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AT THE INTERSECTION

INTEGRATING THE **BALANCED SCORECARD** WITH
OPERATIONAL RISK MANAGEMENT
TO ENHANCE STRATEGIC EXECUTION

BY

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‘Linking the scorecard to manage operational risk seems like an excellent idea’

Professor Robert Kaplan, co-creator of the
Balanced Scorecard, writing to the author

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At the Intersection

Integrating the Balanced Scorecard with Operational Risk Management
to enhance strategic execution

1 Introduction and Background

This paper introduces a strategic measurement and management methodology which integrates and aligns corporate performance management (CPM) and operational risk management (ORM) which is designed to enhance strategic execution through improved management discussions, decision-making and action taking.

The methodology was born out of observing the behaviours of UK-based financial service and other organisations, from hands-on experience consulting for these organisations, and out of a year long research project that asked 21 financial services executives this question:

How can UK financial services organisations integrate and align their corporate performance management (CPM) and operational risk management (ORM) processes to enhance strategic execution?

The importance of, and need for, this question was identified over a ten-year period, during which the author worked with many organisations to implement CPM or ORM processes. Over this time, the author observed that too often these processes were implemented in isolation – as ‘silo’ processes. Given the amount of common ground within these processes – around data, process, audience – such implementation practises processes were bound to create duplication, complexity and confusion, leading to increased costs, reduced quality of, and ‘information’ around, performance and risk that was not effectively supporting decision-making.

And, ultimately, a failure to fully and effectively execute strategy. Such failure might take the form of a failure to achieve strategic objectives...to effectively respond to risks and threats to the organisation...or a combination of both.

The research on which this paper was based, undertaken in late 2006, and early 2007, investigated how to integrate and align existing CPM and ORM processes to enhance strategic execution.

Given the lack of both knowledge and best practise around the integration and alignment of these processes, a research question and objectives were created to focus on the 'how' of integration and alignment.

The scope of any project, particularly research projects, can be defined as “*ensuring that enough, but only enough, work is undertaken to deliver the project’s purpose successfully*” (Turner, cited by Wright and Race, 2004).

The scope of this research can be considered from two key perspectives – the theoretical and the practical (industry). From a theoretical perspective, this research will focus on strategic execution, the Balanced Scorecard (BSC, as it is a leading CPM methodology) and ORM. From an industry perspective, the scope is limited to the UK financial services industry.

In addition to the scope, it is also worth considering the strategic context around this paper – the changing business environment driven by globalisation in the context of the UK financial services and the regional GCC context.

1.1 *The UK’s Financial Services Industry*

The health of the UK financial services industry is critical to the overall health of the country’s economy.

The industry is the single largest contributor to the UK balance of payments, a major contributor to the GDP, and a major employer (just over one million people). London is

one of two major international financial centres, the other being New York. A key difference between London and New York is that the latter sources a large volume of business from the US domestic market, whereas London has the largest share of international business.

1.2 The Changing Business Environment

'In the history of humankind, there has never been a more challenging environment than today'

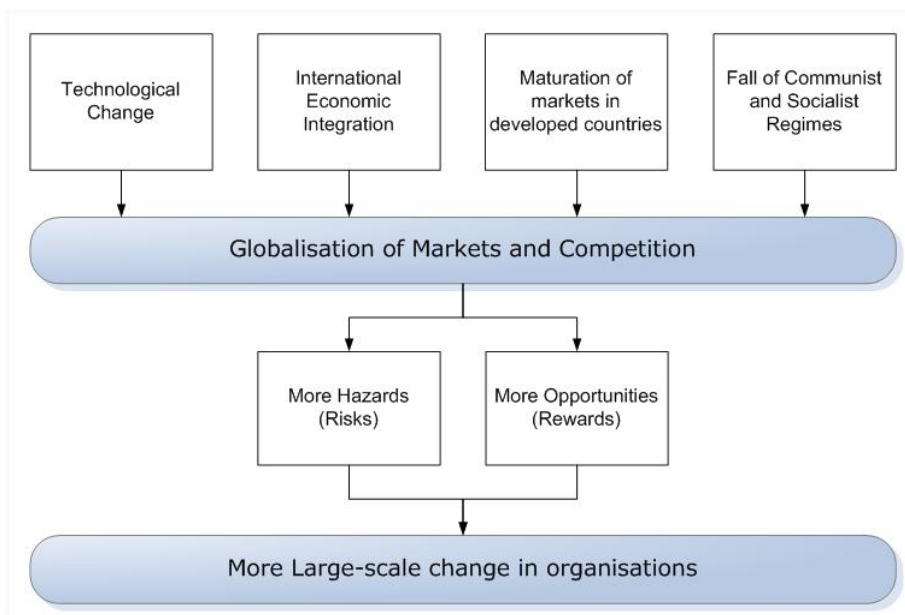
Garrison et al (2001)

Today political, economic and technology factors, driven by globalisation and the emergence of the 'new economy', are all cited as drivers of change and uncertainty.

Figure 1 demonstrates the rapidly changing environment by its failure to mention the emergence and integration of the developing economics in the 'world' economy. In a recent study of global trends, Becker and Freeman (2006) show the important role of developing economics, with four out of the top ten trends directly related to these emerging economies.

Figure 1: Economic and Social Forces Driving Change

The relationship between key macro factors and the need for change in organisations



Source : Adapted from Kotter (1996)

With the UK financial services industry, and London in particular, playing a central role in enabling the global exchange of goods and services that fuel globalisation, it is not surprising to find that these same factors are creating change and uncertainty in this industry, as discussed by HM Treasury in 2006.

Whether we are really living in an environment of unparalleled change or simply taking another step in business evolution, today's change and uncertainty create both opportunities and risks in the present and future. Therefore, to enhance strategic execution and benefit shareholders, organisations must be able to effectively manage with "one eye on performance and one eye on risk".

1.3 GCC – a changing, dynamic region

Just as the forces of globalisation are a major driver of change in the UK financial services industry, these same forces are driving change in the GCC states. The Gulf Cooperation Council (GCC) states - Bahrain, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates (UAE) make up one of the most dynamic and fast changing economic regions of the world today. The GCC states are awash with money, having seen a tripling of oil and gas revenue, \$100 billion in 2002 to \$325 billion in 2006, and an even more dramatic jump in direct foreign investment, from just under \$2 billion in 2001 to \$20 billion in 2005, de Boer and Turner (2007). With these windfalls there is growing pressure for economic and social reform. One area in particular where reform is needed, and beginning to take hold, is in the financial services industry.

If the GCC is to create the jobs and economic prosperity needed to meet the needs of its relatively young, growing population, the financial services industry must do a better job of allocating capital. At present there is a bias towards allocating capital to large, well established, 'safe' and often state-owned enterprises rather than smaller companies with greater growth potential. This bias is due to the immature nature of the financial services industry, for example, the lack of credit agencies and credit risk capabilities.

With external and internal pressures to reform financial services, and with many GCC states already undertaking such reform programmes, the GCC financial services industry will rapidly be faced with demands for the levels of transparency, reporting and regulation investors and other providers of capital demand of western companies.

2 Strategic Execution and Organisational Capability

The online management publication, *Strategy + Business*, identified ‘execution’ as the most important conceptual breakthrough in the last 10 years. Execution is defined by Kanter (2005) as “making it happen” and by Bossidy and Charam (2002) as the missing link’, ‘the gap between what a company’s leaders want to achieve and the ability of their organisations to deliver it’.

Bossidy and Charam stress that ‘no worthwhile strategy can be planned without taking into account the organisation’s ability to execute it’. Similarly, Hendrickson (1994) points to the failure of organisations to build strategic execution capabilities as a key reason for execution failures, identifying four key dimensions in developing execution capabilities: strategy, business processes, people and technology.

Continuing to focus on organisational capabilities, Aspesi and Vardhan (1999) believe that organisational ability should be considered in the strategy-selection process. Supporting the notion of developing execution capabilities, Stewart and O’Brien (2005) quote Dell and Rollins from Dell: “It takes years of consistent execution for a company to achieve sustainable competitive advantage. The key to our success is years and years of DNA development within our teams that is not replicable outside the company. Other companies just can’t execute as well as we do”.

Mankins and Steele (2005) focus on planning and execution to understand why generally 60% of companies fail to realise their strategies’ potential value. Whereas Zagotta and Robinson (2003) believe that execution, more than planning, determines success. Aspesi and Vardhan reported a 40% execution failure during their 40-company study. Kaplan and Norton (2001) also support the assertion that strategies fail not because of bad strategy, but bad execution.

