
At the Intersection

An investigation into the integration and alignment of the Balanced Scorecard with operational risk management frameworks to enhance strategic execution in the UK Financial services industry.

Literature review

Change and uncertainty

“ In the history of humankind, there has never been a more challenging environment than today.” Garrison et al (2001). Political, economic and technology factors, driven by globalisation and the emergence of the ‘new economy’ are all cited as drivers of change and uncertainty. Supporting Garrison’s bold statement are;

- ❑ Handy, (in Gibson, 1998) – “We are living in confusing times”.
- ❑ Toffler, (cited by Gibson, 1998) predicting a “ world of chaos and uncertainty” and a “world of accelerating change”.
- ❑ Prahalad (in Gibson 1998) – “Change [is] no longer generational issue”.
- ❑ Kotter (1996) –“The rate of change is not going to slow down anytime soon”.

Change and uncertainty (2)

However, not all commentators agreed;

- ❑ Duening (1997) "Current change, whilst significant, is evolutionary rather than revolutionary".
- ❑ Mintzberg (1993) "We glorify ourselves by describing our own age as turbulent".

Figure 2 - Drivers of change and uncertainty

This figure shows the relationship between key macro factors and the need for change in organisations.



Source : Adapted from Kotter (1996)

This figure, originally published in 1996, 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 fast emerging economics.

Strategic execution

- ❑ The concept of 'execution' was identified as the most important conceptual breakthrough in the last 10 years - Strategy + Business (Booze, Allen and Hamilton).

- ❑ Bossidy and Charam (2002)
 - 'the missing link', 'the gap between what a company's leaders want to achieve and the ability of their organisations to deliver it'

 - 'no worthwhile strategy can be planned without taking into account the organisation's ability to execute it'.

 - Four dimensions, strategy, processes, people and technology.

Strategic execution (2)

- ❑ Kanter (2005) – ‘Making it happen’

- ❑ Aspesi and Vardhan (1999)
 - companies fail to make informed choices between a ‘second best’ strategy they could execute and an ‘ideal’ strategy that demands capabilities that they simply don’t have.

 - their 40 company study, 40% failed to execute.

- ❑ Pfeffer and Sutton (2000) - gap between ‘knowing what to do’ and ‘doing it’

- ❑ Powell (2004) – ‘execution holes’, when organisation fails to enact strategies that are known to be viable.

Strategic execution (3)

❑ Mankins and Steele (2005)

- generally 60% of companies fail to realise their strategies' potential value
- companies rarely track performance against long-term plans, multiyear results rarely meet projections
- value is lost in translation and performance bottlenecks are frequently invisible.

❑ Porter (1985)

- activities are the bridge between strategy and implementation
- 'everyone in a firm...part of the strategy'

❑ Kaplan and Norton (2001)

- 'Make strategy everyone's job'

Balanced Scorecard

- ❑ Balanced Scorecard is now positioned as an enabling tool, supporting strategic execution.
- ❑ It appears that it evolved into this role from its original positioning as a performance measurement tool, as shown in figures 4-6.
- ❑ Financial Services appears to have strongly adapted the Balanced Scorecard as shown in figures 7 & 8.

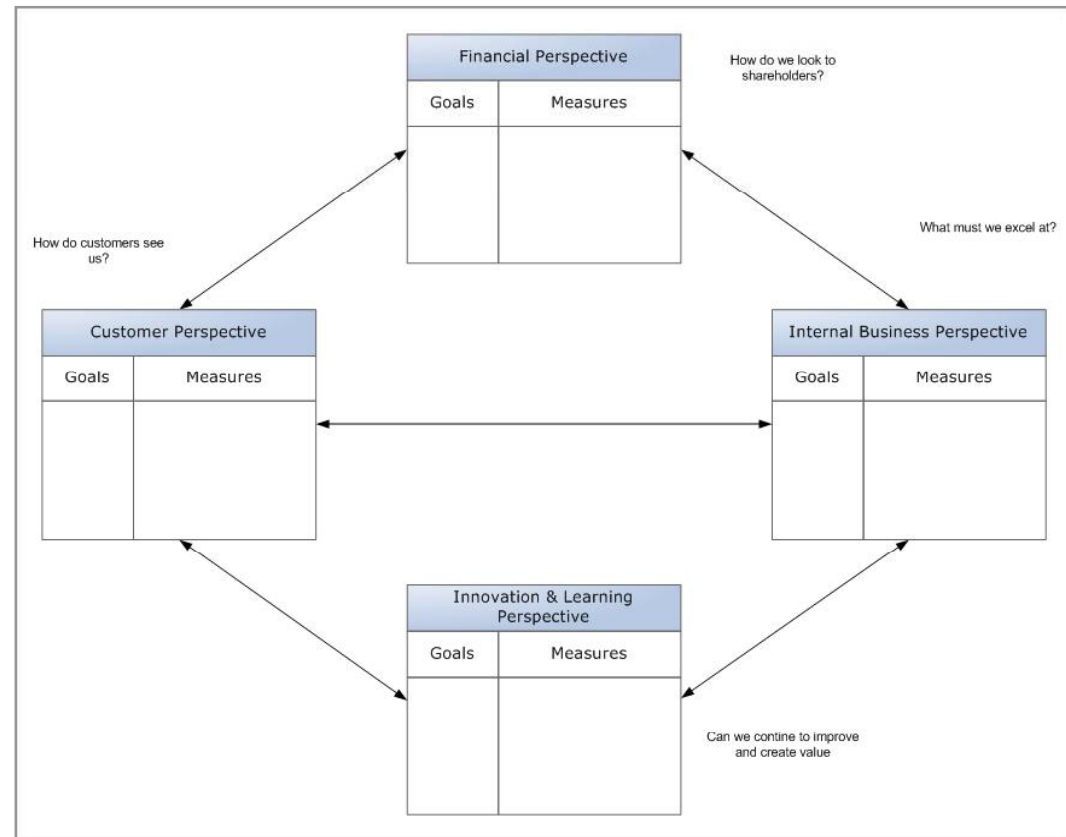
Balanced Scorecard (2)

