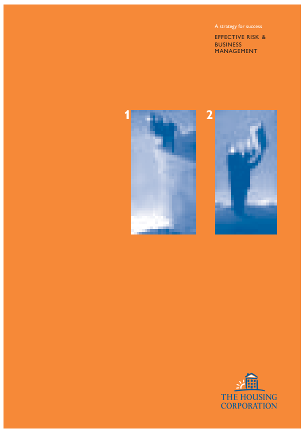
RISK MANAGEMENT TOPIC PAPER No. 5

A PRACTICAL APPROACH TO IDENTIFYING RISK

By Caroline Shah



INTRODUCTION

Risk management is increasingly prominent on the agendas of managers and regulators in the social housing sector, as shown by this series of papers. Yet while the management of risks is well established, the process of identifying those risks is sometimes given less prominence. *Chief Executives …assert that the most important task is not to identify risks but to manage identified risks well* (Topic paper No 1, The Quantification of Risk). But if the approach to risk identification is haphazard and unchallenging, key risks can go unnoticed, leaving the process of risk management at arm's length from planning and managing the rest of the business.

A logical approach to risk analysis helps an organisation to test the valuable intuitions of its people about what drives its success or failure. Equally important, such an approach ensures that everyone is assessing risk on the same basis. Thus a culture of risk awareness and ownership of identified risks will automatically start to appear.

This paper shows how risk identification can become a core part of effective business planning and management. It offers practical hints on how to carry out a risk-identification process that is thorough, rigorous and grounded in the actual business, leading to a comprehensive and robust approach to preventing and managing risks.

The paper is in three parts. First, it examines the importance of linking risk analysis to objectives and the activities undertaken to fulfil them. Second, it addresses the key components of a comprehensive approach to risk identification. Finally, the paper suggests how to translate identified risks into practical steps to prevent the risks from materialising and to minimise their impact.

LINKING RISK MANAGEMENT TO OBJECTIVES

In assessing risk, business managers try to understand what could cause their organisation to fail. By successfully preventing identified risks or managing their consequences, managers free resources to focus on the factors that drive business success.

In practical terms this means that risk identification should:

- provide an effective check that the activities of a housing association help it meet objectives;
- improve the quality of strategic planning; and
- facilitate the design of an effective control structure.

Checking activities against objectives

Organisations benefit from producing strategic plans to guide development over the medium to long term. Strategic plans, however, can hover high above actual day-to-day business, at a level of abstraction that means they are not

EDITOR'S FOREWORD

This fifth paper on risk management is published as part of a short series sponsored by the Housing Corporation. The aim is to encourage development of best practice among housing associations. The papers follow on from previous publications that sought to introduce and develop effective risk management. In particular the publication in 2000 of Effective Risk and Business Management was designed to identify the elements of a risk management framework for housing associations.

The views expressed in these topic papers are those of their authors and not the Housing Corporation. It is hoped that they will stimulate discussion and the development of best practice in specific areas of risk management. Comments on the papers would be welcomed.
Roger Lustig

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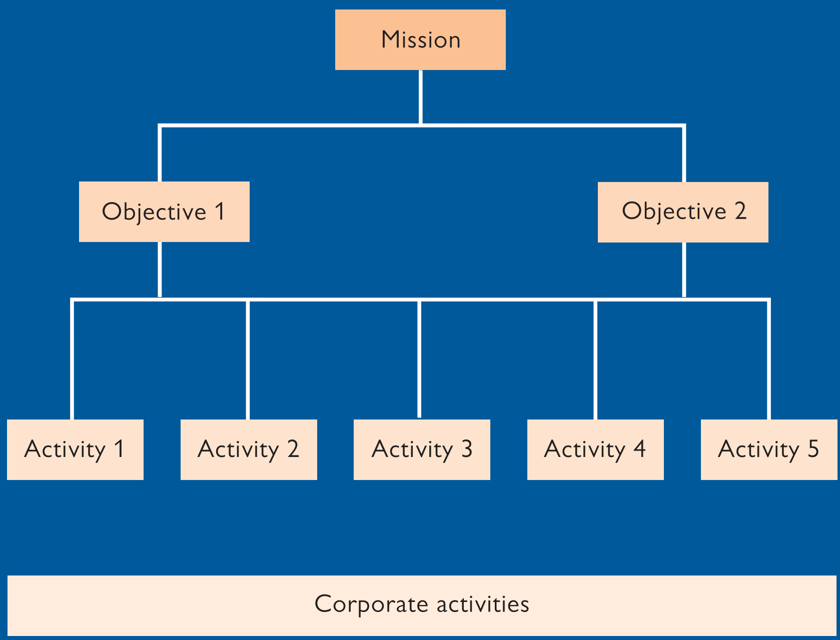
Diagram 1
Objectives link directly to activities



