

# Strategic risk:

## Can it be measured?

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### **Abstract**

Strategic risk is hard to measure. One of the reasons is definitely that there was no direct regulatory requirement in the banking industry. Other industries are not so regulated, although the corporate governance requirements focus on risk management as well.

Due to the strong focus on pillar I and the risk capital calculation for the various risk categories: credit-, market and operational risk, the requirements as defined in pillar II were not in the main project streams in banks. In pillar II the so called internal capital adequacy assessment requirement process is described. Except for the risks defined in pillar I also the not quantified risks like strategic and reputational risks need to be considered as well. Most of the time a kind of a lump sum calculation is made.

From an internal risk management perspective such an approach is to be seen as insufficient. It is expected, that at least a qualitative assessment is already required in pillar II to underpin the risk capital amount considered. In this article a first attempt is made to decompose strategic risk in order to learn about the risk by identifying, assessing and aggregating the strategic risk components.

### **Introduction**

Compared to operational risk strategic risk has also various dimensions with low commonality. The measurement of such risks requires a considerable amount of data resulting from various data sources.

Strategic risk is considered as a risk, which may jeopardise a firm more seriously as any other risk type. Some examples of strategic risk can be given:

- A company buys another company is the expectation that the products of both are complementary, but expenses can be saved. Afterwards it appears not to be true. In such cases goodwill amounts need to be written off (the company paid too much for the other one)
- A company is not really innovating and therefore loses its market. For example a large photograph retailer did not adequately react on the upcoming digital photography and therefore lost customers and contribution margin over time
- Competition is changing. In most cities small retail companies have been absorbed by bigger retail organisations or were forced to terminate their business due to lost customers
- New products are substitutes for other ones: nobody is

currently buying typewriters anymore, since almost everybody is using a personal computer for writing.

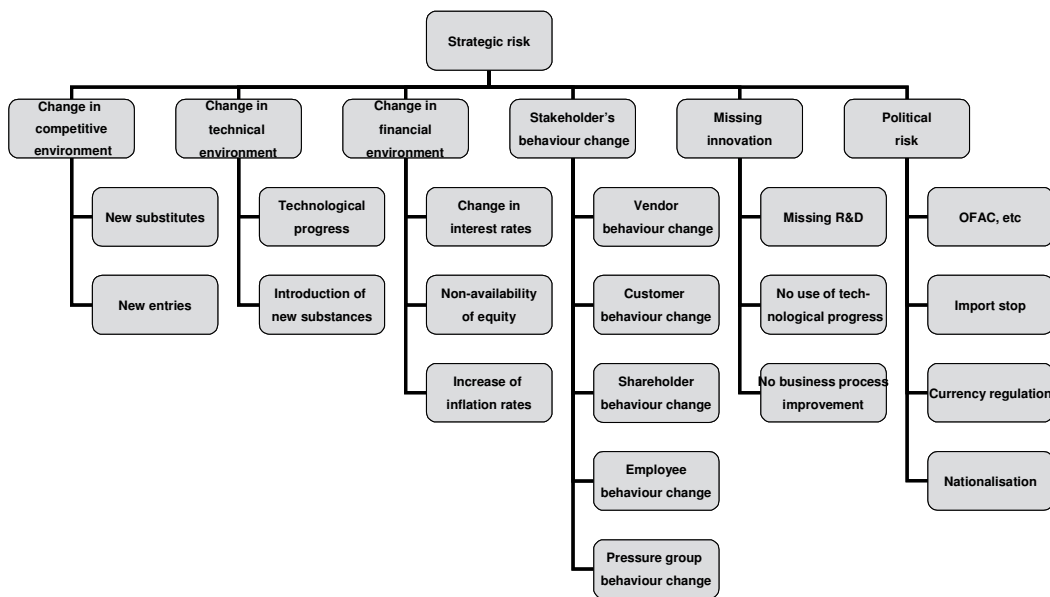
the company is not able to recover itself as soon as such a risk materialises.

All these examples show, that the effects can be quite seriously: the existence of the company is at least endangered. In some cases

### Strategic risk taxonomy

The following risk categories can be distinguished regarding strategic risk:

### Strategic risk taxonomy



The strategic risk taxonomy shows a broad range of various risks, which do not show the same behaviour. Changes in a competitive environment do not have the same frequency patterns as for example the risk of missing innovation. In this section each risk type on the first level is briefly discussed.

#### Change in competitive environment

Changes in the competitive environment contain both new market players entering the battle field and new products coming to the market. It is quite interesting to see, that markets

sometimes ignore new participants for a while, since they are deemed too small to become a real risk and they are considered to be condemned to fail. This was the case which dominant market players like Microsoft. In some cases, the effect was not so dramatic, but still considerable: ING DiBa was not a big player in the German retail banking market for a decade, but now the bank shows an interesting number of more than five million customers. The reaction of the other banks was too late. Some of them believed too much in the customer's

loyalty, which was not really given in the end.

### **Change in technical environment**

Technical improvements sometimes change economic paradigms. It was believed that economies of scale were the answer to the problem of falling margins. In such cases cost leadership was achieved for. However, a number of companies became capital intensive and were therefore less flexible. As soon as smaller solutions came up, which were able to produce at at least the same low cost levels the bigger production environment were endangered. The investments in smaller solutions were less and therefore the firms using such solutions became more flexible, which allowed to quickly react on (unexpected) the changes in their environment.

### **Change in financial environment**

This category is well known, however it is interesting to focus on the availability of owner's capital. It is currently relatively easy to receive owner's equity in a EUR 5 mn stake. But if the company likes less equity most investors reject, since the cost of handling is higher than the expected return. This problem was faced by a number of German SME-companies after the introduction of Basel II credit ratings. Those companies were traditionally heavily financed, since the capital market was not really developed in Germany. At the same time the financing cost increased due to higher credit spreads required based on a more risk oriented pricing.

### **Stakeholders behaviour change**

Customers and non-customers may change their behaviour regarding the company or its products. Sometimes public pressure comes on the company since their products or even research is no longer appreciated (like bio-scientific companies). The customer sometimes also changes his behaviour, e.g. the hype for low-fat or low-carb products have put some conventional products in the back.

### **Missing innovation**

Missing innovation causes serious problems over time. Depending on the product life cycle, it may take considerable time before the company is suffering from the negative effects. The example of the photograph retailer showed the problem.

### **Political risk**

Political risk is an issue in case of instable governments or influence of other governments in the jurisdiction in which the company acts.

Strategic risk management is still in its early stages even in the financial markets industry. It may be caused by the regulatory requirements, which are not so many as in the case of other risk types. However, the risk can not be omitted in the case of an enterprise risk model. It is also the case for banks and insurance companies in current regulations regarding the internal capital adequacy assessment process, which need to be adhered to already in many countries.

In a coming article the assessment of strategic risk is discussed.

## **Literature**

Kaninke, Mark, **Analyse strategischer Risiken**, Bankakademie Verlag GmbH, Frankfurt am Main, 2004

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