- ❑ In addition to the 'fathers of the Balanced Scorecard', Kaplan and Norton, a number of others have made contribution to the BSC theory;
 - Neely et al (2002) - attempt to overcome perceived limitations of the original Balanced Scorecard with the performance prism.
 - Lusk et al (2006) - Balanced Scorecard needs to widen its scope to incorporate the societal environment.
 - Lawrie, G.J – destination statements
 - Bible et al (2006) - has the Balanced Scorecard 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 of over complicating what is essentially a common-sense approach.

Figure 3 - Evolution of the Balanced Scorecard (1)

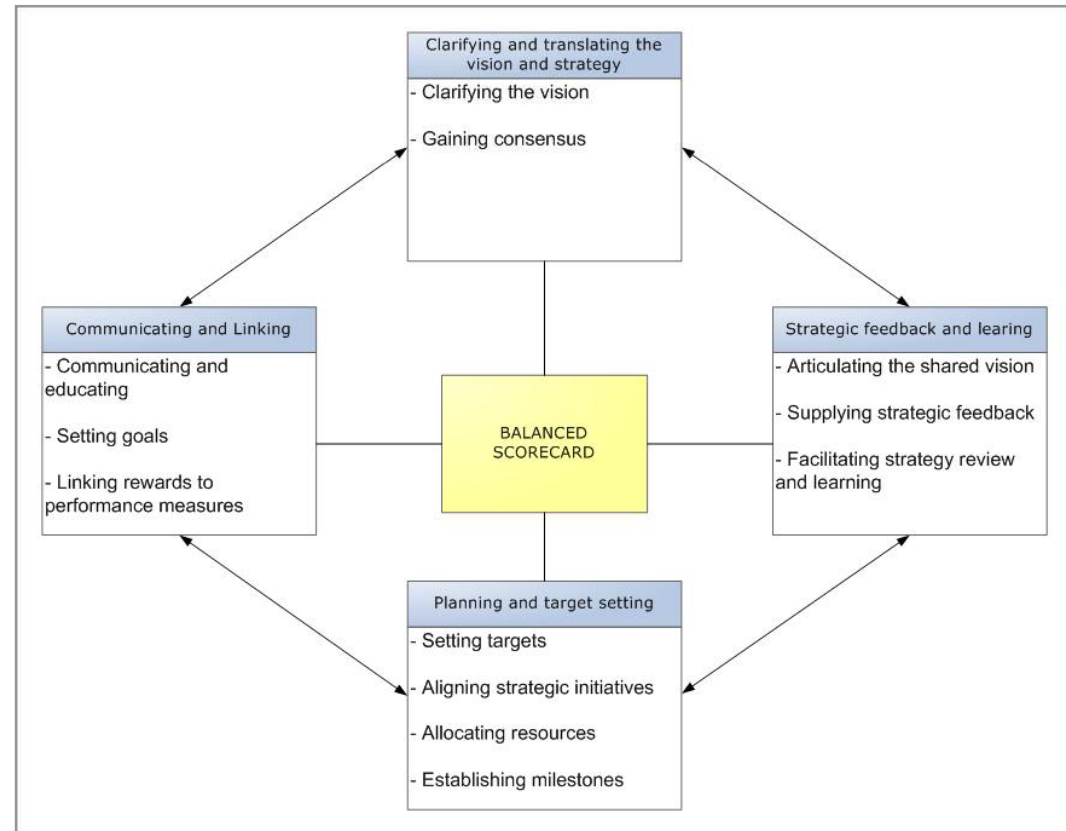
Originally the Balanced Scorecard was positioned as a performance measurement tool that helped executives move away from a predominately financial focused set of measures to a more 'balanced' set, including non-financial measures.



