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elton consulting

Managing Strategic Risk

Case study | three

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 diversification. The organisation uses a group structure to expand. It is able to accommodate a wide range of entities within the broader group, balancing the benefits of scale with a level of independence for the subsidiary organisations.

Key strategic risks identified by the organisation include the financial impact of a broad range of changes in the housing market, as well as the financial and social impacts of policy change on tenants and the organisation directly. The organisation also places a high priority on ensuring that it is positioned to take advantage of opportunities as they emerge.

Key facts

Number of properties	6,000+
Staffing numbers	640
Operations in multiple locations	Yes
Core social housing activities	» Managing tenancies » Managing properties » Supporting tenants
Other activities	» Developing properties » Community regeneration » Independent living assistance » Advice services » Supporting social enterprises » Private sector leasing » Housing for people with a disability

03 About the organisation's management of strategic risk

Undertaking due diligence

The organisation has a strong focus on growth and diversification. This has included multiple mergers of various kinds with other organisations, and the establishment of new businesses within a group structure to deliver specific services. The organisation has adopted a range of practices to support decision making about these types of opportunities, to manage strategic risks effectively.

The organisation has adopted a step by step process for conducting due diligence on organisations which have indicated an interest in merging or joining the group structure. The process commences very informally and becomes increasingly formal as it progresses. The process includes:

- initial informal discussions at CEO level
- early involvement of Board members of both organisations in a social or informal setting, in order to assess cultural compatibility
- review of potential benefits to the primary organisation and clients – for example, expansion into new geographic areas, addition of expertise with specific tenant target groups or services, improvement in service delivery generally
- formal due diligence led by a senior staff member with external support from qualified consultants – the other organisation conducts its own due diligence in parallel
- careful assessment of financial risks of the possible merger
- appraisal of options for the style of merger, including full amalgamation and incorporation within the group structure while remaining a largely independent agency
- formal consultation with tenants.

The organisation generally responds to approaches initiated by other organisations, and does not have a standard set of assessment criteria for all merger opportunities. However the organisation uses its purpose statement to guide its considerations.

In considering the establishment of new businesses within the group structure, the organisation typically carries out a SWOT analysis to identify and assess its strengths, weaknesses, opportunities and threats. For example, in considering whether to take on a new leasehold portfolio, the organisation's SWOT analysis revealed:

- Strengths: deep knowledge of property management; positive reputation for quality tenancy and property management
- Weaknesses: no experience in managing this specific type of leasehold portfolio; lack of information about costs and revenues could lead to underpricing
- Opportunities: project would create jobs and provide an income stream to other businesses within the group structure
- Threats: lack of certainty of continued participation of landlords in a leasehold scheme; cashflow challenge of paying landlords before receiving tenant rents.

In considering whether to establish an in house maintenance business, the organisation's SWOT analysis revealed:

- Strengths: sizeable market based on existing portfolio; tenant support for the proposal
- Weaknesses: lack of core maintenance skills
- Opportunities: achieve direct control of maintenance, with the ability to prioritise quality work and customer service while keeping costs down; significant increase in staff moral; increase in tenant satisfaction with repairs (to 98 percent)
- Threats: requirement to engage staff of previous maintenance contractor could lead to poor cultural fit.

This approach brings rigour to the decision making process, and helps to make explicit the risks which would need to be managed in any decision to proceed.

The organisation uses scenario planning to test critical financial assumptions. These assumptions are based on a sensitivity analysis of a range of financial considerations which could have an impact on the organisation's operations, activities, or surpluses. Examples of assumptions include:

- the organisation's anticipated inflation rate
- interest rates forecasts
- projected levels of operating surplus
- investment programs in planned and cyclical maintenance
- investment in staffing resources

A sensitivity analysis is undertaken to assess risks for the organisation and identify the potential impact of certain events. Key financial risks identified through this analysis include:

- increases in interest rates
- decreases in inflation
- running costs rising above inflation
- low housing demand and increase in voids
- high levels of bad debts.

