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MANAGING GROWTH RISK: LESSONS FROM THE CURRENT CRISIS

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The current financial crisis has caused multi-billion dollar losses and broken a long period of strong and steady growth in the investment management industry. Despite the importance of strategic risks, current management practices tend to cope with them poorly, particularly when facing strategic risks linked to growth. Strategic risks are those exposures that materially affect the capacity of a company to survive. By reviewing literature and exploring how the world's top 50 banks recognize strategic risks in their annual reports, this paper highlights that these risks are not adequately perceived by the financial world and draws lessons from the current situation. Furthermore, this paper suggests a clear definition of strategic risk and shows that uncontrolled growth is a major potential source of strategic risk and increases the vulnerability of an organization. Finally, this paper discusses a number of key factors that need to be taken into account to manage growth risk effectively in order to secure sustainable value growth.

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BY

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Biography

Mathias Schmit (m.schmit@sagora.eu or mschmit@ulb.ac.be) holds a PhD in Finance from the Solvay Brussels School of Economics and Management (Brussels), where he is a part-time Professor and member of the Emile Bernheim Research Centre. He has worked in banking and public affairs-related activities since 1995. Currently, he is conducting research and consulting activities in banking and risk management. He is also a regular speaker at major conferences around Europe on banking issues, with a special focus on financial analysis, risk management and strategic risks.

Lin-Sya Chao (lchao@ulb.ac.be) graduated from the Solvay Brussels School of Economics and Management with a major in Finance. Having a special interest in strategic issues underlying the financial crisis, she completed a Master's thesis on the topic 'Strategic Risk Management: The Next Challenge for Financial Institutions', under the supervision of Prof. Mathias Schmit.

Abstract

The current financial crisis has caused multi-billion dollar losses and broken a long period of strong and steady growth in the investment management industry. Despite the importance of strategic risks, current management practices tend to cope with them poorly, particularly when facing strategic risks linked to growth. Strategic risks are those exposures that materially affect the capacity of a company to survive. By reviewing literature and exploring how the world's top 50 banks recognize strategic risks in their annual reports, this paper highlights that these risks are not adequately perceived by the financial world and draws lessons from the current situation. Furthermore, this paper suggests a clear definition of strategic risk and shows that uncontrolled growth is a major potential source of strategic risk and increases the vulnerability of an organization. Finally, this paper discusses a number of key factors that need to be taken into account to manage growth risk effectively in order to secure sustainable value growth.

1. Introduction

The financial crisis has caused multi-billion dollar losses and put an end to a long period of strong and steady growth in the investment management industry. More importantly, the crisis has revealed the weaknesses and unsustainability of the growth achieved by several financial institutions.

Well-known examples include Merrill Lynch's market share push in CDOs, Northern Rock's liquidity crisis, Fortis' hazardous acquisition of ABN Amro, and the disastrous rapid international expansion of Icelandic banks. As apparent from the following Exhibit, which shows extracts from their annual reports, these financial institutions pursued a strategy focused on growth.

EXHIBIT 1: Extracts from annual reports of several banks pursuing a strategy focused on growth

	Northern Rock	Kaupthing	Fortis	Merrill Lynch
2005	"The Northern Rock strategy encompasses efficiency, **growth** and value for both customers and shareholders. […] By growing lending and improving the mix of higher margin products, Northern Rock aims to **grow earnings** and improve returns to shareholders, at the same time as providing innovative and consumer friendly products to our customers[1]."	"In recent years, Kaupthing Bank has been **one of the fastest growing financial groups in Europe**. The Bank's expansion has been achieved through **sound organic growth and a number of strategic acquisitions**[2]."	"There are three strategic axes to the new strategy we launched at the beginning of 2005. […]**Drive organic growth through sharpened customer focus […] Increase focus outside Benelux [and] Seize non-organic growth opportunities**[3]."	"Our goal is simple – […] establish a foundation from which we can continue to **invest for growth in revenues and profits** while producing strong, consistent financial performance; attract and retain top talent; and, above all, add more value to every client relationship[4]."
2006		"**Year of Organic Growth.** Kaupthing Bank reported net earnings of ISK 85.3 billion (€972 million) in 2006, **an increase of 73%** from the previous year. Earnings per share amounted to ISK 127.1, **increasing by 69%** from 2005. Return on shareholders' equity was 42.4% in 2006, which is well above the Bank's long-term target of 15%[5]."	"Our success in the past two years has given us the confidence to **reconfirm and accelerate our strategy of growing** this company into a leading European provider of high-quality financial services[6]."	"Our rapidly expanding franchise outside of the U.S. generated revenue growth of 42% in 2006, increasing non-U.S. operating revenues to 37% of total, the highest proportion in our history. Since 2004, we have announced **more than 30 acquisitions, alliances and other strategic investments to accelerate our growth** across a broad range of businesses and geographies[7]."