practical management tools. To be useful, a strategic plan must be grounded in the real world of the business's day-to-day activities; it must also look forward to where the business wants to be in future, and how it will get there.

An organisation's objectives need to have concrete, measurable outcomes. As Robert S. Kaplan and David P. Norton said in their article 'The Balanced Scorecard: Measures that drive Performance' (Harvard Business Review 1992): *What business managers measure is what business managers get*.

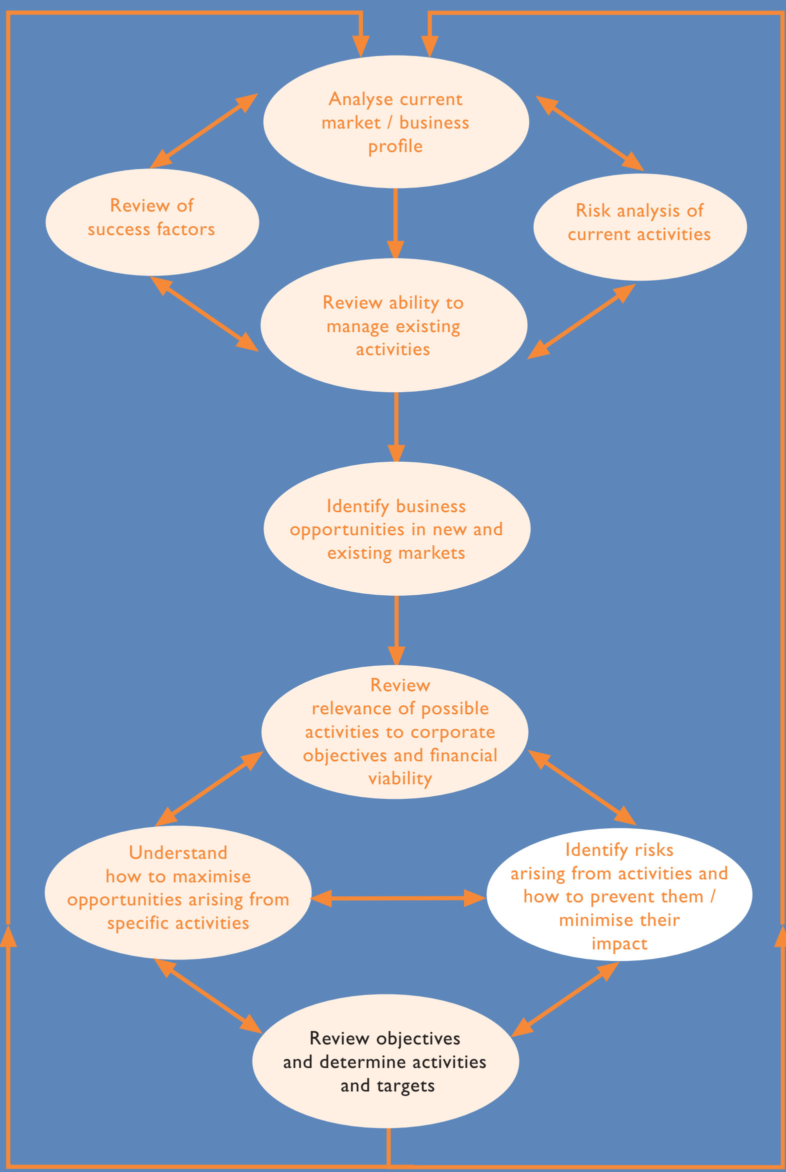
Measurable outcomes are achieved by ensuring that every objective links directly to the activities that arise from it. Without this, strategic planning is little more than a vague aspiration. (See illustration at Diagram 1.)