Source : Harvard Business Review January-February 1992

Figure 4 - Evolution of the Balanced Scorecard (2)

The Balanced Scorecard concept quickly evolved to take a more strategic focus.



Adapted from Kaplan and Norton (1998)

Figure 5 - Evolution of the Balanced Scorecard (3)

The Balanced Scorecard concept continued to evolve into a strategic management tool with release of the 'principles of the strategy focused organisation' and the strategy map.

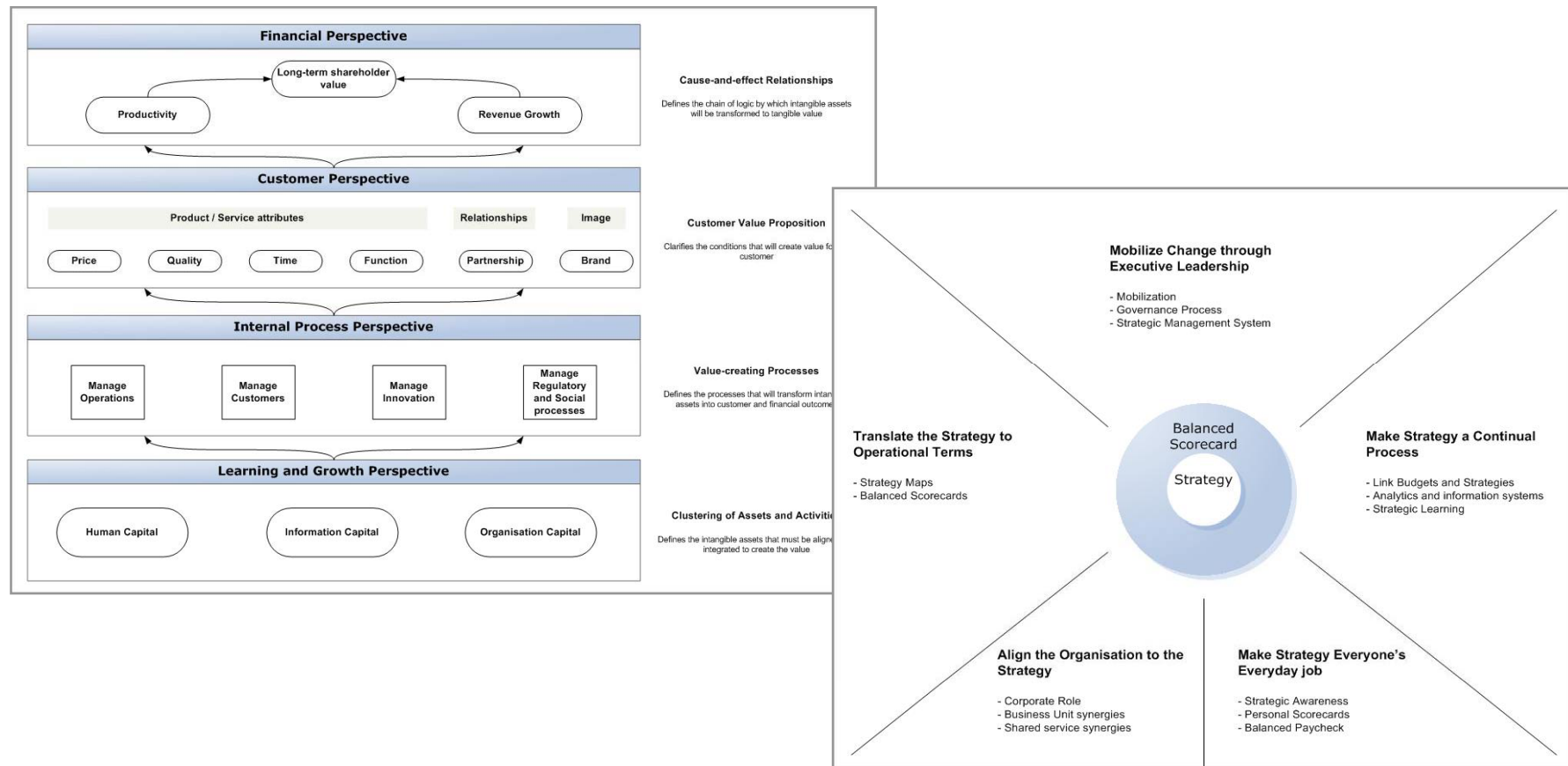
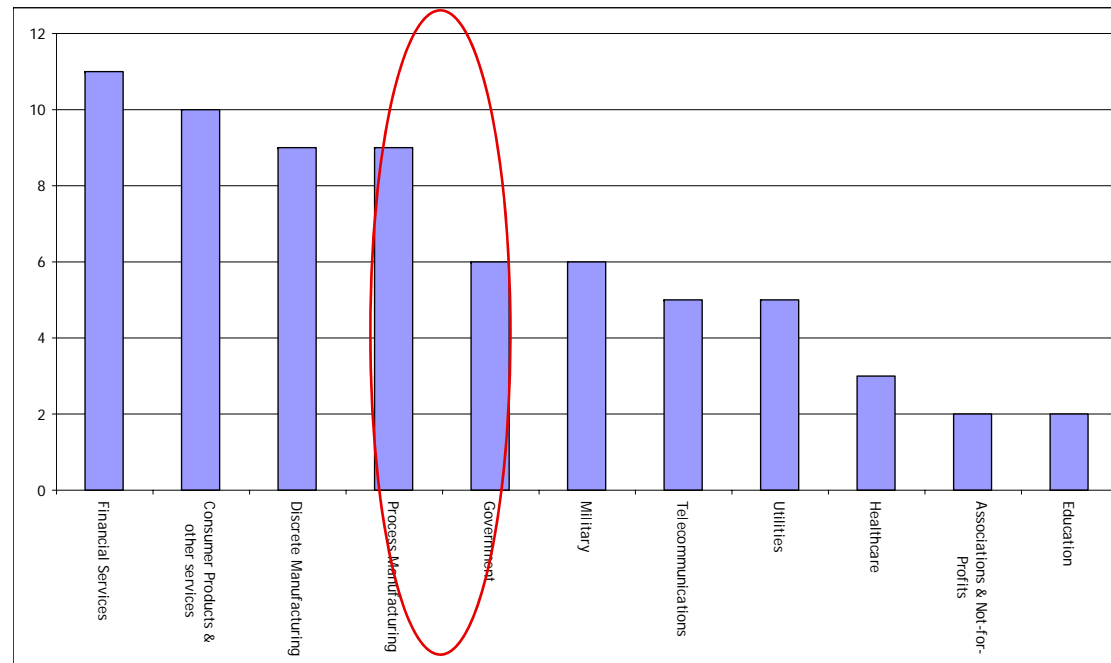


