Dangerous adventures for HR: Managing strategic risk

By **Andrew MacLennan**

People in organisations are a bit like nuclear material – potent. Managed effectively, they have the power to deliver fantastic results. Mismanaged, their impact can be catastrophic.

The current financial crisis is a reminder of how things can go horribly wrong very quickly in business. Not that we should need a reminder. Events like the nationalisation of Northern Rock or collapse of Lehman Brothers look less shocking against historic commercial disasters and scandals involving names such as Enron, Kmart, WorldCom, Financial Corporation of America, Polly Peck, Pan Am, BCCI, Barings, Texaco and the Maxwell Corporation.

As the number of large-scale business failures steadily grows, it becomes clearer that such disasters have varied and complex causes. In some cases, inexcusable criminal activity occurred. In others, basic management controls failed. Sometimes, more sophisticated forms of governance were needed but did not exist. Sudden environmental changes (some of which probably should have been anticipated, others of which could not have been) have also played their part.

Many of these organisations were probably a bit unlucky – to have been caught out or caught short when they were, not have spotted problems earlier and not to have been able to recover the situation in time. As some would wryly observe, some were unlucky not to have been part of a nation's critical banking infrastructure and as such, worthy of government bail-out. Conversely, many organisations that encounter problems are lucky to survive, some of the aforementioned pressures only decimating performance, rather than killing off the enterprises affected.

However, every business disaster has one thing in common – people. People make decisions that have irreversible consequences and people do things that place organisations in jeopardy. Managing the risks associated with people in organisations is a huge challenge for which all managers must take some responsibility. HR is better positioned than most to take the lead. "We already do," might be the response of some HR Directors, but history colourfully demonstrates that there is little room for complacency. Indeed, success itself can be 'blinding'[1].

Strategic risk management is a relatively recent notion, developed in recognition that risk management has conventionally been operationally-focused and fragmented. Lots of organisations could claim to be good at managing liquidity risk, credit risk, health and safety risk or regulatory risk, for example. However, very few could claim to have an integrated, organisation-wide view of risk and how it provides both opportunities for and threats to the achievement of strategic objectives. The science of strategic risk management is still in its infancy, and even the experts are still finding their feet.

Perhaps the biggest challenge faced is risk interdependency. In large or complex organisations, no one individual, process owner or function has full knowledge of the business, let alone the insight to predict how its systems might interact in unintended ways. Very diverse risks can arise. Businesses have been destroyed by big decisions by boards and illegal actions of errant Chairmen. So too have they been irrevocably damaged by the everyday and perfectly legal behaviours of salespeople working within poorly designed reward systems.

HR functions naturally focus on obvious risks – the trustworthiness of new recruits, certification for regulated work, succession planning and so on. These areas can certainly create huge risks[2]. But many other organisational risks are much subtler. They stem from systemic processes, designs and decisions – in which HR is often involved.

How can organisations approach strategic risk management and ensure organisations handle their most potent asset with appropriate care? Here are five key suggestions.

1. Use a well integrated strategy process

Risk management cannot be compartmentalised or treated as a bolt-on activity. Responsibility for it has to be shared across organisational boundaries. For that reason, it's vital that a robust strategy process is in place to bring together insight from across the organisation and ensure that the right issues are addressed to identify strategic risks. This sounds easy enough but in practice can be a complex process and is rarely completed effectively.

A lot of organisations simply don't have a well-developed strategy process that incorporates the data collection, analysis, options development, decision-making structures and detailed planning necessary to translate ideas into action effectively. A strategy process is much more than a series of meetings between specified groups to produce some outputs. What they must decide and how they go about it is what really matters.

Another major weakness in many organisations is that the strategy process is not owned and driven by a senior executive with a dedicated professional team. Accountability for the strategy process sometimes cannot be located at all, or might be buried deep in the Finance function where it is adjunct to the budgetary planning cycle. This just does not work. No corporate Chief Executive can claim to be managing strategic risk without a good strategy team, headed by a member of the executive team. This is an issue HR functions can help to address through careful organisation design and resourcing.

A third problem is that the strategy process is often too narrowly focused, being limited to strategic planning only. Complex organisations also need an explicit framework to guide the execution of strategy, systematic change and programme management and a performance measurement system that is integrated with these. And, of course, risk management needs to be addressed throughout these components.

2. Clarify and communicate strategy effectively

Many serious but preventable problems affect organisations not because they arise suddenly, but because their implications were not understood by those in a position to detect the risks. The proportion of employees who truly understand the strategy of their organisations is typically alarmingly low. Without them having an understanding of strategy, it's not reasonable to expect people to spot risks that relate to it. So helping staff to understand organisational strategy – and interpret its implications for them and the implications of their insights for it – is an essential challenge.