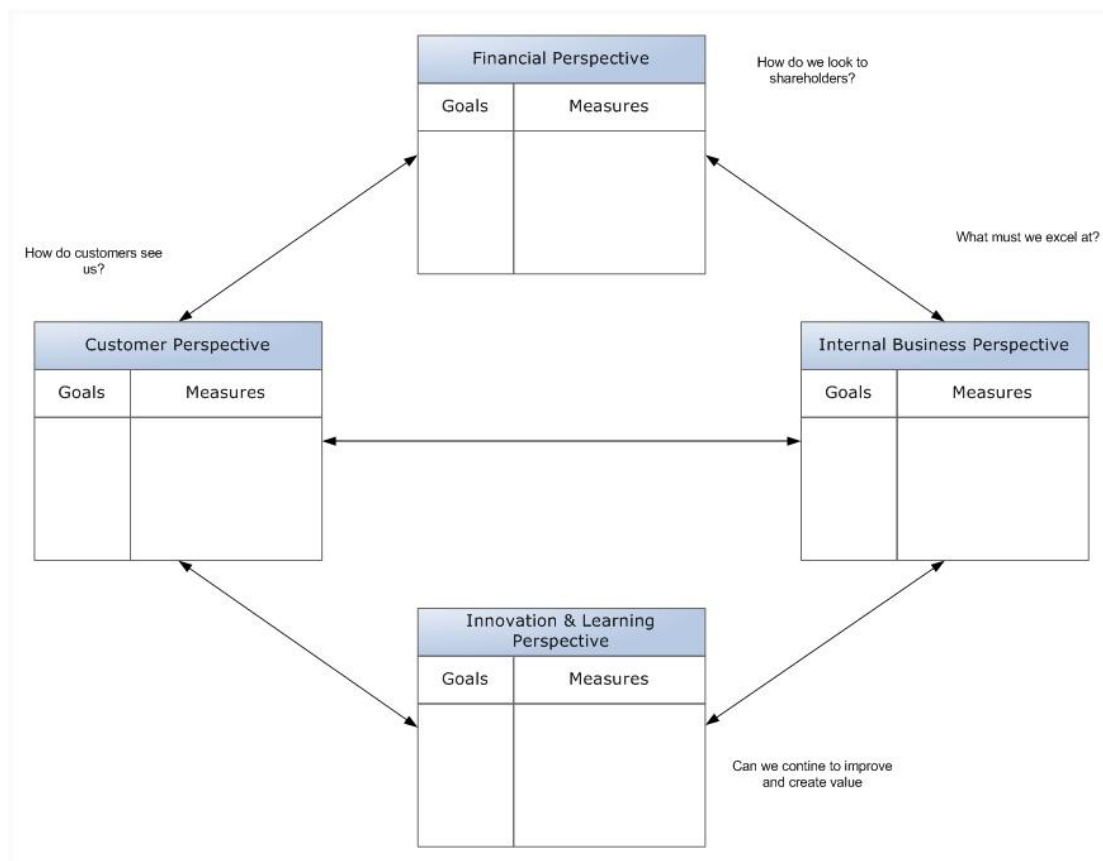
While the father of modern business strategy, Porter (1985) suggests activities are the bridge between strategy and implementation, with activities making strategy operational, thus making ‘everyone in a firm...part of the strategy’. Kaplan and Norton (2001) echo these sentiments in one of their five SFO principles – ‘Make strategy everyone’s job’.

3 CPM and the BSC

Given the widespread usage of the BSC as a CPM methodology, this will be the focus of discussion around CPM. Clearly strategic execution remains an issue for organisations and it is one that the BSC now seeks to address.

Originally introduced as a performance measurement tool (Kaplan and Norton, 1992), BSC measured performance in four areas: financial, customer, internal business process, and innovation and learning. Kaplan and Norton suggested replacing traditional financially oriented measures with a balanced set of measures, balancing leading and lagging, and financial and non-financial measures.

Figure 2 – The Original BSC Links Performance Measures



Source : Harvard Business Review January-February 1992

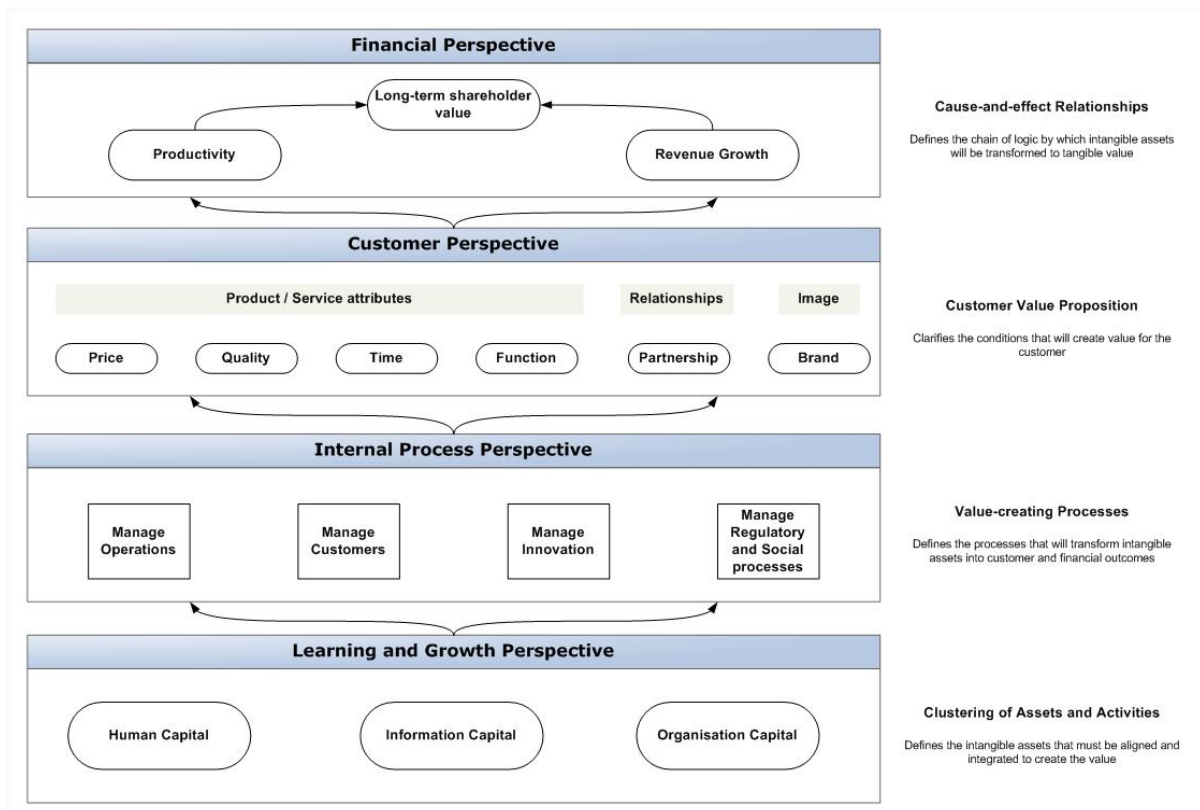
The BSC evolved strategically from measurement to *translating strategy into action* (Kaplan and Norton, 1996) and with the introduction of the strategy-focused organisation and its five principles (Kaplan and Norton, 2001).

The five principles of the strategy-focused organisation are:

1. Translate the strategy to operational terms
2. Align the organisation to the strategy
3. Make strategy everyone's job
4. Make strategy a continual process
5. Mobilize change through executive leadership.

With the introduction of the Strategy Map (Kaplan and Norton, 2004), the casual relationships that underpin the BSC concept, and strategy generally, were able to be explicitly set out. This author would argue that this marked the end of BSC's evolution from a performance measurement tool to a strategy execution tool.

Figure 3 – The Strategy Map



Whilst the strategy map may end the evolution from performance measurement to strategic execution, this didn't end the development of the methodology. This continued with the introduction of the Office of Strategy Management (Kaplan and Norton, 2005) and the concept of 'enterprise-derived value' (Kaplan and Norton, 2006). That is, how the corporate head office can create alignment within – and value out of – their portfolio of businesses or business units.

Though Kaplan and Norton may be considered the 'fathers of BSC', they are not the only ones to make significant contributions to the literature in this area. The Performance Prism (Neely et al, 2002) was an attempt to overcome perceived limitations of the original BSC by focusing on a broadly defined set of stakeholders and the integration and alignment of organisational strategies, processes and capabilities.