Figure 6 - Balanced Scorecard adaptors in Financial Services

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, J.P Morgan.
Becker et al (2001)	Wells .
Kaplan and Norton (2004)	Bank of Tokyo-Mitsubishi HQA, Swiss Re, Volvofinans, Thomson Financial.
Huselid et al (2005)	Wells , Prudential Insurance, Allstate Insurance.
Ward (2005)	Lloyds TSB.
Kaplan and Norton (2006)	Bank of Tokyo-Mitsubishi HQA, First Commonwealth Financial Corporation.

Figure 7 – BSCoI Hall of Fame winners by industry

Amongst the Balanced Scorecard Collaborative (BSCoI) Hall of fame winners, financial services represents the largest industry group.



Risk Management

Why is risk management important?

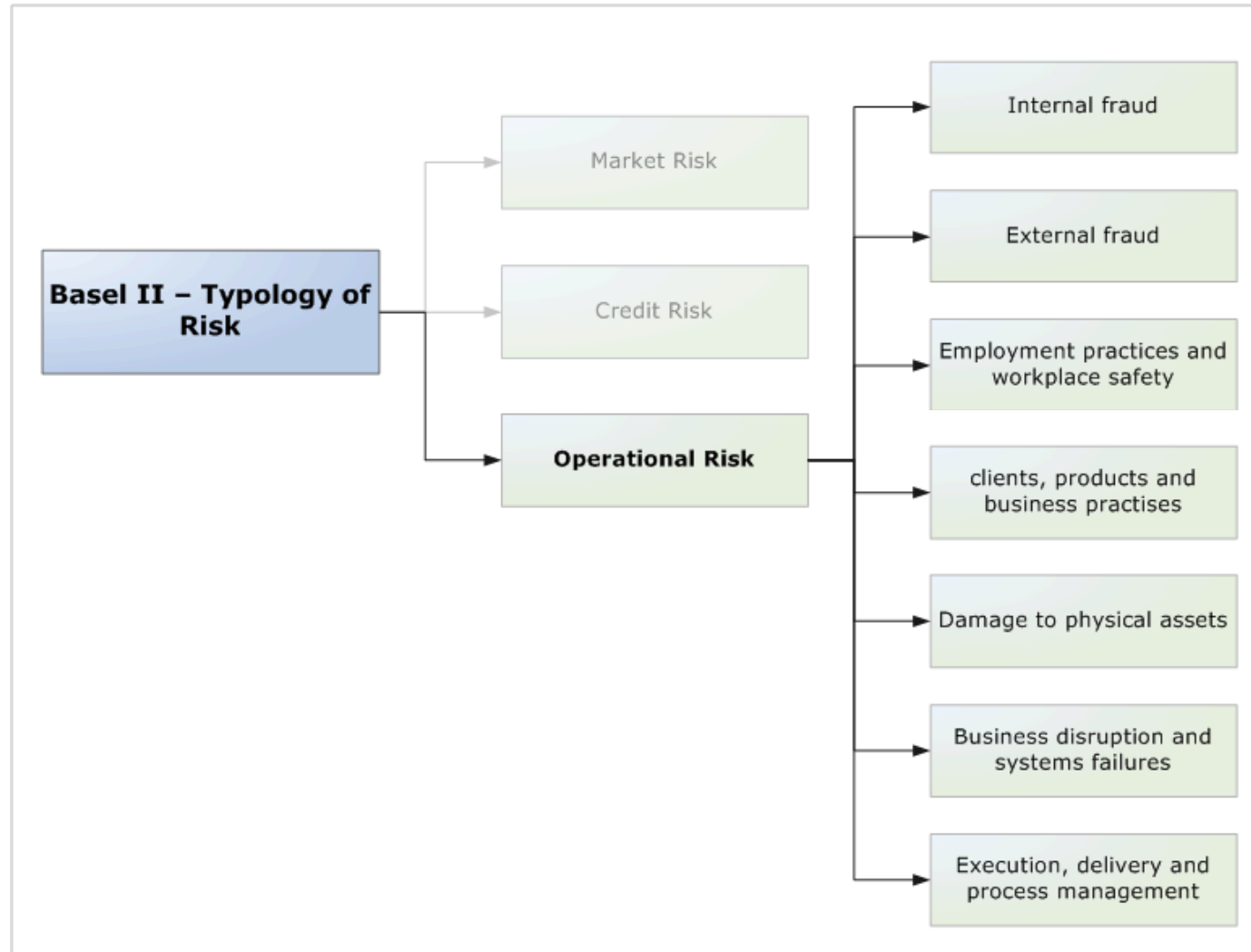
- Bernstein (1996) - understanding risk will help differentiate tomorrow's winning from those less successful.
- Buehler and Pritsch (2003) - "Taking and managing risk is part of what companies must do to create profits and shareholder value".

Risk Management (2)

What is Risk?

- Hilson (2006) - potential future events or sets of circumstances or conditions
- Waring and Glendon (1998)
 - More than mere existence of hazard.
 - Should consider likely scale of consequences, frequency, duration and extent of hazard exposure, the probability of an unwanted/desired event and the time scale over which consequences might be manifested and probabilities assigned.
 - The Risk Management standard, IRM, airmic & ALARM (2002) - combination of the probability of an event and its consequences.
 - Basel Committee on Banking supervision (2004) - operational risk is 'the risk of loss from inadequate or failed internal processes, people and system or from external events'
 - Basel definition has gained widespread support, Hoffman (2002) , Blacker (in Hilson, 2006), Alexander (2003) etc .

Figure 8 - Basel II Typology of risks



Risk Management

Operational risk has become increasingly important within Financial services over the last 5-10 years.

- Hoffman (2002), Alexander (2003), Belluz et al (2006), Blacker in Hilson (2006), all highlight headline-grabbing cases of ORM failures to understand its rapid move up the management and regulatory agenda.