Sensitivity analyses are then run in order to generate some 'what if' scenarios. The Board was involved in setting the scenarios and discussing remedial and mitigating actions. Scenarios included:

- interest rates for loans increasing by 3 percent
- inflation reducing to 1 percent
- running costs increasing by 1 percent above inflation
- voids increasing to 5 percent
- bad debts increasing by 5 percent.

Structuring the organisation

The organisation uses its group structure to provide options when developing and acquiring new businesses, without having to affect the operations and risk profile of the parent entity. This allows it to choose the best response rather than a one-size-fits-all response.

For example, bringing in an existing social housing provider through a formalised agreement, rather than a merger, allows the provider to retain its name, history, board, style of operations and housing portfolio. This reduces the risks involved in any organisational change, while ensuring that both organisations can benefit from the increased capacity. The parent entity holds ultimate control over the assets and operations of the acquired organisation. The level of control retained by the acquired organisation can be tailored to suit the circumstances, including the strategic risks.

A group structure adds complexity, and may therefore be considered to increase the risk profile of an organisation. However, this organisation considers the use of a group structure to be effective in managing risk. It ensures that the relationships between the various parts of the business remain transparent and allows for separation between the performance of the group and the performance of individual entities.

Subsidiaries are not always established to carry risk. Where the organisation believes that a business activity could return a surplus, it considers establishing it as a separate entity within the group structure. This avoids the risk of hidden cross subsidisation. The group structure also helps the group make good decisions about responding to business opportunities. The entity with the best capability for the opportunity, and which is best able to hold the risk, is selected to respond. This does not always result in a subsidiary taking on new business. In fact the decision is often taken that the parent entity is best placed to hold the risk.

Setting risk appetite

A critical aspect of any organisation's risk management approach is to determine its risk appetite, which is the overall amount and type of risk the organisation is willing to accept as it pursues its business objectives. In its Risk Management Strategy the organisation acknowledges that some risk is inherent in all its activities and in its social and political operating environment. It states that it seeks to control its exposure to risk, without stifling opportunity, presenting itself as risk aware rather than risk averse.

In particular, the Group Board takes the view that the organisation's size and structure gives it financial and operational stability which allows it to take calculated risks. Indeed, the view is that the organisation has an obligation to take appropriate risks, and to use its strength to fulfil its purpose in new ways and new locations. The scale of new initiatives can be kept small, by comparison to the size of the overall group structure, in order to contain risk to manageable levels and to quarantine it to the individual project.

The organisation addresses its risk appetite as part of its annual strategic planning process. The Group Board and the executive from across all entities collaborate to develop a risk profile across the group structure.

To strengthen processes further, the Group Board is increasing the role of the Audit and Risk Committee, which will include a regular review of risk appetite. The risk identification, assessment and reporting processes set out in the Risk Management Strategy also provide regular opportunity for the organisation to consider its exposure to risk.

Considering sovereign risk

The organisation has identified that its primary strategic risk relates to the potential for government policy and funding settings to change in ways which dramatically affect the organisation's income streams and opportunities, directly or indirectly. This type of 'sovereign risk' is outside of the organisation's control, with few available strategies for influence.

The organisation has put in place routine processes for identifying and sharing information about the key factors in the operating environment, in order to position itself most effectively to respond to any changes. These include:

- annual environmental scanning as part of the Group Board's business planning processes
- inclusion of information about changes to the operating environment in monthly Board reports
- formal monthly senior executive meetings, with an explicit focus on sharing information about policies and programs across the Group
- dedication of a high proportion of the CEO's time to advocacy and networking – to position the organisation to gather intelligence and to communicate this across the Group as often as necessary.

Attending to reputation

As a large organisation which has grown, in part, through mergers and acquisitions of other social housing providers, the organisation is conscious of the need to maintain a positive reputation. This helps ensure that its presence in its various locations of operation is well accepted. The organisation places a high priority on its reputation amongst tenants, and seeks their views on key business expansion and diversification decisions. The organisation places a high priority on tenant satisfaction, including satisfaction with the level of information provided by the organisation and with the opportunity to participate in decision making. It receives consistently very high tenant satisfaction results in surveys.