The author welcomes the contribution of Bible et al (2006), who ask, 'has the BSC been overdeveloped, resulting in a loss of utility?' Reflecting on practical experience in implementing these approaches, the author contends that Neely et al (2002), Lusk (2006) and even Kaplan and Norton (2006) run the risk over complicating what is essentially a common-sense approach.

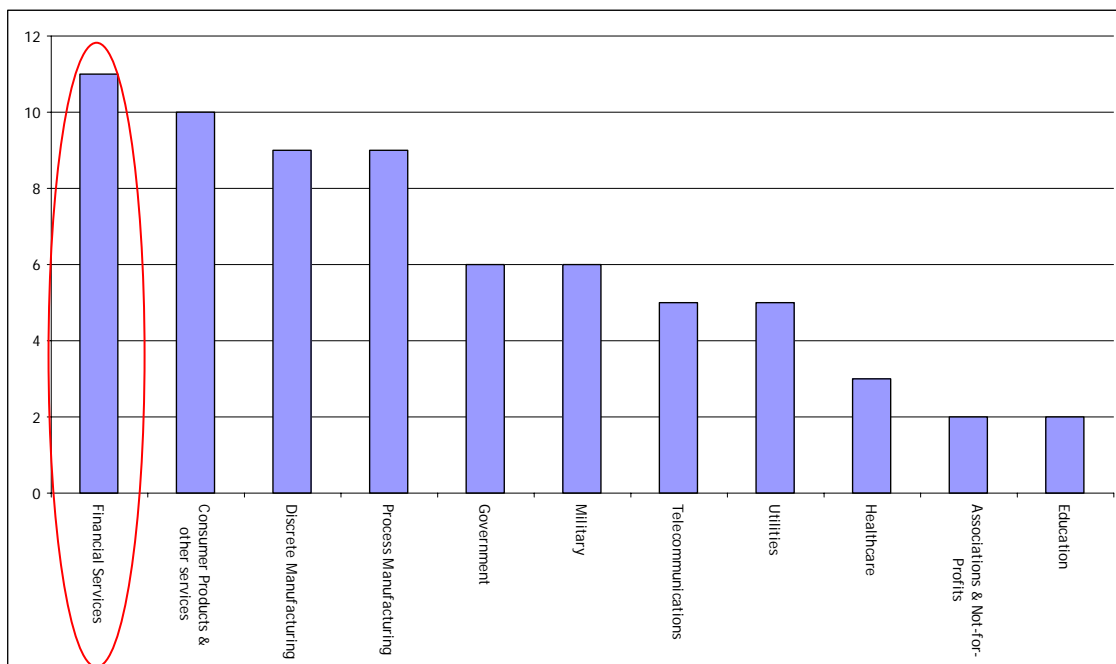
The literature around the BSC is extensive and it's appears to suggest widespread adoption, particularly with financial services. There are a number of financial services companies cited as adopters of the BSC, as shown in Figure 4, and amongst the BSC Collaborative Hall of frame members, financial services represents the largest industry group, as shown in Figure 5.

Figure 4 – Balanced Scorecard within Financial Services

A selection of financial services organisations cited as users of the BSC

Authors (cited in)	BSC adaptors (financial services)
Kaplan and Norton (1996)	Metro Bank, National Insurance
Olve et al (1999)	Natwest Life, Halifax, Skandia
Friigo et al (2000)	An un-named ‘community bank’
Kaplan and Norton (2001)	CIGNA Property & Casualty, Chemical (Chase) Retail Bank, Nationwide Financial Services, JP Morgan
Becker et al (2001)	Wells Fargo
Kaplan and Norton (2004)	Bank of Tokyo-Mitsubishi HQA, Swiss Re, Volvofinans, Thomson Financial
Huselid et al (2005)	Wells Fargo, Prudential Insurance, Allstate Insurance
Ward (2005)	Lloyds TSB
Kaplan and Norton (2006)	Bank of Tokyo-Mitsubishi HQA, First Commonwealth Financial Corporation

Figure 5 – Balanced Scorecard Collaborative ‘Hall of Fame’ Winner by Industry



4 Risk and Operational Risk Management (ORM)

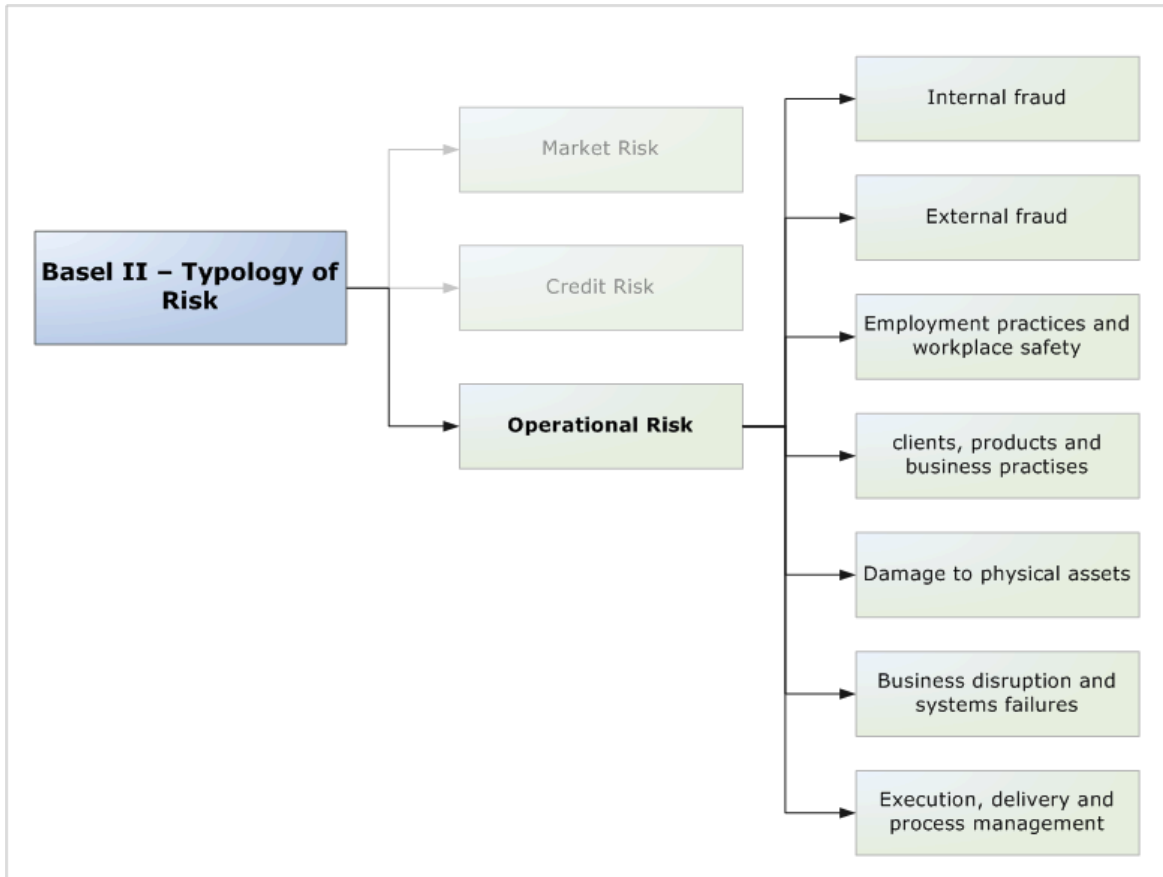
Bernstein (1996) describes the mastery of risk as the revolutionary idea that defines the boundary between modern times and the past. Recognising that risk and risk management are vital to business, Bernstein (1996a) contends that understanding risk will help differentiate tomorrow's winning organisations from those that will be less successful. Similarly, Buehler and Pritsch (2003) succinctly state that: "Taking and managing risk is part of what companies must do to create profits and shareholder value".

What is 'risk'? Hilson (2006) defines risk as potential future events or sets of circumstances or conditions. Waring and Glendon (1998) are more expansive, contending that risk represents more than mere existence of hazard and it should take account of the likely scale of consequences: the frequency, duration and extent of hazard exposure; the probability of an unwanted or desired event; and the timescale over which consequences might be manifested and probabilities assigned. The Risk Management standard, IRM, airmic & ALARM (2002) describes risk as the combination of the probability of an event and its consequences. The COSO Integrated Enterprise Risk framework (2004) introduces consideration for strategic objectives with its definition of risk as "*the possibility that an event will occur and adversely affect the achievement of objectives*".

These are just a few of the variety of risk definitions. Suffice to say that despite their variation in emphasis and scope, all focus on (and generally quantify) the probability of an event occurring and its likely impact. Garrison et al (2001) make the point that in popular expression risk generally is associated negatively with outcomes – with positive outcomes put down to luck.

