

## Real-world Risk Management

In an increasingly unruly global economy, companies need ways to guard investments, reduce threats and build a competitive edge. Yet just 39 percent of executives in a recent survey said their organizations had strong risk-management cultures.<sup>i</sup> It's not difficult to see why companies feel like they can scrape by with the bare minimum. If risk management is done right, its ROI remains largely invisible—until a crisis rears its ugly head.

Whether it's an IT glitch halfway around the world or a hurricane bearing down on their project site, project executives must be aware of—and prepared for—dangers both small and large. When companies don't understand the risk scenario, their entire project portfolio is left exposed.

"Risk management is what helps you identify the potential crisis that will cause your schedule to fall apart," says Kevin Lyday, director of information resources at the Centers for Disease Control and Prevention (CDC), Washington, D.C., USA. "Without effective risk management, the difference between what you think you'll achieve and what you end up with are often significantly different."

To be sure, project managers and their team members must assess the risks to an individual project and adjust forecasts, tasks and

processes accordingly. But risk management at the project level isn't enough. The most effective risk-management processes go beyond individual projects and take root at the portfolio level. Only by examining the intertwining relationships between projects and business objectives can opportunities—and risks—be accurately gauged.

"There are many tradeoffs that need to be properly understood in order to set priorities and ensure that projects will be successful," says Mário Henrique Trentim, PMI-RMP®, PMP®, director at iPM Consult, a project management training and consulting company in Recife, Brazil.

"Using risk management best practices prevents future project problems and helps companies focus on what is really important, which results in better use of resources and efficiency," he explains.

Senior management may be beginning to see the light. **A full 96 percent of global executives believe their risk management could be improved**, according to an Ernst and Young survey.<sup>ii</sup> Almost half of those respondents felt that investing in stronger risk-management practices would help them achieve greater competitive advantage.

The increased awareness of the need for better risk management comes as companies must contend with an especially tumultuous business landscape. More than 63 percent of executives interviewed for the *Report on the Current State of Enterprise Risk Oversight—2nd Edition* reported the number and complexity of risks their organizations face has changed "extensively" or a "great deal" in the last five years.<sup>iii</sup> The researchers also found that **39 percent of executives admit they were caught off-guard by risk events that impacted project success "extensively" or "a great deal."**

"These findings suggest that weaknesses in existing risk identification and monitoring processes may exist," the report authors wrote.

Many organizations are increasingly turning to project managers who have carved out solid track record in risk management and who hold a PMI Risk Management Professional (PMI-RMP)<sup>®</sup> certification.

**"Having project managers with risk management skills and the PMI-RMP<sup>®</sup> certification brings strategic benefits to the organizations because they create a new environment of project management aligned**

**with our fast-changing world,”** says Mr. Trentim. “Skills and certifications show that these professionals have good understanding of risk and they are able to keep risk under control.”

## In the Balance

To effectively assess and manage risks across the portfolio, executives must first define their organization’s risk appetite: the degree of uncertainty they’re willing to accept if a project falters or fails, and how much of their investment they can tolerate to lose if the worst-case scenario occurs.

They must also consider whether the portfolio has the proper complement of high-risk and low-risk projects. To define and maintain this delicate balance, they need risk-management processes implemented consistently and thoroughly at the portfolio level.

Looking at the sum of the risks across the entire portfolio creates a very different picture than looking at the individual parts, says Sam Savage, consulting professor at Stanford University in Palo Alto, California, USA and author of *The Flaw of Averages*.

**“Every project investment involves risk,”** he explains. **“But if you understand the relationship between the risk and return of all your projects, you can build a portfolio that balances those risks.”**

Failure or success in one project will inevitably impact other teams and initiatives. One project crashing, for example, can throw another one wildly off track by depleting resources or changing the short-term priorities of the organization. “How the risks are interrelated is a huge issue,” Mr. Savage says.

He and his team built an interactive tool for the senior

management team at Shell International to illustrate the risk across the petroleum giant’s exploration projects. The goal was to show executives how changing or eliminating one project from the portfolio altered the organization’s entire risk profile.