- Cases include; Drexels, Barrings, Bank of Credit and Commerce International (BCCI), Allied Irish Bank, Enron, Firestone, and the Australia National Bank.

Risk Management (2)

Research shows why it has become more important;

- Dunnett et al (2005)
 - 350 large risk events (greater than US\$1 million) at european and north american financial institutions since the 1990s
 - decline in market capitalisation of the affected institution was approximately equal to the short term financial loss, on average US\$65 million
 - 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 to meet a professional obligation or a defect in the nature or design of a product – all factors within the institutions control

Risk Management (3)

Research shows why it has become more important;

- Levy et al (2006)
 - from 2001 to 2005 operational risk related losses at the top 12 US banks represented 4-5% of their net income
 - this excludes unpublished events
 - at least two banks had losses that wiped out more than 10% of their pre-tax net income
 - most harmful loss events were; embezzlement, loan fraud, deceptive sales practices, antitrust violations and non-compliance with regulation
- Buehler and Pritsch (2003)
 - study of 200 leading financial services institutions between 1997-2002
 - 150 cases of significant financial distress at 90 of the institutions

Risk Management (4)

Operational risk management also has significant upside

- Levy et al (2006)
 - up to a 25% reduction in regulatory capital held
 - can take on and succeed in businesses that competitors either are unable or unwilling to accept
 - cost saving achieved by reducing error rates (losses from operational risks) can far outweigh the savings achieved via more traditional cost reduction measures

Measuring risk

□ Grody et al (2005)

- the nature of the risk events has important implications
 - high-frequency/low-impact (HiLo)
 - credit card fraud
 - subject to detailed analysis and efforts to reduce the level of losses and create the basis for expected losses
 - low-frequency/high-impact (LoHi)
 - terrorist attack
 - contingency planning, insurance policies and risk mitigation
 - low-frequency/low-impact (LoLo)
 - managed with consideration for the cost/benefit.