When focusing specifically on operational risk, the emphasis shifts slightly and requires refinement. In responding, the Basel Committee on Banking Supervision (2004) established the definition for operational risk as "*the risk of loss from inadequate or failed internal processes, people and system or from external events*" (Figure 6).

Figure 6 – Basel II Typology of Risks



There is wide support for the Basel II definition. Hoffman (2002) states it is generally agreed, with the exception of some fringe areas of debate, and Blacker (2006) states it is now widely accepted within the financial services industry in the UK and internationally. Alexander (2003) also supports the Basel II definition, highlighting the utility of its seven distinct types of operational risk.

Operational risk has become an increasingly important issue for the financial services industry over the last five to ten years. Hoffman (2002), Alexander (2003), Belluz et al (2006) and Blacker/Hilson (2006) all highlight headline-grabbing cases of ORM failures – including Drexel, Barrings, BCCI, Allied Irish Bank, Enron, Firestone, and the Australia National Bank.

Presenting their analysis of 350 large-risk events (greater than US\$1 million) at European and North American financial institutions since the 1990s, Dunnett et al

(2005) and Levy et al (2006) found that the decline in market capitalisation of the affected institution was approximately equal to the short-term financial loss, on average US\$65 million. More startling was that after 120 days these losses had, on average, climbed to 12 times the initial loss – an average of US\$780 million. Approximately half of these events were caused by negligence, unintentional failure or a defect in the nature or design of a product – all factors within the institution’s control.

Levy et al further report that from 2001 to 2005 operational-risk-related losses at the top 12 US banks represented 4 to 5% of their net income, and this figure *excludes* losses from unpublicised events. Additionally, at least two banks had losses that wiped out more than 10% of their pre-tax net income. The most harmful loss events were:

- Embezzlement
- Loan fraud
- Deceptive sales practices
- Antitrust violations
- Non-compliance with regulation.

Reinforcing the extent of operational risk losses, Buehler and Pritsch (2003) report that a study of 200 leading financial services institutions between 1997 and 2002 found 150 cases of significant financial distress at 90 of the institutions.

In addition to the downside losses and disruptions of operational risk, Levy et al (2006) remind us that it can be mitigated and there is, in fact, a potential upside of operational risk. Banks that are required to hold regulatory capital against operational risk can significantly reduce (up to 25% by some estimates) the amount of regulatory capital required to be held by reducing their risk-related losses. Levy also states that banks with robust ORM practices can often take on and succeed in businesses that competitors either are unable or unwilling to accept. Additionally, they generally enjoy improved market sentiment and, ultimately, higher share prices. Finally, Levy et al (2006) contend that companies need to create a methodology that simultaneously tackles costs and operational risk, trading them off against each other where necessary.

The results of the studies outlined above¹ clearly demonstrate why operational risk is now high on the regulatory and management agenda and why it is critical to be able to measure and manage operational risk.

Swenson (in Alexander, 2006) states that the operational risk discipline is in an ‘embryonic state’, which has important implications for measurement of operational risk. Best practice is yet to emerge and operational risk professionals are taking ideas, concepts and approaches from other areas of risk measurement, such as credit and market risk, and using these without a solid understanding of their capacity to add value. Dowd (in Alexander, 2006) makes the statement “measurement has to start with a clear understanding of what is to be measured”.

The literature review and results of this study indicate that organisations are keen to develop an understanding of their risk profile; in fact, a large number of organisations consider it a critical element of their business. Not only do they require an appreciation of their risk profile, but also how it may change (and under what circumstances), what their losses and potential losses are and – in line with Basel II requirements – what the impact of operational risk is on the organisation’s capital and its allocation to operational risk.

4.1 *Integration and Alignment*

Perhaps surprisingly, there is little discussion in the literature related to the integration and alignment of performance and risk. Garrison et al (2001) highlight the lack of attention within the current literature related to the role of risk in strategic decision-making. Likierman (2005a) confirms this, commenting, “as far as I know, there's nothing specifically linking performance and risk”. Further, Likierman (2005) argues it is impossible to separate the measurement of performance from the risks taken to achieve it, and points out that when the performance of companies is compared, their risk profiles are rarely mentioned.

¹ The author notes that these three studies, though presented by different authors, were all McKinsey studies rather than three independent result sets.

Kaplan and Norton (1996) have touched on risk management and its integration with the BSC, stating “risk management is an overlay, an additional objective that should complement whatever expected return strategy the business unit has chosen”.

Calandro and Lane (2006) highlight the lack of consideration that Kaplan and Norton – and BSC literature in general – give to risk. They say that while a performance-only managerial focus was understandable in the past, recent events are forcing the focus on risk and performance – accounting transgressions, governance issues, increased regulatory activity and the increasing cost of uncertainty.

Calandro and Lane reference the Bank of Tokyo-Mitsubishi and the Public Sector Scorecard approach (Moullin, 2002), but they highlight a lack of specific detail on how risk was linked into the BSC, suggesting that managing the scope of a scorecard with both performance and risk included could be a challenge. They propose separate scorecards for performance and risk, suggesting a dual scorecard approach will enable managers to balance their time and attention between performance and risk.

Beasley et al (2006) take a very similar approach to integrating ORM with the BSC, suggesting organisations should include risk-related goals and measures within each perspective. However, they appear to suggest the use of a single BSC, which would likely be confusing.

While this author is encouraged by efforts to integrate and align performance and risk via scorecards, it appears that these authors have taken a rather basic approach and do not appear to have considered the implications for the type of scorecards or indicators required, the role of risk appetite or the importance of the causal relationship between risk and performance.

Lawrie et al (2003) argue that today’s risk management processes have much in common with systems designed to manage strategic performance, such as the BSC, and also argue that risk management without an effective strategic PM system to provide context can misguide or obscure important risks.

This author agrees with the thrust of the arguments made by Lawrie et al, particularly the comments on use of a strategic PM system to provide context for risk management.

In our rapidly changing and uncertain business environment, the ability to manage the trade-offs between performance and risk is becoming an increasingly important consideration as organisations attempt to close the execution gap.

5 The Risk-Based Performance Methodology as a Solution

Risk-based performance (R-bp) is a strategic performance and risk measurement and management methodology that delivers the processes, tools and information to enable managers to improve their management discussions, decision-making and action-taking, thus leading to enhanced strategic execution.

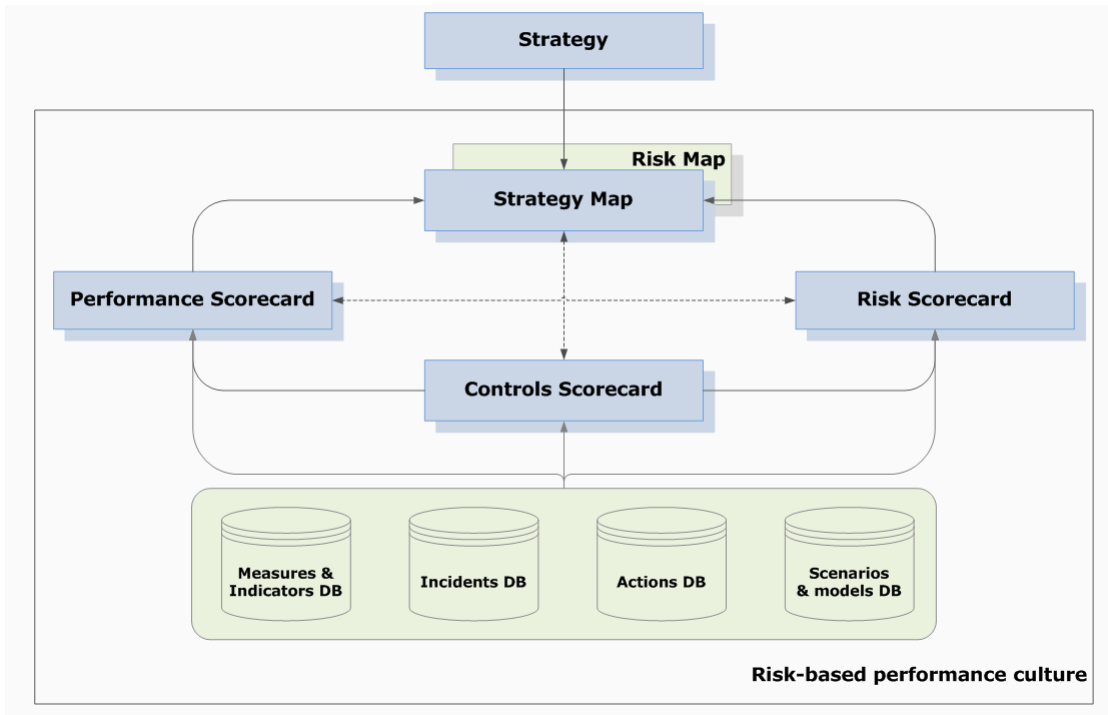
It builds on existing management processes and frameworks, specifically the BSC (Kaplan and Norton, 1992) and the COSO Enterprise Risk Management framework, (COSO, 2004) and is designed to enable managers and decision-makers within organisations to manage with *one eye on performance and one eye on risk*.