**By diversifying the portfolio, companies can hedge their risks through other projects.**

For example, the Shell portfolio might have two discovery projects focused on meeting the oil needs of the European Union (EU). One project, in Russia, has higher risks due to political and infrastructure issues, but the potential payoff is attractive because the cost of labor and taxes on oil are low in that country. The second project, in Norway, has fewer risks, but the costs are substantially higher because of labor, taxes and the remote location of the oil, making the potential ROI lower.

Each project on its own has a very different risk/reward profile, but when you put them together the risk picture changes. If, for example, the Ukraine blocks oil delivery to the European Union, the Russian project is jeopardized. But the move would also force up the price of oil in the European Union, making the Norway project more appealing.

**Seeing how projects are interconnected and how events in one area could impact others helps companies maintain a properly balanced portfolio that can better absorb the financial impact of a failure.** Instead of focusing on how one project had a setback, it can be put in a greater context of business opportunities.

## From the Top

Awareness of opportunities to improve the way projects are chosen and managed stretches up to the highest levels of organizations. According to the *Enterprise Risk Oversight* report, 45 percent of respondents said

their boards of directors are demanding senior executives increase their involvement in risk oversight when it comes to the projects they choose to invest in.<sup>iv</sup>

But most executives don’t have the full story on their risk profile. That same report revealed that even though 43 percent say that their risk exposures are considered “extensively” or a “great deal” when evaluating new strategic initiatives, 53 percent of organizations conduct no formal risk assessment.<sup>v</sup> And **although only 15.5 percent have formal guidelines on how to assess the probability or potential impact of a risk event, 60.5 percent believe risks are being effectively reviewed and monitored.**

“This is when problems arise,” says David Rowe, recently retired executive vice president of risk management at SunGard, an IT services firm in London, England.

When executives don’t formally assess the risks in their portfolio and make decisions based on that risk picture, they can end up with an unbalanced portfolio that puts the entire organization in jeopardy. **“If you are not careful about how you choose the projects in your portfolio, you may be living with greater risk than you realize,”** he says.

Truly effective risk-management can only occur if it’s promoted from the highest levels of the organization, advises Mr. Rowe. **“You have to have someone at the top driving this way of thinking about portfolio decision-making because you can’t manage risk from the middle.”**

He points to banking giant JPMorgan Chase CEO James Dimon, who backed away from the mortgage market when that part of the industry was still booming. “At the time he received a lot of flack for that decision and the stock prices dropped, but today he looks

like he saved the bank,” Mr. Rowe says.

Such a decision couldn't have been made by a risk analyst or mid-level manager. Even if that person had been able to recognize an unacceptable risk scenario, they wouldn't have had the power to do anything about it.

The same would be true of investing in any high-risk project or program that might make the organization vulnerable. Project managers may be able to identify major risks, but “the big decisions about risk have to be made by the CEO,” says Mr. Rowe.

**Creating open and formal lines of communication between project teams and senior management in the only way to ensure executives have the information they need to make difficult decisions.**

And executives must be vigilant in their risk monitoring. “The correlation between projects and risk changes constantly,” Mr. Rowe says.

**“What’s happening on Project A may have implications on Project B, but you can’t make judgments unless you have accurate project data,”** Mr. Rowe says.

To get that data, project managers and their teams must be given a forum and support to honestly share their concerns about risks. Executives, in turn, have to pay attention—and have the courage to take action.

“It takes a radical mindset to achieve this kind of culture,” Mr. Rowe says.

#### RISK MANAGEMENT IN ACTION

**Company:** Rovi Corp., Tulsa, Oklahoma, USA

**Sector:** Digital media

**Lesson Learned:** Effective risk management takes executive buy-in.

Even in the high-speed, high-stakes world of digital media, implementing robust risk-management practices can take years to accomplish. And it usually doesn't get very far without support from the executive suite, says Kris Reynolds, senior manager over program management at Rovi Corp.

Mr. Reynolds spent two years helping develop a portfolio risk-management process for TV Guide Interactive before the company was purchased by Rovi in 2008.

Executives had been using the system to evaluate whether projects were aligned with corporate strategy, met client needs and were appropriate for the existing business climate.