Measuring risk (2)

□ Swenson (in Alexander, 2006)

- operational risk discipline is in an 'embryonic state'
- best practice is yet to emerge
- concepts and approaches copied from other areas of risk measurement, credit and market risk
- significant differences between these three risk disciplines from a measurement perspective, relating to the quality and availability of data
- many organisations simply do not have the internal risk and loss data to enable them to either provide robust reporting or to feed into operational risk models

Economic capital

□ Anders (in Alexander, 2006)

- “amount of capital that a company needs to protect against insolvency due to unexpected losses over a given period”
- must understand the difference between expected and unexpected losses
- challenges in calculating Economic capital, include
 1. developing a good model
 2. sourcing good input data

Economic capital (2)

□ Anders (in Alexander, 2006)

- suggests two sources of input data, historical loss data and expert evaluations however he warns;
 - historical loss data only represents the past, and its value as a predictor of the future is questionable
 - likely to be deficiencies in the completeness of the data
 - external data maybe considered but may not accurately represent an internal risk situation
 - best choice seems to be use of experts within the organisation and capture data using a 'Risk Scorecard' approach (figure 10)

Figure 9 – Example of a Risk Scorecard

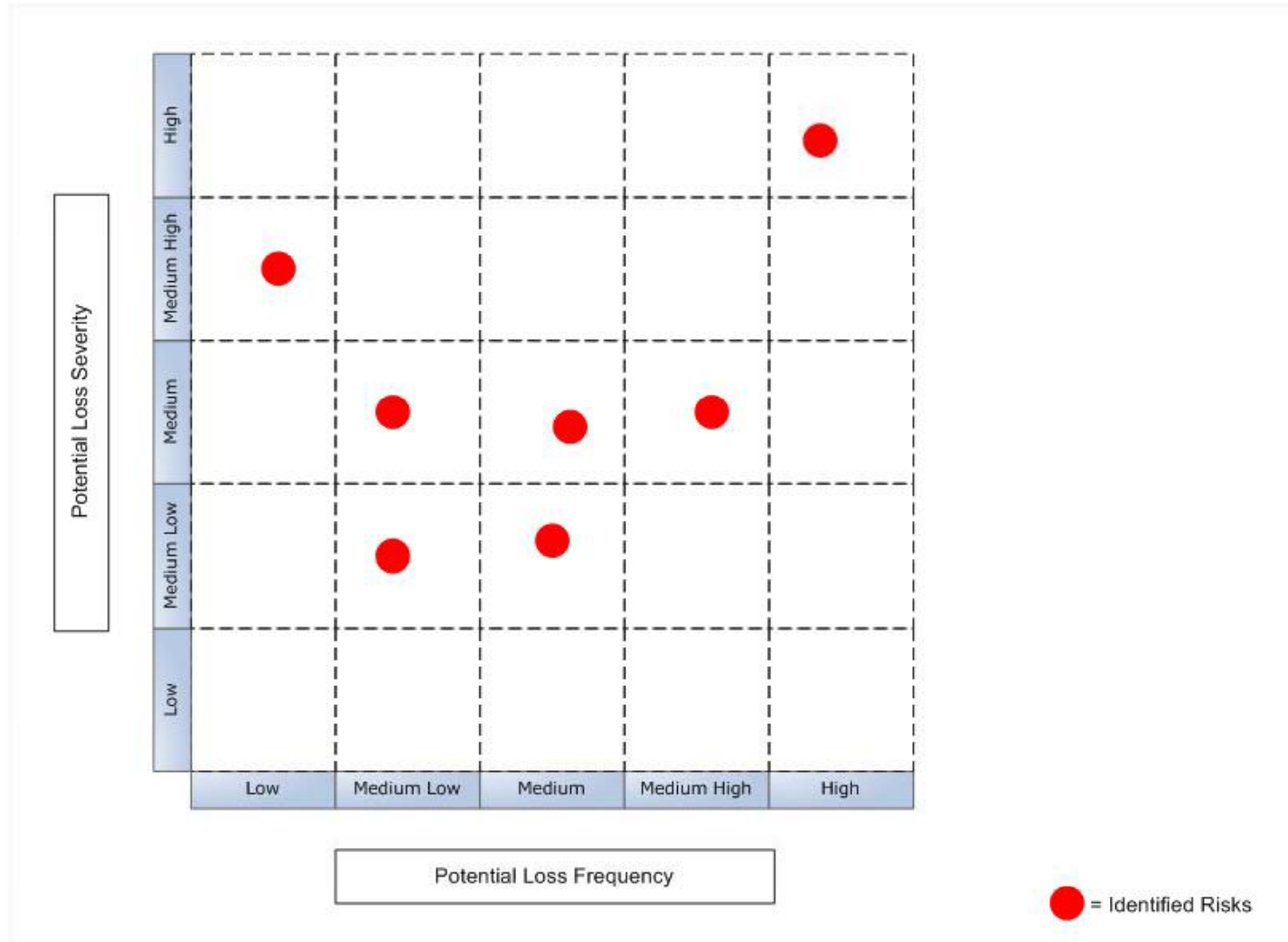
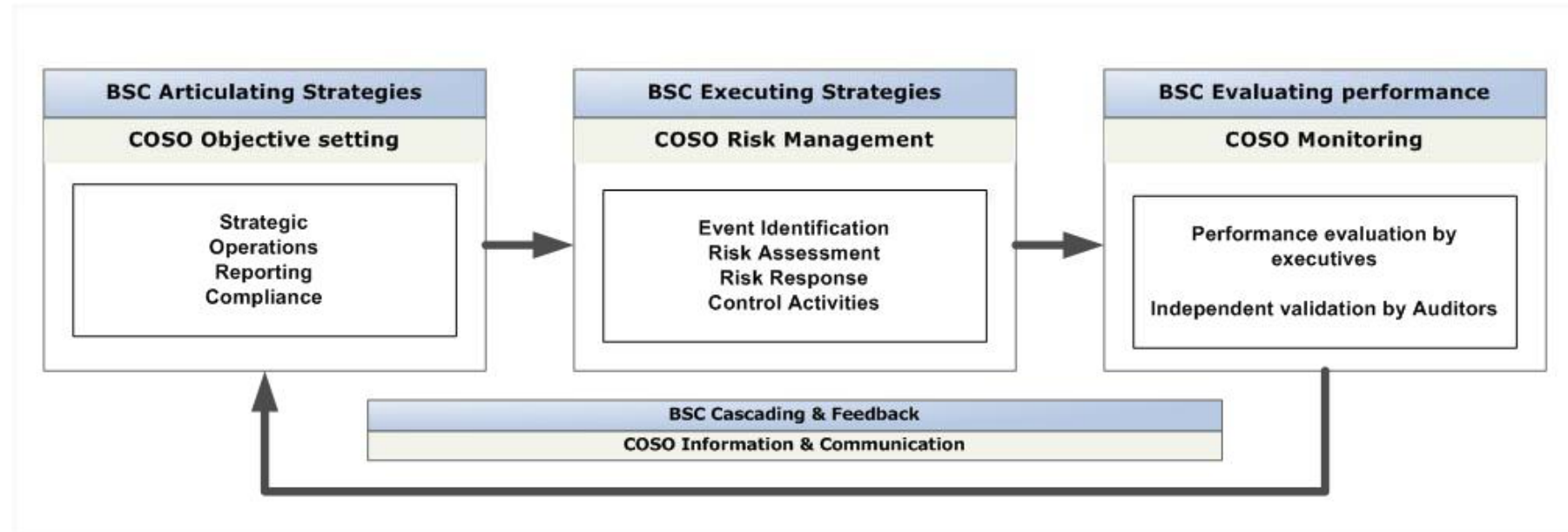


Figure 10 – BSC-COSO EPM Mapping

This figure shows the elements of risk management defined by the COSO ERM model, and corresponds to the three strategy-related processes defined by the BSC and to the BSC feedback properties.



Economic capital

❑ Blunden (in Alexander, 2003)

- supports the use of a scorecard approach and use of indicators
- suggests focus should be on risks, controls and performance
- suggests risk and controls self-assessment as a first step
- developing risk culture and capability is critical

❑ Peccia in (Alexander, 2003)

- questions the use of risk and control self-assessments
- argues they are not an effective tool when risks or controls are out of control
- suggests the use of operational risk models in addition to any self-assessment to supplement management judgement

Integration and alignment

Surprisingly, there appears to be little in the literature related to the integration and alignment of performance and risk.