Garrison et al (2001), Likierman (2005a) and Calandro and Lane (2006) explicitly suggest that organisations should look beyond simple performance-only approaches. With the Bank of Tokyo case, Nagumo (2005), and Kaplan and Norton (1996) appear to implicitly agree with this sentiment. In fact, Kaplan made the statement to this author that “*linking the scorecard to manage operational risk seems like an excellent idea*” (Kaplan, 2006).

With studies showing execution failure rates from 40%, there is a compelling need to effectively manage performance and risk. Added to this, there are a number of regulatory demands that organisations must address (Sarbanes-Oxley et al.)

However, within the UK financial services industry no clear best practice has emerged to effectively address these challenges, and within the literature, whilst the need appears to be becoming increasingly recognised, the question of how to effectively manage performance and risk remains unclear and unanswered.

Figure 7 - The Risk-Based Performance Framework



R-bp is based on a three-scorecard model comprising: (i) performance scorecard (ii) risk scorecard and (iii) controls scorecard, with each scorecard rolling up information into the Strategy Map. This provides a richer set of information than a traditional Strategy Map by incorporating, within the appropriate perspectives, performance, risk, controls and actions dimensions. Supporting the three scorecards is a data layer where measurement and indicators, incident, actions and scenario and models data are captured. This layer supports both regular reporting and review processes and infrequent, ad hoc ‘deep-dive’ analysis.

Additionally, the R-bp methodology incorporates a Risk Map where the key risks associated with the strategic objectives (at the same organisational level) are defined, and then mapped along impact and probability dimensions. A key strength of the R-bp methodology lies in the interaction between the Strategy Map and the Risk Map.

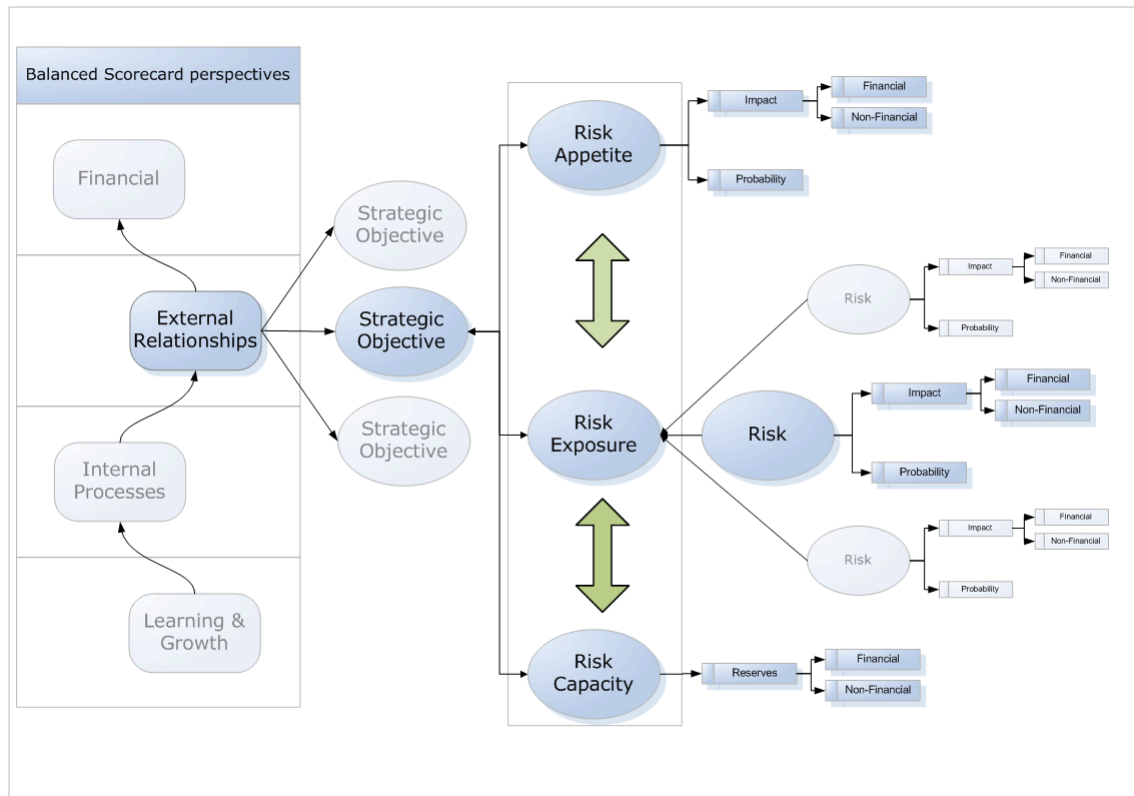
Whereas objectives on the Strategy Map are colour coded using a RAG/RAGAR (red, amber, green) approach based on roll-up scores from the three underlying scorecards, the risks on the Risk Map are ‘rated’ using impact and probability dimensions based on management interpretation of the Strategy Map and scorecards combined with

judgement and experience. Requiring decision-makers to 'rate' the key risks requires them to engage actively in this strategic process, considering both the hard data from the scorecards and the softer data present in an organisation's environment.

For a management team, the discussions around and interaction between the Strategy Map and Risk Map leads to a deeper understanding of both organisational strategy and risks. The Strategy Maps and Risk Maps should be 'owned' by the management team responsible for delivering the objectives laid out in the Strategy Map at each level within the organisation. As the strategic objectives cascade through the organisation, so the risks similarly cascade. Therefore the management discussions, decision-making and bias towards taking action will also cascade, building organisational capability and developing culture.

As part of the process, R-bp challenges organisations to consider the performance and risk trade-off at a macro (broader business environment) and micro (individual strategic objective) level. At both levels organisations should model, understand and monitor their risk appetite, their current risk exposure and their risk capacity.

Figure 8 – Integration at a Macro and Micro Level



To simplify the development and sustainability of the R-bp process, the R-bp methodology addresses what may be called the ‘measurement dilemma’. This is the situation where organisations attempt to ‘measure everything’ because of uncertainty as to what should be measured, and because of uncertainty surrounding what their ‘right’ measures should be.

This can result in organisations having hundreds of ‘key’ measures that provide little management or strategic insight. The R-bp methodology addresses this by:

1. Providing the strategic context within which to define indicators and measures
2. Differentiating between different types of indicators – performance indicators, risk indicators and controls indicators – and being very specific about their use
3. Differentiating between an ‘indicator’ and a ‘measure’ and providing clear guidance on each of their roles within the overall process.

In addition to giving greater clarity to the information provided by the R-bp process (and thereby generating better quality management discussions, decision-making and