SOURCE: Banks' annual reports

These financial institutions made the common mistake of neglecting the strategic risk associated with their growth strategy, whereas this can be one of the most serious causes of value destruction.

[1] *Northern Rock*, 2005 and 2006 Annual Report, p. 1.
[2] *Kaupthing Bank*, 2005 Annual Report, p. 2.
[3] *Fortis Holding*, 2005 Management Report, p. 2.
[4] *Merrill Lynch*, 2005 Annual Report, p. 2.
[5] *Kaupthing Bank*, 2006 Annual Report, p. 5.
[6] *Fortis Holding*, 2006 Annual Review, p. 1.
[7] *Merrill Lynch, 2006* Annual Report, p. 3.

In this turbulent context, the aim of the present paper is to discuss how sustainable growth in the financial industry can be achieved through effective management of the strategic risks. By reviewing the literature and exploring how the world's top 50 banks recognize strategic risks in their annual reports, this paper highlights that these risks are not adequately perceived by the financial world and draws lessons from the current situation. Furthermore, this paper suggests a clear definition of strategic risk and points out that uncontrolled growth is a major potential source of strategic risk and increases the vulnerability of an organization. Finally, this paper discusses a number of key factors that need to be taken into account to manage growth risk effectively in order to secure sustainable value growth.

2. Literature overview

2.1 Definition

Currently, the literature on strategic risk is extremely limited compared to the literature on other types of risk. Moreover, we find a wide variety of approaches, with a multitude of definitions and interpretations of strategic risk.

Jorion (2001) was one of the first authors to provide a definition of strategic risk as the *"result of fundamental shifts in the economy or political environment*[8]*",* thus implying that strategic risk arises from **external sources** and is not under the control of the firm. Similarly, the definitions given by Slywotzky (2005) ["*the array of external events and trends that can devastate a company's growth trajectory and shareholder value*[9]*"*] and Allen (2007) ["*external risks to the viability of the business arising from unexpected adverse changes in the business environment with respect to: the economy (business cycle); the political landscape; law and regulation; technology; social mores; and the actions of competitors*[10]"] take into account only external sources of risks. Although most other researchers follow a similar approach, some also consider internal sources of strategic risk.

STRATrisk[11] (2005), for example, suggests that strategic risks are *"those 'big picture' risks which can destroy shareholder value and even threaten the very survival of organizations*[12]*"* and distinguishes a number of **internal sources** of strategic risk ("Strategy, Structure, Systems, Skills, Staff, Style, Shared Values") from the external sources ("Political, Economic, Social, Technological, Environmental, Ethical, Legal"). Beasley *et al* (2007) also uphold the view that strategic risk can originate from internal as well as external events. While not considering internal sources of strategic risk, Emblemsvag and Kjolstad (2002), for their part, make the link between external and internal factors in strategic risk management. They argue that while many strategic risks may arise from the organization's environment and hence be external, how these external risks are managed is determined by the organization's internal characteristics and competences.