**“We didn’t just look at the bad things that could happen, we looked at the opportunities of those risks and what we could gain from putting some resources into high-risk projects,”** Mr. Reynolds explains.

But when TV Guide Interactive was purchased, Rovi brought in its own systems and processes. “They are more reactive,” Mr. Reynolds says. And although the company thrived through the recession, he says he believes a more robust risk-management effort would have improved project outcomes.

Mr. Reynolds has been pushing for increased risk management at the front end of project decision-making, and the executive team is beginning to embrace the idea. The company's leadership is bringing more people into the risk-evaluation process and better managing the risks associated with project assessments.

“It didn't happen overnight, but it is happening,” Mr. Reynolds says.

Rather than letting the sales team dictate project schedules, for example, the vice president of operations evaluates project plans

and revises numbers based on realistic outcomes defined by project leaders. And that reduces the risk that project expectations won't be met.

Mr. Reynolds also has a greater voice in determining whether his team has the resources to support potential projects, and if not, to help select the projects in the portfolio that best serve the strategic goals of the organization.

**“By doing risk management across the portfolio, you align all of your projects with the strategies of the business,”** he says. Such alignment ensures companies balance their appetite for risk and improve their ability to take advantage of market opportunities. **“That gives you greater efficiencies, less stress and more customer satisfaction.”**

#### Expect the Unexpected

No matter how balanced the portfolio risk, organizations still must be able to accommodate an unexpected event. From floods to political coups, certain threats may not necessarily be on—or even near—the radar. Executives and their project teams must be armed with a firm grasp of not only what the risks are, but also how they will respond to them to avoid total chaos.

“Some companies just don't see the depth or breadth of the risk they are facing,” says Chris McClean, analyst at Forrester Research, Foster City, California, USA. **“Low-likelihood, high-impact risks that can have a huge effect on the company warrant more time and thought on how to mitigate and control them.”**

Organizations must implement a process to identify those things that cannot be compromised under any circumstances. “You cannot analyze the tradeoff of deadly consequences,” Mr. McClean

says. “You either choose not to engineer it or you put in every conceivable precaution to prevent it.”

Not only does this mitigate the risk, but if the worst-case scenario does occur, the company can demonstrate it did absolutely everything possible to prevent it.

Again, such decisions require senior-level leadership and support, particularly when the decisions impact the bottom line. “You need someone at the top who will accept nothing short of maximum precautions to avoid this level of risk,” Mr. Rowe says.

Without that involvement in the risk-analysis process, shortcuts are often taken that put the entire organization at risk. Look no further than BP. The organization’s failure to manage the threat of its oilrig blowout on the U.S. Gulf Coast was a key factor in putting the global oil giant in a precarious position. In cases like BP, inconsistent portfolio risk-management processes lead to bad decisions that in turn lead to corporate crises, says Mr. McClean.

“When you do risk analysis, you can’t just look at historical data. **You have to consider worst-case scenarios and the impact of interrelated risks if they happen concurrently—like an oil spill during a hurricane,**” he says. “You don’t necessarily have to plan for every scenario, but you have to plan for the results.”

In other words, there may be 100 reasons why an oil spill might occur, but the attention should be on one response plan.

**“Having a standard way to discuss risk and asset exposure across the whole portfolio allows you to prioritize investments and to keep risk at a reasonable level,”** Mr. McClean says. “You don’t need detailed quantities or elaborate logarithms, but risk management does have to

be part of the portfolio decision-making process.”

And those risks must be conveyed across the organization.

**“Risk communication is an important topic because it ensures stakeholders are all on the same page,”** Mr. Trentim of iPM Consult says. This way, if problems do arise they are ready to respond. “When stakeholders understand the importance of risk management, they will work harder to support the process because they understand the consequences.”

#### RISK MANAGEMENT IN ACTION

**Organization:** Centers for Disease Control and Prevention, Washington, D.C., USA

**Sector:** Government

**Lesson Learned:** Up-front planning minimizes the impact of worst-case scenarios.

Tasked with protecting the health and welfare of more than 300 million people, risk management comes with the territory at the U.S. Centers for Disease Control and Prevention (CDC).