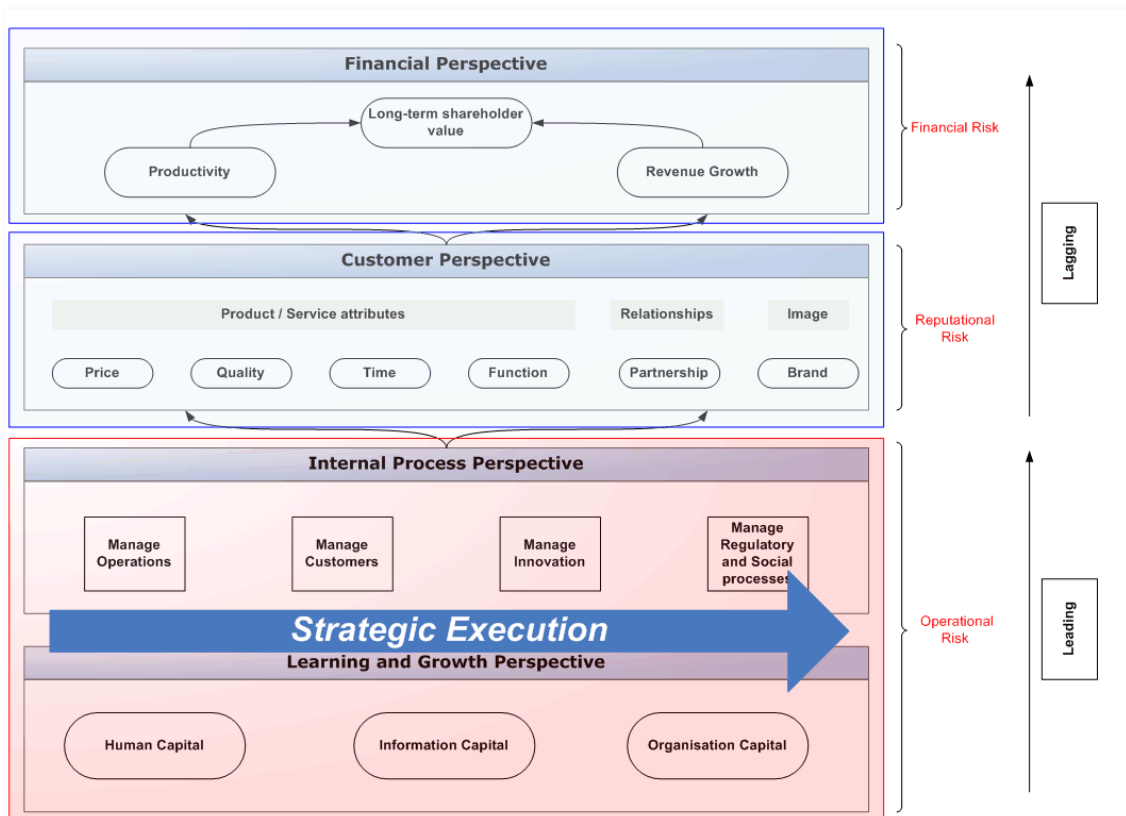
action-taking), performance and risk processes become simplified and more sustainable by addressing the ‘measurement dilemma’.

When considering the integration and alignment of performance and risk management it is important to be clear about where execution takes place within an organisation – what could be called the strategic execution architecture of an organisation (Figure 9).

Using the strategy map to provide a strategic framework, the key factors in the execution of strategy, performance and operational risk (Basell II) are people, processes and systems. These are all contained within the leading perspectives of the strategy map, Learning & Growth and Internal Processes. This author would argue that this is where execution happens, and the R-bp approach is designed to focus attention of these perspectives to drive strategic execution.

Figure 9 – Strategic Execution Architecture

Demonstrating that the keys to strategic execution are the processes, people and systems within an organisation. These are within the ‘leading’ perspectives within the BSC and are also where Operational Risk resides

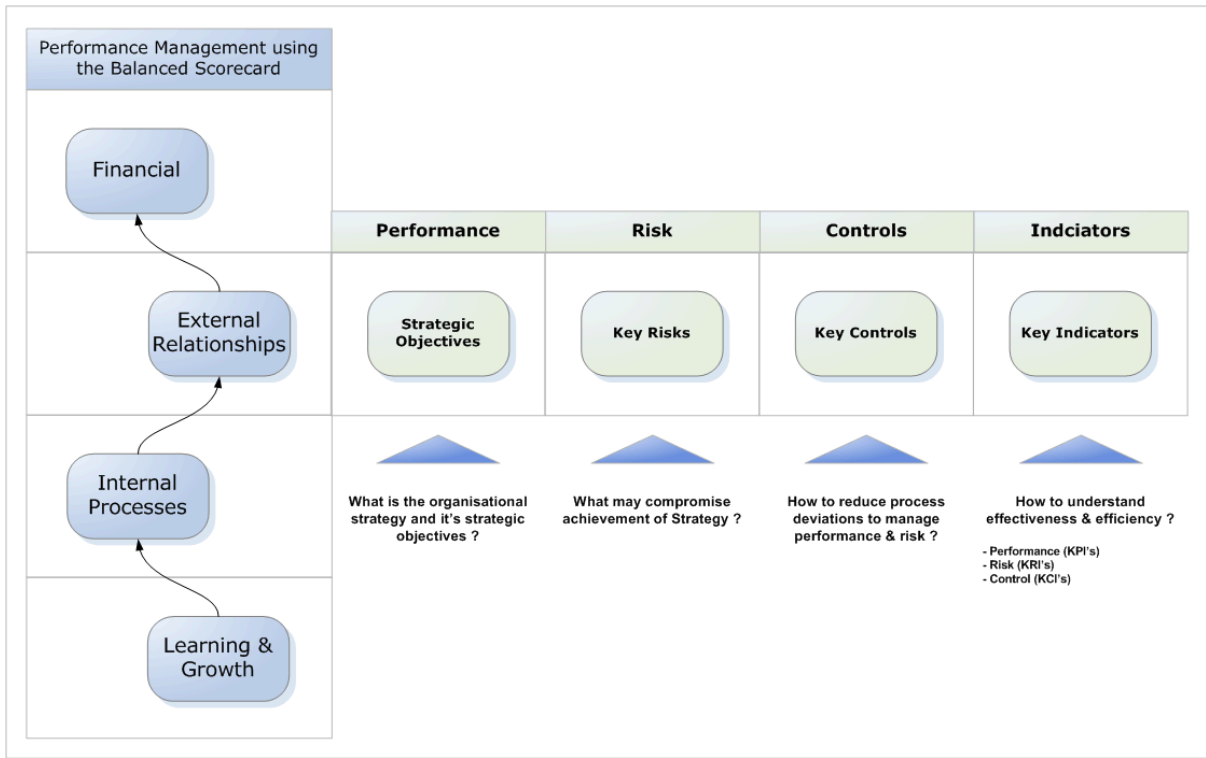


This has important implications when making decisions about where to assign resources and where to set controls to maximise overall control effectiveness, and importantly it provides clarity around the relationship operational risk has with other types of risk – for example, what is often referred to as ‘Reputational Risk’ is, in fact, an outcome and thus should be managed as such. Understanding the execution architecture is critical to enhancing performance and risk management and thus enhancing strategic execution.

There is an inherent relationship between the three dimensions of, performance, risk and controls, and understanding and managing this relationship is important to enable strategic execution. For example, organisations that set unrealistic performance targets may see their internal controls side stepped or short cuts taken to enable achievement of the performance targets. From the risk perspective, the amount of risk that an organisation is willing to take will influence performance levels. Risk-taking organisations are often able to take advantage of opportunities that more conservative competitors are unwilling to engage with. From an internal controls perspective, the level and complexity of the controls that an organisation puts in place at can affect its ability to achieve performance targets and/or manage risks.

Figure 21 – Relationship within the R-bp Methodology

The relationship and alignment of the major components within the R-bp methodology

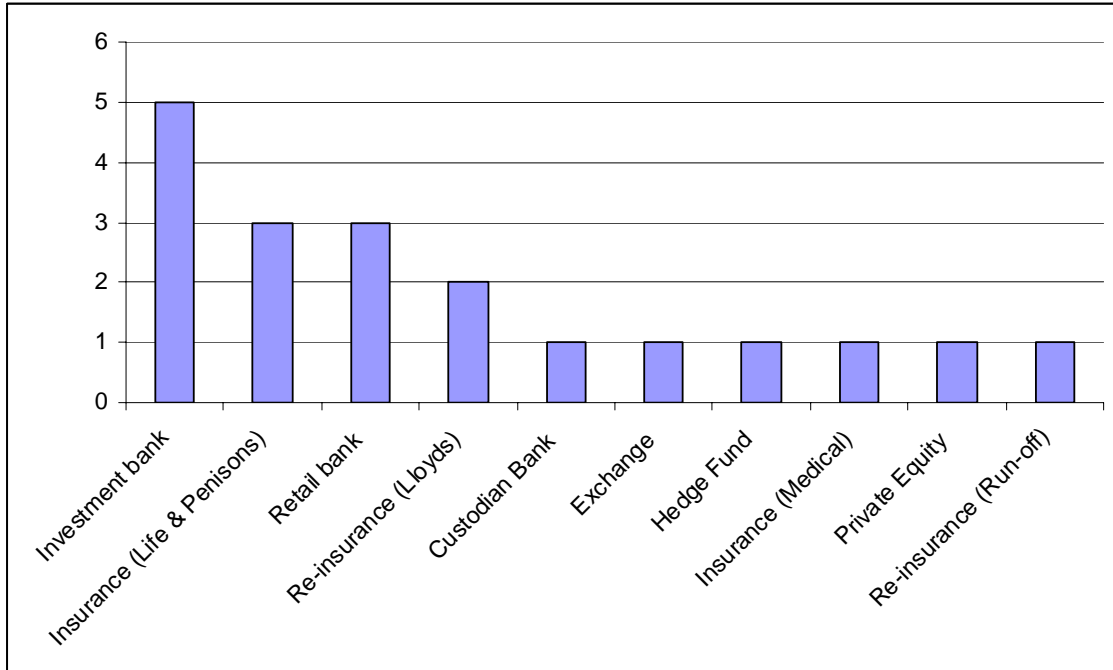


5.1 Research Findings

Whilst the target was 25 interviews, only 21 were undertaken due to time constraints. The summary results of the interviews will be presented using two summary matrices: the UK financial services environmental matrix and the Performance and Risk matrix. More detailed results are also presented using the McKinsey 7S as a model to present key themes identified within the research results.