Several researchers highlight the relationship between **strategic risk and the firm's strategy, strategic decisions, and/or strategy implementation.** For instance, Raff (2001)

[8] Jorion, P. (2001). *Value at Risk.* McGraw-Hill, p.3.
[9] Slywotzky, A. & Drzik, J. (2005). Countering the Biggest Risk of All. *Harvard Business Review*, April.
[10] Allen, B. (2007). Strategic risk: The best-laid plans…. *Risk - London*, 20(7), p. 142.
[11] The STRATrisk research project is a collaborative venture between a professional institution, two universities (Bath and Bristol) and industry, aimed at firstly gaining an understanding of how strategic risk is identified and managed in UK construction companies and, secondly, providing a toolkit for company Boards to better understand and manage those strategic risks and opportunities.
[12] *STRATrisk* (2005). Interim report, available at www.stratrisk.co.uk

provides a definition based on strategic decisions: *"All strategic decisions induce and impose constraints on the types of risk banks traditionally monitored and managed. […] Strategic decisions also impose a new type of risk […] which also needs to be analyzed, monitored, and controlled.[13]"* The definition proposed by Emblemsvag and Kjolstad (2002), *"the risks that arise in pursuit of business objectives[14]",* also suggests a link with the organization's strategy. Gilad (2003) introduces the term "strategic risk" to describe factors that can erode a company's ability to implement its business plan and that appear when the strategy does not fit the market reality anymore. Asher and Gale (2007) also uphold this view: *"we define strategy as preparation or investing for success, and for our purposes define strategic risk as the risk that these preparations will fail, or – perhaps more often – that insufficient preparation will be made for optimal decisions in future. We therefore see these risks as a by-product of strategy[15]".* In agreement with Asher and Gale, Mango (2007) defines strategic risk as *"unintentional risks as by-products of strategy planning or execution[16]"*.

Definitions often indicate the potentially **devastating nature of strategic risk**, as in the definitions of Slywotzky (2005) and STRATrisk[17] (2005), both of which present strategic risk as the **risk to the sustainability and viability** of the company. Similarly, in the above-mentioned definitions, Allen (2007) emphasizes the potentially devastating nature of strategic risks (*"external risks to the viability of the business arising from unexpected adverse changes in the business environment[18]"*); and STRATrisk (2005) suggests that strategic risks are *"those 'big picture' risks which can destroy shareholder value and even threaten the very survival of organizations[19]"*. Likewise, Drew *et al* (2005) define strategic risks as those risks that *"threaten a firm's long-term competitive success and survival: risk to its market position, critical resources, and ability to innovate and grow[20]"*.

As shown later in this paper, the lack of a unique and recognized definition of strategic risk plays a key role in its misunderstanding by financial institutions, and hence in its inappropriate management.

2.2 Sources of strategic risk

In addition to defining strategic risk, several authors have classified the sources of strategic risks (see Exhibit 2). Using classic strategic tools, as suggested by STRATrisk (2005) and Allen and Beer (2006), four strategic risk categories can be distinguished: the macro-economic environment (using a PESTEL), the micro-environment (using Porter's 5 forces), the internal environment (using McKinsey 7S framework) and "Others" – which include strategic risks not included in previous categories as well as the SWOT matrix suggested by Emblemsvag and Kjolstad (2002) and Allen and Beer (2006).

[13] Raff, D. (2001).Risk Management in an Age of Change. *Working Paper, Reginald H. Jones Center - The Wharton School (University of Pennsylvania),* p.2.
[14] Emblemsvåg, J., Kjolstad. (2002).Strategic risk analysis - a field version. *Management Decision*, 40(9): 846.
[15] Asher, A., & Gale, A. (2007). Strategic Risk Management: Mapping the commanding heights and hazards. *The Institute of Actuaries of Australia*, p. 2.
[16] Mango, D. (2007). An Introduction to Insurer Strategic Risk - Topic 1: Risk Management of an Insurance Enterprise. *Enterprise Risk Analysis, Guy Carpenter & Company, LLC,* p. 145.
[17] See footnotes 4 and 5.
[18] Allen, B. (2007). Strategic risk: The best-laid plans…. *Risk - London*, 20 (7), p. 142.
[19] *STRATrisk (2005).* Interim report, available at www.stratrisk.co.uk
[20] Drew, S., Kelley, P., & Kendrick, T. (2006). CLASS: Five elements of corporate governance to manage strategic risk. *Business Horizons*, 49(2), p. 128.