And this government agency clearly understands the necessity of **weighing risks, planning ahead, making tradeoffs to maximize resources and limiting the fallout when problems occur.**

In 2009, for example, the agency’s biggest risk turned out to be the H1N1 flu epidemic.

“Every project we had going was frozen in time, and all of those resources were reallocated,” says the CDC’s Mr. Lyday.

It’s not an unusual scenario for the CDC, which is the go-to agency for emergency response to human health issues. Mr. Lyday’s team must **always be prepared for the unexpected.** “We don’t know when it’s coming, but we have a

core infrastructure in place to respond to these events,” he says.

That includes moving resources from low-priority projects to crisis response, and having a communication and response plan in place *before* an event occurs.

**“Whether it’s swine flu, a hurricane or a food-borne illness outbreak, the plan has to be in place to deal with the event before the event happens,”** he says.

Risk management can’t be limited to environmental catastrophes or disease outbreaks, though. The agency relies on a formal multilayered approach consistently applied across the entire portfolio of projects at the enterprise level.

As part of the agency’s portfolio risk-management process, a review team examines how each project aligns with the goals of the organization—and how it specifically delivers critical strategic functions to the organization.

By looking at the whole portfolio, the CDC team can choose those projects with the best risk-reward scenario and make sure they receive top priority.

**“Another risk we must consider is the likelihood of success,”** Mr. Lyday explains. “We may have several projects that are all good ideas, but if the budget isn’t there or we don’t have the human resources, then they won’t succeed.”

#### Risk Leads to Reward

Uncertain economic times understandably make companies wary of taking on too much risk. Many prefer to play it safe—perhaps too safe.

To get an accurate gauge of the risks—and opportunities—across the portfolio, project executives

must probe the details of every project:

- What are the challenges that could impact the project's scope or budget?
- What are the problems that have impacted similar projects in the past?
- How will issues on this project impact others in the portfolio?

With that data, project leaders should then discuss the potential responses to those risks, Mr. McClean says. These conversations should include senior business leaders as well as project managers and other internal stakeholders who will be affected by the project outcome.

Creating a baseline of data also makes it easier to compare projects across the portfolio. **"If you talk about risk in the same way with every project, it's easier to monitor,"** says Mr. McClean.

By encouraging such dialogue, executives have greater control

over the portfolio and its risk-return ratio. They can balance the portfolio accordingly to accrue greater benefits from the risks they do take.

Mr. McClean points to his work with a large construction contractor to develop a risk assessment of its project-bidding process. The company had a win rate of 85 percent when it bid projects, but the bids were mostly for smaller undertakings. In undergoing a risk assessment, the leadership team determined that it was prepared to take on more risk in an attempt to win larger projects.

The company lost more bids, but the deals it did win were bigger—meaning increased revenue in the end.

"This is an excellent example of the **opportunity side of risk**," Mr. McClean says. "If they hadn't had a mature risk-assessment process, they would only have looked at mitigating risks so they could win every deal possible. Instead they

took the more sophisticated approach of assessing the value of taking on more risk."

## Summary

From evaluating the mundane everyday risks involving budget and schedule to high-impact events such as oil spills and terrorist attacks, risk management should be at the core of the decision-making process for every project in the portfolio.

Risk management is quite simply the best way for organizations to protect their assets and make the most of their project portfolio.

"Whether it's adopting a new technology, pursuing a new market or doing more outsourcing," Mr. McClean says, "when you have a mature risk-management process, you can better appraise the value of your risk."

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<sup>i</sup> *Risky Business: Organizational Effectiveness at Managing Risk of Outsourced Projects*, ESI International. Results based on an April 2010 survey of 615 global contractor managers, subcontractor buyers, project managers, senior executives and outsourcing decision-makers.

<sup>ii</sup> *The Future of Risk: Protecting and Enabling Performance*, Ernst & Young. Results based on a June/July 2009 survey of 507 global executives.

<sup>iii</sup> *Report on the Current State of Enterprise Risk Oversight—2nd Edition*, American Institute of Certified Public Accountants and North Carolina State University. Results based on a December 2009 survey of 331 chief financial officers or equivalent positions.

<sup>iv</sup> Ibid.

<sup>v</sup> Ibid.