Figure 11 – Breakdown by Industry Sub-sector of Interviewee Organisations

A breakdown of the organisations taking part in the study, by industry sub-sector



5.2 The Research Process

In-person, semi-structured interviews were originally identified as the optimal method of data collection. Given the complex subject matter and inductive approach to the project, it was determined that the research method required both interactive dialogue and the flexibility to pursue new lines of questioning throughout the process of gathering information. This would allow the author to continually refine his approach during the research and provide respondents with an opportunity to explore the issue in a sophisticated, interactive manner.

As the research progressed, however, a number of interviewees requested telephone interviews. Two participants also requested a small group interview. In considering this, the potential drawbacks of telephone interviews in comparison to in-person interviews were considered. These included those identified by Saunders et al (2003):

- Inability of the researcher to establish personal contact and build trust

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- Reduced reliability because interviewees are less willing to engage in an exploratory discussion
 - Lost opportunity to witness non-verbal behaviour, potentially adversely affecting the interviewer's line of questioning and ability to pursue specific issues
 - Participants may be less willing to provide as much time to talk, and it can be more difficult to record the interview.

There are, however, clear advantages of speed and convenience related to telephone interviews which Saunders et al (2003) acknowledge. Thirteen out of the final 21 interviews were recorded and transcribed. The seven interviews that were not recorded were due to incompatible atmospheric conditions, participants' request not to be recorded, or equipment failure.

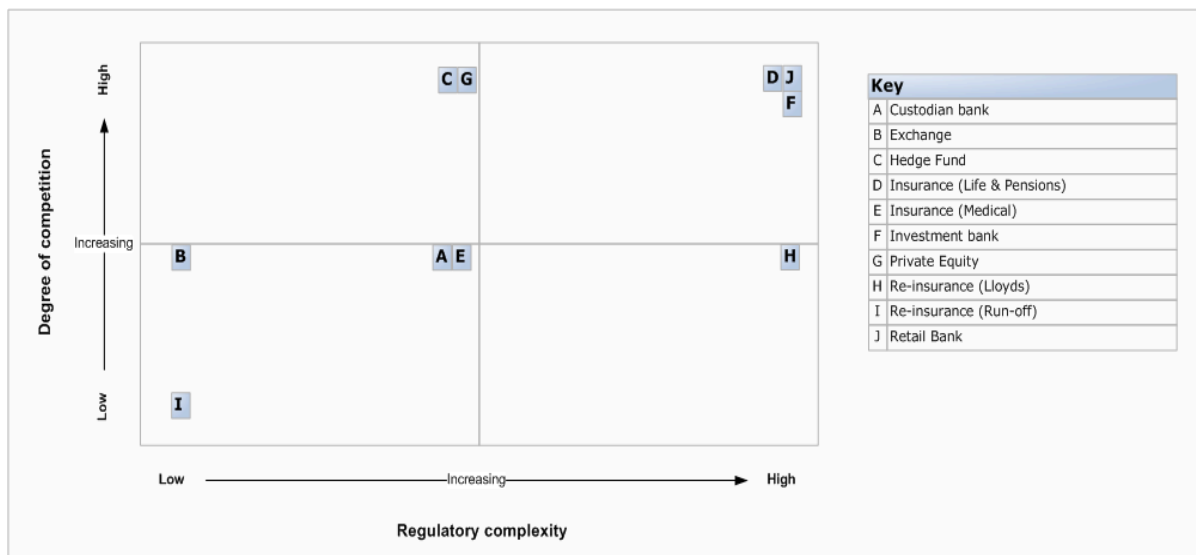
After completing 21 interviews with executives from 19 different financial services companies, the data was distilled using template analysis to create a 'long list' of approximately 60 points. These points were grouped and distilled further using two matrices developed by the author and the McKinsey 7S model to enable the identification and clarification of clear themes.

5.3 *Environmental Context*

During each interview, the competitive and regulatory environment of the company was discussed, with degree-of-competition and regulatory complexity used to frame this discussion. Using a simple matrix, the results of these discussions are shown in Figure 12.

Figure 12 – UK Financial Services Environment by Sub-sector

The results of the research, grouping interviewees into sub-sectors within the financial services industry



The results demonstrate the challenging environment within which the UK financial service industry operates, with eight out of the 10 industry sectors included in the research indicating increasing and/or high levels of both competition and regulation.

5.4 PM and ORM Overview and Performance and Risk Matrix

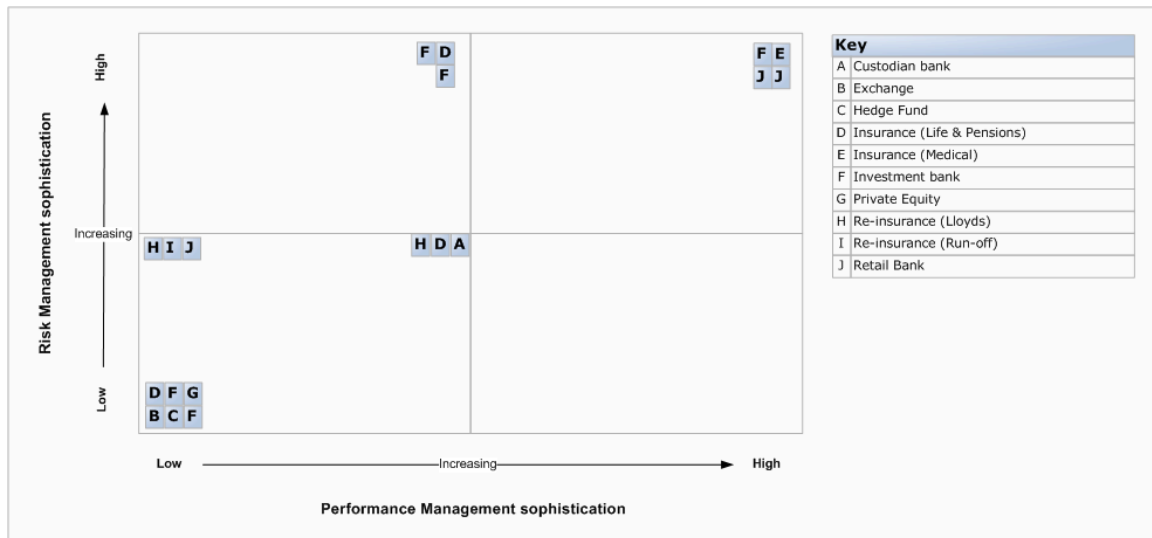
To provide an overview of how the organisations that took part in the research are responding to the competitive and regulatory challenges from a PM and ORM perspective, the performance and risk matrix was developed by the author.

This matrix characterises each organisation based on its level of sophistication from a PM and ORM perspective. Organisations are characterised as Metric-focused, Risk-Management-focused, PM-focused or Execution-focused.

The organisations were also plotted by industry sub-sector to enable comparison within the industry and to enable insights to be drawn by comparing the environmental context with organisations' responses (Figure 13).

Figure 13 – Performance and Risk Matrix

All participating organisations by industry sub-sector



The Performance and Risk matrix shows that the organisations within the study are largely Metric-focused, with only four organisations characterised as Execution-focused. Additionally, the matrix shows us that there is a lack of consistency with regards to PM and ORM even within sub-sectors within the industry.

5.5 Detailed Research Finding

The results from the interviews were distilled into a ‘long list’ of points, and then the McKinsey 7S model was used to further refine this list to identify main points or key themes, as shown in Figure 14.