Strategic planning

Identifying and measuring risks at the planning stage enables business managers to assess two things: whether an activity is the best way to achieve a given objective, and whether the objective itself is sensible. In this way managers can form a comprehensive and relevant strategy to plan and manage the activity. This is illustrated in Diagram 2, which shows how risk identification is an ongoing part of the business planning and review process.

This process is particularly important for housing associations, which may have social objectives but nevertheless have to make capital and revenue budgeting decisions now, faced with a changing regulatory environment and the need to remain financially viable. The need to understand risks arising from the planning of specific activities is analysed at insert 1.

Diagram 2
Risk identification in business planning and review



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Effective strategic planning: Understanding the risks arising from planning specific activities

A housing association has an objective to provide support services for local people. The association is considering taking on a number of residential care homes for the elderly to meet this objective.

However, the association has identified that these activities could give rise to significant financial deficits, as a result of high staff costs and uncertain revenue from local authorities. In addition, the association believes that difficulties recruiting qualified staff could also result in bad press coverage that could lose it business.

As part of strategic planning for this activity, the association will need to judge the likelihood that these risks will materialise, the ability to prevent them and the severity of their impact. This will enable the association to make an

> *informed decision about whether to engage in the activity. If it decides to go ahead, the association will need to form a strategy for the terms on which it will enter into the business and how it will manage identified risks in order to maximise the social benefits and minimise the financial risks.*

Controlling the business

By focusing risk identification on specific business activities, managers are testing whether the organisation's high-level vision of where it should be heading is practically achievable. As they examine each activity in more detail, managers can start to explore the specific reasons why it could fail. This leads automatically to a full analysis of the areas where managers need to concentrate efforts and resources to prevent identified risks from materialising and manage the consequences of those that do.

This approach demands concentration and thoroughness. It introduces a discipline to risk identification that brings significant benefits to the management and control of the business. The process is useful because it links each risk directly to its specific causes. As a result, areas where actions may be needed to prevent a risk from materialising are automatically identified. It enables business managers to review the business from the top down and to challenge how the business is planned, run and reviewed.

The process of risk identification requires managers to ensure that for each activity all the following areas are effective:

- organisational structures;
- terms of reference and delegated authorities;
- strategic decision-making and review processes;
- policies and procedures and their implementation and review;
- human-resources issues;
- financial planning, budgeting and performance monitoring; and
- information-technology issues.

IDENTIFYING RISKS

The aim of risk identification is not to produce a long, unstructured list of risks that has no practical use. Instead, it is to highlight the key risks facing the business and determine the most effective levers for preventing them materialising or managing their consequences if they do.

A successful and rigorous approach to risk identification should incorporate the following elements:

- It must be driven by senior management and the Board.
- It must involve all stakeholders in the organisation.
- It must be firmly rooted in the actual activities of the business.
- It must be logical, and consistently applied across the entire business.
- It must take nothing for granted.
- It must result in quantifiable outcomes if the risk is financial.
- It must be a dynamic process that grows with the business.

Let's examine these in more detail.

Driven by senior management and the Board

It is essential that senior managers and the Board are involved with risk identification for a number of reasons:

– To ensure that senior managers have agreed the purpose of the risk-identification process.
– To emphasise the strategic impact of risk on the long-term success of the business.
– To facilitate the link between risk identification and strategic planning, ensuring the two processes are inter-related and complementary.
– To help establish a culture of risk awareness in the organisation.
– To ensure that the process gives people the authority to challenge accepted practice and wisdom about where risks lie and how they should be managed and controlled.

Risk management is about running the

business successfully. Senior management must therefore take responsibility for establishing the outcomes that could cause the housing association to fail. Such outcomes could include, for example, 'failure to meet financial targets' or 'failure to meet a specific objective'. This approach enables everyone in the organisation to assess the material risks arising from individual activities in a consistent way, with a focus on specific corporate areas of concern.

Involve all stakeholders

While risk identification needs the support of senior management, it cannot be an exclusively top-down process. The people with day-to-day responsibility for running the business are likely to have key insights about what could go wrong. It is important to tap this expertise.