EXHIBIT 2: Sources of strategic risk identified in existing literature

Source of SR		Authors									
		Emblems-vag & Kjolstad (2002)	Sadgrove (2005)	Drew *et al.* (2005)	Gilad (2004)	Allen (2007)	Van den Brink (2007)	Slywotzky (2005)	STRATrisk (2005)	Allen & Beer (2006)	TOTAL
Macro-Environment	Political		•		•	•	•		•	•	6
	Economical					•	•		•	•	4
	Social				•	•	•		•	•	5
	Technological		•	•	•	•	•	•	•	•	8
	Environmental								•	•	2
	Ethical								•	•	2
	Legal and regulatory				•	•			•	•	4
Market Environment	Suppliers			•			•	•		•	4
	Customers		•	•			•	•		•	5
	Competition		•	•	•	•	•	•		•	7
	Substitutes			•			•	•		•	4
	New entrants			•	•		•	•		•	5
Internal Environment	Strategy - Projects							•	•	•	3
	Style								•	•	2
	Structure								•	•	2
	Systems								•	•	2
	Staff			•			•		•	•	4
	Skills								•	•	2
	Shared Values								•		1
Others	Brand							•			1
	Stagnation							•			1
	Critical Resources			•							1
	Other stakeholders						•				1
	SWOT	•								•	2

SOURCE: Author's own analysis

Exhibit 2 shows that strategic risks are mainly considered as arising from the external (macro-and micro-) environment and hence not under the control of the firm. In the macro-environment, strategic risks related to technology are the most widely recognized type of strategic risks, followed by risks related to the political, social, economic and legal/regulatory environment. As regards the micro-environment, the most frequently mentioned strategic risks are those resulting from competition, followed by the risks arising from customers and new entrants. Again, strategic risks are seldom considered as arising from the internal environment; only STRATrisk (2005) and Allen and Beer (2006) include internal sources of strategic risks.

This literature overview suggests that strategic risk can arise from a wide variety of sources, making it even more difficult to apprehend and to manage. The next section of this study looks at how strategic risk is defined and managed in the financial industry.

3. A suggested definition of strategic risk

For the purposes of this paper, and working on the basis of our review of the available literature (despite its scarcity and the disparity between the approaches of different authors), we have defined strategic risk as follows:

> *Strategic risk is the risk to the sustainability and viability of an organization as a result of inadequate strategic decisions or improper implementation of strategic decisions by the organization's management body[21], or lack of responsiveness of the management body in relation to the internal and/or the external environment.*

This definition is based on three dimensions: the level, the sources and the impact of strategic risk.

Firstly, following the approach of Raff (2001), we consider that strategic risk arises from inadequate strategic decisions or lack of responsiveness to developments; strategic decisions being decisions taken at a high level in the organization, i.e. at the board of directors and/or top management level. For example, the decision to pursue growth objectives, or to enter into a merger or an important acquisition, is a decision taken at the level of the management body and hence might induce strategic risk. As in the case of Mango (2007), our definition states that the implementation of strategic decisions can create strategic risks; but in our view this is so only if strategy implementation is decided/conducted at the level of the management body. In order to avoid any confusion and overlap, we consider that risks arising from strategy implementation not conducted by the management body should be categorized as operational risks[22].

Secondly, we consider that the sources of strategic risk are both internal and external, as suggested by STRATrisk (2005), Allen and Beer (2006) and Beasley *et al* (2007). This last point is especially important when we remember that internal sources of strategic risk, though often neglected, can be an important cause of value destruction, as shown later in this paper. The Exhibits below summarize the different kinds of factors – in both the internal and external environments – that can induce important strategic risks.