Figure 14 – Themes/Key Points distilled using the McKinsey 7s model

	Themes / Key Points
Structure	<ul style="list-style-type: none"> • Process silo • Committee structure • Risk and Compliance focus
Strategy	<ul style="list-style-type: none"> • Reactive approach taken to regulation <ul style="list-style-type: none"> ○ Effective use of capital and increasing transparency ○ Just good strategy
Systems	<ul style="list-style-type: none"> • Clear and well defined reporting and review cycles • Lack of use of the Balanced Scorecard • Tactical indicator driven approach • Formal IT systems vs. Spreadsheets • Keep it simple, stupid (KISS)
Shared Values	<ul style="list-style-type: none"> • Challenge of embedding Operational Risk into the daily culture & decision-making • Developing and sustaining the desired culture • Role of organisational learning
Skills	<ul style="list-style-type: none"> •
Style	<ul style="list-style-type: none"> • Lack of maturity surrounding CPM and ORM • Data, data and more data
Staff	<ul style="list-style-type: none"> • Linking compensation to CPM and/or ORM indicators • Use of Gateway process • Chief Risk Officer appointed

5.5.1 Structure

Process silos – One of the assumptions at the outset of the research project was that there was a widespread ‘silo approach’ taken to CPM and ORM. The results of this research project appear to validate this assumption, with nine interviewees highlighting this as an issue.

Feedback on the proposed R-bp approach indicated that it could readily cross functional or team boundaries, helping to overcome process silos. To quote one of the

interviewees, “I think your approach makes a lot of sense. The challenge in many organisations is that they operate [their CPM and ORM processes] in silos”.

Use of committee structures – One of the key points to emerge was the use of a committee structure to review and sign-off on the organisational risk profile. This contrasts with performance, where the concept of ownership and accountability is orientated towards individual managers. In the context of risk, responsibility commonly rests with committees. The use of the committee structure was discussed by 10 interviewees.

Risk and compliance focus – An examination of where the focus of the operational risk and the compliance function should be was, this author believes, particularly relevant. Two organisations in this study differentiated between the operational risk function and the compliance function, focusing the former on the corporate agenda and the latter on the regulatory agenda. Reflecting on the interview notes, risk and compliance roles and mandates appear to lack clarity in a number of the organisations.

5.5.2 Strategy

Reactive approach taken to regulatory pressures – Given the highly regulated nature of the financial services industry, perhaps it is not surprising that 14 of the interviewees indicated that their efforts to enhance performance or risk-management processes were largely reactive and driven by individual regulatory requirements. This suggests that few financial services organisations are taking a strategic view or attempting to drive business value from these processes.

5.5.3 Systems

Clear and well defined reporting and review cycles – This emerged as a common practice (14 interviewees said this was part of their current process). The length of the cycle varied from daily through to annual reviews, though the most common review period was monthly. The Execution-focused organisations had the most disciplined and focused reporting and review processes.

Lack of use of the BSC – One of the most surprising results from the research was the limited use of the BSC. Ten interviewees said their organisation did not use the BSC, and a further three stated that they ‘might’ use the BSC but could not be sure. Only two interviewees, both from Execution-focused organisations, stated that they used the BSC.

Feedback on the proposed R-bp approach was very positive, with its use of the BSC as an underlying concept.

Tactical indicator-driven approach – Given the previous point, perhaps it is not surprising to find that eight interviewees indicated that their CPM and/or ORM processes were very much driven by the use of tactical indicators, primarily Key Performance Indicators (KPIs).

Formal IT systems vs. spreadsheets – Almost half the participant organisations stated they employed formal IT systems (eight), with others using spreadsheets (seven); three employed both. In terms of respondents’ assessment of their relative merits, two, using formal systems, believed the systems were making their jobs more difficult and therefore did not favour their use.

Keep it simple, stupid (KISS) – The need to remove complexity from CPM and ORM processes and take a ‘keep it simple’ approach was highlighted by five interviewees as either one of their current focuses or as one of the critical success factors in their processes.

In relation to the R-bp approach, the feedback was mixed. There was concern about the comprehensive nature of the approach, which may make it complex and difficult to implement. However, there was also recognition that by being specific about the use of the different scorecards and indicator types should reduce complexities. Six interviewees suggested integrating CPM and ORM.

5.5.4 *Shared values*

Embedding ORM into the daily culture and decision-making – This emerged as one of the most significant challenges facing the financial services industry, with nine interviewees touching on this topic.

A desired culture – Some in the literature and at least one of the interviewees hold the view that CPM and ORM are primarily about culture and creating a conducive environment. Seven provided some insights into the type of culture they were seeking to create, characterising it as an “open, honest, no surprises” culture, with accountability and open communications. Four reflected opinions on culture reminiscent of Kaplan and Norton, commenting that performance and/or risk should be everyone’s job.

Organisational learning – Two points emerged. Firstly, two interviewees discussed the impact of experiencing a significant risk event and how that shaped approaches to ORM. Secondly, two interviewees discussed the use of organisational learning as a key part of their CPM and ORM processes. The Execution-focused organisations appear to have a greater recognition of the importance of embedding organisational learning into their processes.

Interestingly, each of the four organisations categorised as Execution-focused appear to have evolved into this position over time rather than arriving via a more deliberate path. Two of these organisations had focused on implementation of the BSC, and then added risk management processes to their BSC process. The others developed strong risk management practices and leveraged these in the development of their PM processes. This would be characteristic of a learning organisation.

5.5.5 *Style*

Lack of maturity surrounding CPM and ORM – A significant lack of maturity exists in relation to CPM and ORM, with 14 interviewees highlighting this, apparent across organisations and, more broadly, the industry.

Data, data and more data – While only four interviewees directly touched on the issue of data quality and availability, others indirectly referred to its impact. Discussions centred on the perceived need to develop totally data-centric processes. It appears that many organisations focus too heavily on data, and lack the mechanism for capturing management judgement and experience.

5.5.6 Staff

Linking compensation to PM and/or ORM indicators – Linking compensation, particularly bonus payments, to performance and/or operational risk indicators emerged as a key insight. Six interviewees discussed how their current processes linked compensation to performance and/or risk.

Use of ‘gateway’ processes – Linked closely to the previous point, six interviewees (four in common from the previous point) discussed their use of such a process, which requires an employee to pass through specific gateways, meeting the criteria within each gateway, to qualify for their bonus.

Chief Risk Officer appointed – Only three organisations had appointed a CRO which, given the nature of the industry, seems low and reflects a lack of maturity around these processes.

6 Conclusions

The research on which this paper was based set out to explore how to integrate and align performance management (Balanced Scorecard) and operational risk management processes to enhance strategic execution within the UK financial services industry. This is an industry that plays a key role in a changing, increasingly global economy.

It was found that this industry is becoming increasingly competitive and increasingly regulated, however it appears that the industry's response from a performance management and operational risk management perspective has been reactive and lagging behind these environmental changes. With 12 out of the 19 companies studied categorised as metric-focused and 3 as risk management-focused, it implies that the industry is struggling to develop the required strategic frameworks and approaches to meet these changing demands. With 3 risk management-focused organisations and a further 6 demonstrating increased levels of risk management sophistication, the implication is that participating organisations are responding to regulatory pressure more readily than competitive pressures. The lack of correlation between an industry sub-sector positioning on the environment matrix and its positioning on the performance and risk matrix indicates the industry is not developing, sharing and implementing best practice approaches.

The lack of execution-focused organisations and tactical, reactive responses to the twin environmental drivers of competition and regulation is perhaps less surprising when considering the literature related to performance management and risk management. Whilst the literature on these individual topics is comprehensive and provides significant insight into these individual processes, there is a significant lack of literature around the integration and alignment of performance management and operational risk management processes. However there is support for this integration from both the literature and the participants in the field research.

Risk-based performance is proposed as a methodology to guide and enable the integration and alignment of these processes to meet the twin demands of increasing competition and increasing regulation. It is a methodology that builds on existing, proven methodologies, including the Balanced Scorecard and COSO. It provides the conceptual framework, processes and tools to enable organisations to move beyond a silo performance management or silo operational risk management focus to a strategic execution agenda which enables managers to manage with ‘one eye on performance and one eye on risk’.

The findings of this research provide lessons for the GCC states, and organisations, as they emerge to play a more important role in the world economy and as they undertake social and economic reforms at home. One of the key industries requiring reform in the GCC states is the financial services industry. It is reasonable to assume that these states will look to major financial centres such as London and New York to provide guidance in creating an environment that will be attractive to investors and other providers of capital whilst efficiently allocating that capital to maximise returns, and in the process funding desired industrial growth and development within the GCC.

Given the misaligned response to competitive and regulatory pressures shown in this paper, and the issues uncovered around performance and operational risk management, this author would suggest that there is an opportunity for GCC organisations to take a more holistic perspective when considering performance and operational risk management. Rather than piecemeal, isolated developed processes, GCC organisations have the opportunity to exploit the Risk-based performance methodology to establish a focus on strategic execution, integrating and aligning their performance and risk management processes to ensure delivery of their strategies and achieving objectives both from a shareholder perspective and from an economic/social perspective.

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