Stakeholders' detailed knowledge of the areas of the business they represent must nevertheless be considered in the light of other factors as specific activities have strategic implications on the business as a whole. There must also be authority to question existing practice throughout all areas of the business.

Be rooted in the actual activities of the business

Risks, whether caused by external or internal drivers, arise from the specific activities that a housing association undertakes to meet its objectives. These activites consist of a mixture of external customer-facing activities and corporate activities. So the actual or planned activities of a housing association should always be the starting point for risk identification. This approach also enables managers to understand which activities are critical to long-term success. The need to link risk identification directly to specific activities is examined in insert 2.

2 *The need to link risk identification directly to specific activities*

An association entering the market for student accommodation for the first time is exposed to a completely new set of risks. These may range from misjudging market demand, income that can be generated from schemes or the cost of managing properties. Likewise, an association that runs its own property-maintenance department faces a different set of risks to one that outsources this service. When assessing such activities it would be inadequate to apply a standard set of assumptions derived from evaluating the association's social-housing activities.

Be logical and consistently applied

A risk-identification process is useless if it is not thorough. However, without a focus, risk identification can bring its own problems in terms of the volume of information produced. To generate a really useful and focused outcome, it is critical to assess the relationship between identified risks for each activity, e.g. by grouping similar risks arising from a specific activity. This ensures that the association understands the sequence of events that could cause a risk to materialise and that it uses information to form a clear insight about the actions needed to prevent or manage the risk. The benefit of grouping similar risks arising from a specific activity is shown in insert 3.

3 *The benefit of grouping similar risks arising from a specific activity*

An association might identify the following risks relating to market rented schemes:
1. Occupancy rates lower than expected.
2. Failure to generate sufficient surplus to make interest payments.
3. Build quality is low compared to other available properties.
4. Failure to assess demand from specific client groups.

At first sight, risk 2 is the most striking because it could directly threaten the viability of the activity and potentially of the association. But risk 2 cannot be directly managed. A more logical arrangement of the list leads to the insight *that risk 2 is caused by risk 1, which is in turn caused by risks 3 and 4. And risks 3 and 4 are, at least in part, within the association's power to manage. Armed with this information, the association can now devote time and resources to ensuring that build quality is up to the standards of competitors and that it assesses demand from specific client groups for market-rented schemes.*

Take nothing for granted

A risk-identification process does not start with a blank canvas. Associations have all considered risks before at some level and designed controls and procedures to prevent or manage them. Often it is tempting to dismiss certain risks as irrelevant because they are already controlled. This should be resisted: managers should assess the effectiveness of the control environment itself as part of the risk-identification process. The control environment may be inadequate for two reasons:

- Controls may not have kept up with the development of the business. A property repair service, for example, may have been established for tenants that are unable to move readily to another landlord. It may become inadequate if an association enters a market where tenants are more likely to move on if the service does not meet their expectations. The association could face falling occupancy levels that its procedures had previously been adequate to prevent.
- Existing controls may not be focused on the right lever. For example in insert 3 about market-rented activities, the association may have spent a lot of time designing financial controls for rented social housing but failed to design relevant controls around the underlying business drivers for market-rented housing – in this case, build quality and demand from specific client groups.

Produce quantifiable outcomes if the risk is financial

It is no good identifying a risk in the abstract. For the risk-identification process to yield useful information, the association needs to quantify the impact if the risk materialises. This enables managers to prioritise the human and financial resources needed to prevent those risks that could have a significant financial impact on that activity's performance and on the business as a whole.

Be a dynamic process

The final feature of a successful risk-identification process is that it is not one-off. It needs to develop as the business develops and should be revisited and challenged regularly. There are a number of reasons for this:

- The profile of a business is dynamic. Business decisions lead to new activities and successful marginal activities may grow to become central. Even if the organisation is not actively seeking new opportunities, its operating environment can change as a result of economic, demographic or regulatory factors.
- Organisations can become complacent, imagining that because they have been through a rigorous risk-identification process once, they don't need to worry about risk again. All parts of the business should be challenged periodically to check that old assumptions still hold and that received wisdom remains valid.
- The process should be used to assess the relevance and viability of individual projects and test existing business assumptions.