□ Garrison et al (2001)

- highlights the lack of attention within the current literature related to the role of risk in strategic decision-making

□ Likierman (2005a)

- “as far as I know, there's nothing specifically linking performance and risk”
- impossible to separate the measurement of performance from the risks taken to achieve it
- suggests integrating performance and risk via the use of performance measures with a risk dimension such as calculating a risk-adjusted return on capital

Integration and alignment (2)

□ (Kaplan and Norton, 1996)

- “risk management is an overlay, an additional objective that should complement whatever expected return strategy the business unit has chosen”

□ (Kaplan and Norton, 2004 and Nagumo, 2005)

- the Bank of Tokyo-Mitsubishi case is one of the few examples where performance and risk are integrated
- banks requirement was to enhance strategy execution and develop robust risk management capabilities
- Risk Management objectives were simply added to business unit Scorecards
- incorporating the COSO ERM model expands the use of the Balanced Scorecard to cover risks arising during the execution of strategy (see figure 11)

Integration and alignment (3)

□ Calandro and Lane (2006)

- highlight the lack of consideration that Kaplan and Norton – and scorecard literature in general – give to risk
- performance-only managerial focus was understandable in the past, recent events are forcing the focus on risk and performance;
 - the accounting transgressions and governance issues that surfaced following the implosion of the new economy boom
 - increased regulatory activity (Sarbanes-Oxley, Basel II and others)
 - the increasing cost of uncertainty (rising oil prices, gold and commodity prices)
 - ever-increasing levels of globalisation and volatility
- suggest a dual scorecard approach covering performance and risk

Integration and alignment (4)

□ Calandro and Lane (2006) continued

- single scorecard approach incorporating performance and risk would create scope issues and confusion in the information delivered
- suggest that the Balanced Scorecard be used to measure the performance of activities undertaken to execute strategy, while the Risk Scorecard should be used to measure risks generated from those activities.

□ Beasley et al (2006)

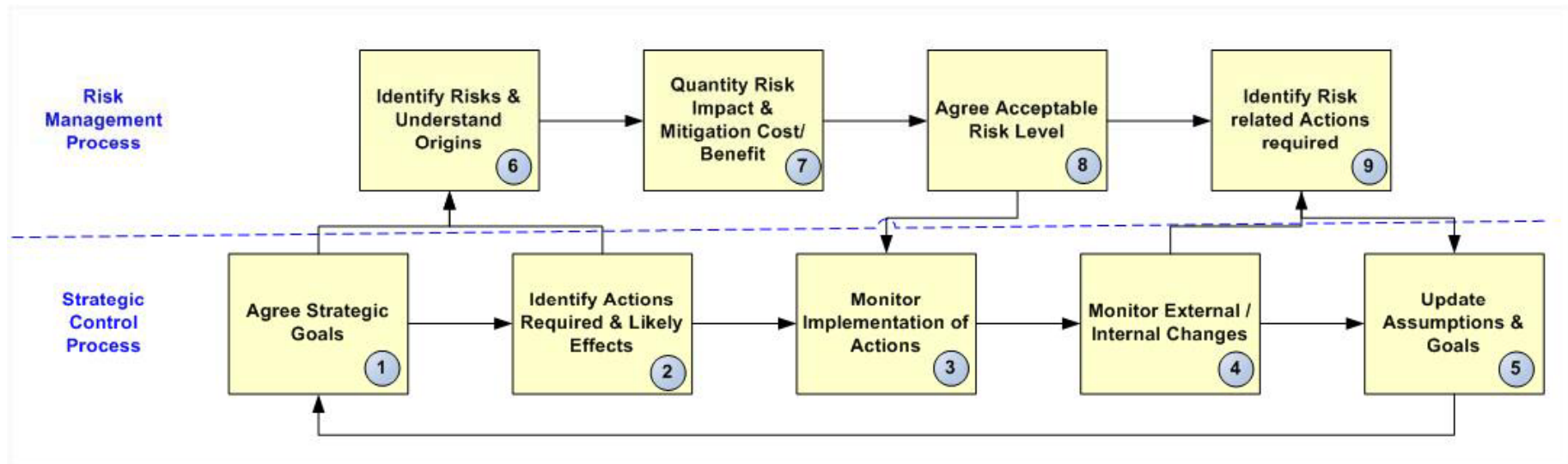
- suggest organisations should include risk-related goals and measures within each perspective
- suggest using a single scorecard approach

Integration and alignment (5)

□ Lawrie et al (2003)

- today's risk management processes have much in common with systems designed to manage strategic performance
- whereas performance management is about identifying and monitoring what should happen, risk management is about identifying and monitoring what should not happen
- considerable probability of duplication of effort between implementing performance and risk management systems as both processes essentially look at the same processes from different perspectives
- recommend using an integrated process and outline the process to follow to reduce duplication and integrate these processes (see figure 12)
- risk management without an effective strategic PM system to provide context is in the best case of limited value, and in the worst case can misguide or obscure important risks

Figure 11 – Integrating Performance Management and Risk Management



Further information

Please visit <http://www.riskbasedperformance.com/> for further information related to this study and the Risk-based performance approach to the integration and alignment of corporate performance management and operational risk management.

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