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Involvement in the strategy process is one way of doing this – and is essential to ensure executable strategy and associated commitment[3]. However it alone won't do the job for large swathes of employees. It's important to develop ways to communicate strategy concisely and show how conceptual objectives are to be achieved through concrete activities. Creating this 'line of sight' is critical if individuals and teams are to work in concert and make the kind of informed trade-off decisions their leaders would. Good 'line of sight' enhances the motivation as well as performance of individuals[4]. HR functions can have an enormous positive influence on strategy through focusing upon how it can be crafted and communicated to ensure wide understanding and commitment.

3. Use performance measurement wisely

As mentioned earlier, an integrated performance measurement system is central to the process by which strategy is developed and implemented and the associated risks managed. But measures are a potent force and need designed and used with great skill and care.

Performance measures do two things in any organisation. They provide useful feedback, helping to explain past performance, and generate 'feedforward', which occurs when people's behaviour alters because their attention is directed to the specific performance variables that are measured. The late Peter Drucker, described by many as the father of management, said over 50 years ago that "what gets measured gets managed". He was certainly right, pinpointing how powerful performance indicators can be. However, Drucker might also have added "...but not necessarily in the way you'd like". Inevitably, unintended effects occur. Countless managers, albeit with the very best of intentions, misinterpret the performance of their organisations (using measures for feedback) and cause performance problems by setting measures poorly (because of feedforward). Measurement is a complex science, and it is all too easy for teams and whole organisations to 'march off cliffs'. HR functions can play a central role in improving measurement, not least through their involvement in performance management.

4. Target and reward cautiously

As highlighted in a previous article in this magazine[5], there is no sound empirical evidence supporting the use of performance-related pay, but a great deal to show how it often creates negative unintended effects. The interaction of the strategy process, performance measures, target-setting systems and reward structures is a great example of risk interdependence in action. These organisational components often combine to create outcomes nobody desires. These (relatively foreseeable) risks have fuelled occurrences of health and safety breaches, disastrous under-pricing, illegal price-fixing, non-compliant regulated sales, options backdating, 'pump and dump' of stock, fraud and many other more mundane games that destroy sustainable value. Reward systems cause regular headaches for those seeking to implement strategy because they create so many serious risks.

Organisations only have to look at the wide range of groups involved in the reward process (but rarely cooperating closely) to see the scope for risks to arise. Line managers know what they need to achieve but not much about reward system design. Reward specialists typically understand pay inside-out but know little about strategy implementation or performance measurement. External pay specialists have a huge incentive to keep reward systems unnecessarily complex. Plausible alignment between pay and performance and the avoidance of unacceptable risk is simply implausible under such conditions.

5. Systematise the way HR adds value

One of the greatest strategic risks confronting HR functions is largely of their own making, though it is another subtle one. For many, 'strategy' within HR means a plan outlining streams of business-supporting activities such as resourcing, development, performance management, employee engagement, reward and benefits and so on. This is fine, provided that such activities are genuinely aligned and designed to help the organisation achieve its objectives. In fact, the 'people strategy' might best simply be configured as part of the business strategy.

However this is not enough. What a people strategy does not articulate is the way in which the HR function operates and interacts with the wider organisation to add value. A people strategy summarises how the organisation should manage people and the implications this has for HR's work. It doesn't explain how HR should help the organisation select these priorities, or how HR will go about delivering its responsibilities.

HR functions need more than people strategies. They need strategies for themselves that precisely articulate their roles and the way they work, to maximise their impact. Without this clearly laid out, there is an enormous risk that HR is doing things right but not doing the right things. In short, why does the organisation need its HR function? What value does it add, and how?

Failing to distinguish the content of HR's work from the process by which it is determined and delivered can be catastrophic. HR's modern enthusiasm to 'partner' the business is pursued for the right reasons but has an associated risk. When HR professionals work within the systems their business colleagues do, they are more likely to adopt common frames of reference and be motivated by the same drivers. Under such circumstances, HR's inadvertent contribution can be to reinforce the dysfunctional systems that push organisations towards catastrophic failure. Being an effective strategic partner means using that human

potency to challenge norms and spot the strategic risks quietly stalking the organisation. Sometimes the best partner is one who can step aside from the stampede to an obvious position and suggest a different approach or a different pace. HR needs a well designed way of doing that.

Risk is not inherently bad and poses as many opportunities as threats. But it does need understood and managed and HR has a central role in doing this. In the words of Ralph Waldo Emerson, "It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it."

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