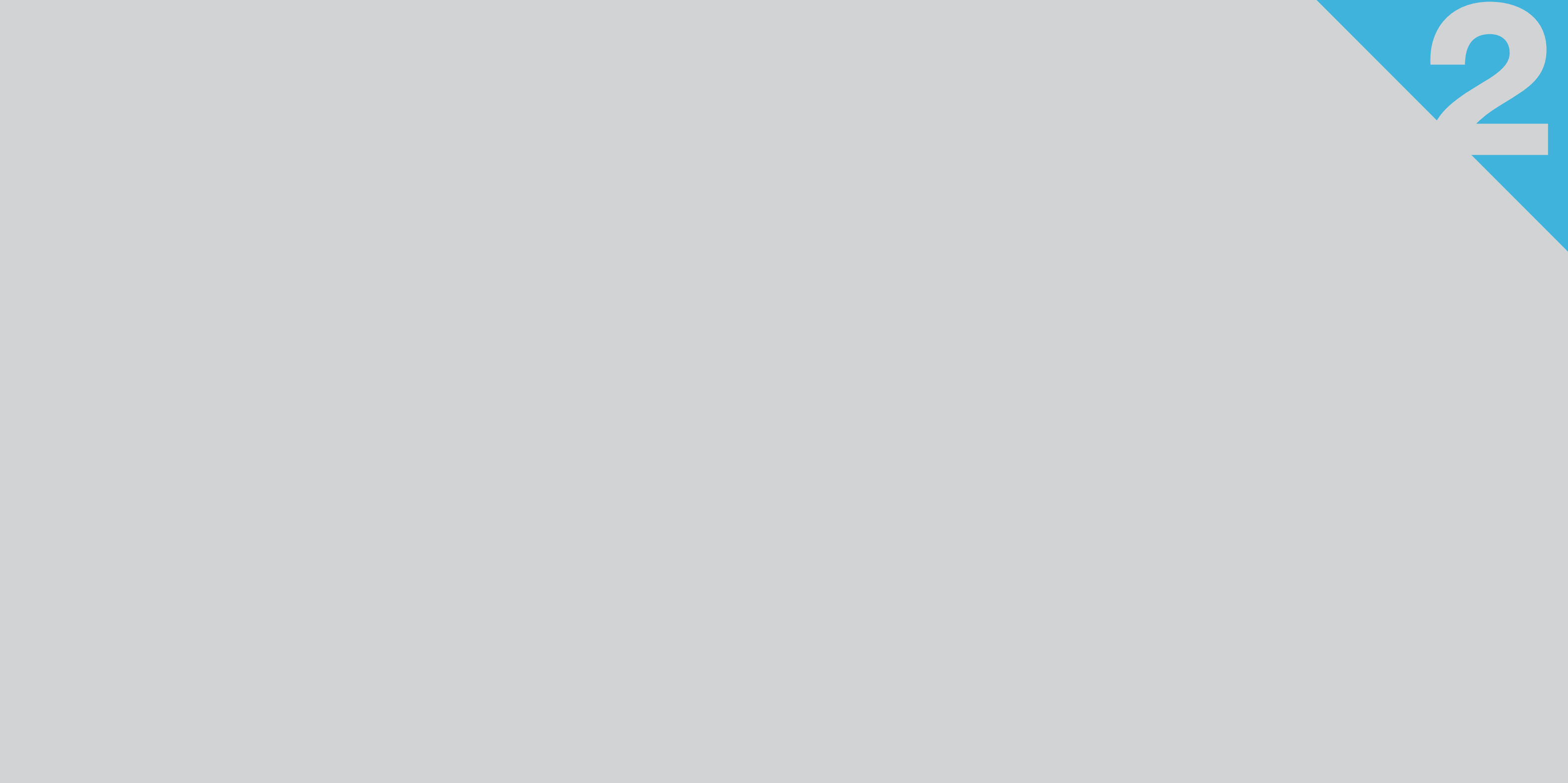
Both organisations have comprehensive risk management documentation and internal controls. Each organisation has a risk management policy, which sets up a framework for the management of risk in accordance with ISO 31000. The policies and associated plans contain risk management categories which explicitly recognise strategic risks. The policies of both organisations set out clear responsibilities in managing risk for key roles, including the Board, committees and the CEO. The policies also establish risk assessment and management processes, roles and responsibilities.

The Board of one of the organisations has a structured process focused on the top eight risks, across a number of different risk categories. The risk register summary and associated treatment plan for one of these top risks is presented at each Board meeting, enabling discussion of all eight risks over the course of a year. This enables the Board to have detailed discussion about its most significant risks, including the actions planned to manage the risk and the associated monitoring and reporting activities.

Both organisations have long established Board committees with responsibilities for risk. The committees have clear terms of reference which are updated frequently. Staff cannot be formal members of the committees, but attend to provide information, advice and secretariat support.

The role of the risk management committees is focused on implementing and monitoring systems of risk management and oversight. This includes review of the organisational risk management plans and control systems. Neither of the committees has delegations for decision making. Given the scale of the opportunity and associated risks, discussion in relation to the partnership project was therefore largely undertaken at a Board level.

As part of its risk management system, one of the organisations appoints an internal auditor to conduct an agreed program of investigations and make recommendations for management improvements. The internal auditor reports to the risk management committee.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