The organisation is also concerned with its reputation within the social housing sector, seeking to avoid other providers perceiving it as a threat. It is also concerned about the views of other stakeholders including government and private finance partners, which are seen as investors and supporters.

Part of the CEO role is to maintain a very high profile in the sector, amongst decision makers and in related sectors. This helps keep the organisation on the radar, and is intended to open opportunities for new partnerships or projects.

In addition, the organisation invests in creating its own content and engaging proactively both with social and traditional media. This includes producing short YouTube videos to market the organisation's activities to an even wider range of stakeholders.

Understanding hybridity

Social housing straddles the public, private and community sectors. Organisations must find a way to respond to the differing, and at times incompatible, priorities and perspectives of these three sectors. 'Hybrid organisations' or social enterprises seek to balance the commercial need to remain financially viable, with the social imperative to meet the needs of clients and communities, with specific obligations and expectations of government in its various roles as funder, policy setter and regulator.

The organisation manages the significant strategic risks of hybridity by:

- identifying which organisations, programs or projects within the Group make a profit, and which require cross subsidy
- identifying specifically where government subsidies are deployed, including capital subsidies
- explicitly identifying its activities as 'core' or 'diversified', in order to maintain the focus on the core activities and ensure that business diversification continues to support the core purpose
- identifying the cost of delivering services internally or externally, in order to make sound business decisions.

The organisation presents itself as a social enterprise, in order to manage the strategic risks of its hybrid business model. This allows it to articulate its business as financially successful. Rather than hiding behind terms like "surplus" the organisation states explicitly that it makes a profit, which it reinvests in services. It engages with government and other partners as investors, rather than positioning itself as seeking grants or subsidies. In addition, it clearly identifies how government investment is used within the business, for example, to achieve specific affordability outcomes for tenants, rather than allowing the perception that the organisation itself requires subsidisation.

Implementing internal controls

Within the group structure, each organisation exercises delegated management over risk. However, the Group Board holds formal responsibility for risk management across the entire group, and has processes in place to support this, including:

- twice yearly reviews of the risk registers prepared by each organisation
- formal review of the overall risk management Strategy every three years
- requirement for the Board of each organisation within the group to review specific risk assessments for all major projects, new initiatives or major changes to the business, and to make recommendations to the Group Board where appropriate
- requirement for risk assessments on all proposed development projects to be presented to the Group Board
- requirement for annual business planning to be specifically linked to the risk register of each organisation within the group, by assessing the risks associated with each objective in the business plan
- the establishment of an Audit and Risk Committee as a subcommittee of the Group Board, which meets at least three times each year
- reporting of the top risks across the group and for each organisation within the group to the Group Board and each organisation's Board, to ensure transparency and sharing of information.

The risk registers prepared by each organisation within the group identify:

- the nature of each risk
- the root cause of each risk
- an initial risk rating based on probability and potential impact on the organisation
- a suite of controls to be put in place
- a residual risk rating, reflecting the implementation of the identified controls.

The organisation also appointed an internal auditor many years ago, and now operates a full internal audit function. The full suite of policies which govern the organisation's activities are subjected to review under a rolling five year audit program. The review includes specific attention to any change in risk profile. This ensures that business as usual activities are reviewed for their strategic risk, not just new initiatives such as potential mergers or proposed developments.

The organisation also conducts a rigorous risk assessment on development projects, as part of seeking Board approval to proceed. The Development and Asset Management Director puts forward a detailed report to the Board containing a suite of development and risk assessment information. This includes:

- the summary results of feasibility studies conducted on the site
- housing demand information
- information on potential competitors
- an assessment of risks associated with technical aspects of the proposal, such as site constraints and seeking development approval
- an assessment of the financial risks, including tender assessment criteria, project costs, financing, and projected rental returns
- a risk control register, containing identified risks and their proposed mitigation strategies
- reputational risk factors, including community consultation plan and a summary of identified community benefits.

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