It is sensible to revisit the risk-identification process as part of the yearly planning cycle. However, major new business initiatives also merit a review of risk.

Some parts of the business are more dynamic than others, while some are the subject of regulatory review that may affect future strategy. These will require a more active reassessment of risk. Knowing how much resource to devote to reassessing risk for each activity is in itself a business decision that merits careful evaluation.

Diagram 3
Supported Housing: scheme closure
Assessment of improvements needed in approach to risk management

Example of cause of scheme closure	Arising from, for example	Identified necessary controls	Adequacy of existing approach
Increased voids	Care standards are perceived to be lower than competitors	■ Twice-yearly analysis of competitors ■ Quarterly review of the adequacy and effectiveness of quality-control procedures	■ No formal analysis is conducted ■ An annual review is performed, but it is not linked to a review of market standards

PREVENTING AND MINIMISING RISKS

Identifying necessary actions

Having identified risks and the main events that could cause them to materialise, managers can focus on taking practical actions that address those causes directly. This involves assessing whether managers are currently doing everything needed to prevent identified trigger events.

Managers should ensure they are taking action at all levels of the business to prevent or respond to each event and its causes, down to the most specific detail. Nevertheless, they should prioritise resources towards preventing those events that would have the biggest impact. This requires subjective judgements based on knowledge and understanding of the issues.

It is important to challenge the way that people currently manage risks. The aim is to improve performance wherever possible. Managers may find that the current response to a risk does not cover all the trigger events they have now identified. Current controls may not be completely adequate. To help managers form a clear idea of how likely the risk is to materialise, it helps to combine the assessment of:

- whether a risk is within the association's ability to control; and
- the adequacy of current controls.

Insert 4 examines the need to translate identified risks into practical actions to prevent them or to manage their consequences.

> **4** ***Translating risks into practical actions to prevent occurrence or manage their consequences***
>
> *Risk: Scheme closure leading to failure to retain supported housing business. Managers need to consider what the association needs to do to control the identified causes of scheme closures and whether improvements in their overall corporate approach to this risk need to be made. See diagram 3 above.*

Taking appropriate actions

Having assessed the effectiveness and relevance of their current strategic and operational management approach and of their control framework, managers can now form an action plan to improve the planning and management of each activity. Action plans need to be practical, with clear timeframes, and allocate clear responsibility for defined actions. It is also critical that managers apply relevant ways of measuring the success of individual controls and can adapt them to respond to changing markets if necessary. Managers also need to establish a contingency plan for those material risks where they believe that controls are currently weak or that the risk is external and therefore beyond their control e.g. a property market slump causing a fall in demand for shared-ownership properties.

Managers need to understand how they will manage the consequences of such a risk if it materialises. They will also need to examine whether they can take any actions to mitigate actual or future losses and prevent other knock-on risks such as loss of future business.

CONCLUSION

Risk identification is a critical tool to help plan and manage all aspects of a housing association's business, from objective setting and business-plan review to establishing and reviewing the effectiveness of controls. In this way, risk identification should result in associations changing their business approach to reflect their activities and their ability to manage the risks arising from those activities.

SUMMARY

Risk identification should be a core part of effective business planning and management. It should provide a check on the relevance of activities to objectives, improve strategic planning and facilitate the design of a robust and relevant control structure.

A rigorous approach should be driven by senior management and the Board, involve all stakeholders and be rooted in actual business activities. It should be logical and consistently applied, take nothing for granted and result in quantifiable financial outcomes. It should also be a dynamic process that grows with the business and informs strategic and individual investment decisions.

The Author

Caroline Shah is an independent expert in corporate governance, strategic planning and risk analysis. She works with housing associations at board and management level to develop a meaningful approach to business planning and risk management. Caroline is the author of Effective Risk and Business Management, published in 2000 by the Housing Corporation. This study identifies the elements of a risk management framework that will help housing associations to run their businesses effectively and meet the viability requirement of the Regulatory Code.

Caroline was a member of the Government's Policy Action Team looking at the role of business in deprived communities. She also sat on the steering committee for a National Audit Office report on Housing Corporation's approach to regulating housing associations' management of financial risk.

Caroline worked for a rating agency and in international banking for 13 years. She has a degree from Oxford University.

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