[21] We use the same definition of "management body" as in the CEBS (Committee of European Banking Supervisors) Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), p. 6: "The term 'management body', which represents the top management level of an institution, is used in this document to embrace different structures, such as unitary and dual boards."

[22] Operational risk is defined in Basel II as "the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events. This definition includes legal risk, but excludes strategic and reputational risk."

EXHIBIT 3: Sources of strategic risk arising from the external environment

EVENT-TYPE	DEFINITION	EXAMPLE
Political	Losses due to inappropriate decisions or lack of responsiveness to changes in the political environment: subsidies, government policy, public investment, trade restrictions, tariffs, tax policy, etc.	Governmental decisions not to rescue a major bank
Economic	Losses due to inappropriate decisions or lack of responsiveness to changes in the economic environment: economic growth or recession, inflation, etc.	Inadequate response to the economic recession
Social	Losses due to inappropriate decisions or lack of responsiveness to changes in the social environment: ageing population, population growth rate, cultural trend, etc	No initiative to attract and retain the ageing population
Technological	Losses due to inappropriate decisions or lack of responsiveness to changes in the technological environment: R&D investment, technological shift, automation, etc.	Investment in the wrong new technology
Environmental & Ethical	Losses due to inappropriate decisions or lack of responsiveness to changes in the environmental and ethical environment: climate change, fair trade, etc.	Missed opportunity to offer green investment products
Legal & Regulatory	Losses due to inappropriate decisions or lack of responsiveness to changes in the legal environment: discrimination law, competition law, employment law, consumer law, antitrust law, etc.	Lack of responsiveness to a new regulation facilitating the entrance of non-traditional competitors (ex. MiFID)
Competitors	Losses due to inappropriate decisions or lack of responsiveness to changes in the competitive environment: new competitor, substitute, rising competitor, switching cost, etc.	Retailers beginning to offer financial services
Customers	Losses due to inappropriate decisions or lack of responsiveness to changes in consumer behaviour: buyers' incentives, price sensitivity, brand awareness, etc.	Not realizing that customers are changing behaviour
Suppliers	Losses due to inappropriate decisions or lack of responsiveness to changes in suppliers: forward integration, switching cost, suppliers concentration, etc.	Bankruptcy of one of the main suppliers

SOURCE: Author's own analysis

EXHIBIT 4: Sources of strategic risk arising from the external environment

EVENT-TYPE	DEFINITION	EXAMPLE
Strategy - Project	Losses due to inappropriate decision or lack of decision concerning plans to reach identified goals	Overreliance on a category of customers, decision to outsource a crucial activity, mismanagement of financial aspects of a growth strategy
Critical Resources capability and availability	Losses due to inappropriate decision or lack of decision concerning the allocation and management of the firm's scarce and critical resources: human, financial and technical resources.	Not sufficient training to compensate skills gap, inadequate recruitment process causing skills gap
Structure	Losses due to inappropriate decision or lack of decision concerning the way the firm is organized regarding the hierarchy, communication channels, cooperation, decision-making process, etc.	Lack of coordination between multiple hierarchical layers, inefficient communication channels causing loss of information
Systems and Processes (incl. Models)	Losses due to inappropriate decision or lack of decision concerning internal rules, processes and systems such as remuneration schemes, models (for pricing, valuation, risk management, etc.) and IT systems	Choice of an inadequate model to measure market risk, use of non-precise project valuation model
Style	Losses due to inappropriate decision or lack of decision concerning management and leadership style	Authoritarian leadership preventing participation
Shared Values	Losses due to inappropriate decision or lack of decision concerning values, work ethics and corporate culture	Lack of clear and strong shared values

SOURCE: Author's own analysis

Lastly, in agreement with most definitions found in the available literature, we state that strategic risk can have a devastating impact on the company's value and viability. This destructive characteristic was confirmed in a survey conducted in 2006 by The Conference Board (*The Role of U.S. Corporate Boards in Enterprise Risk Management*), which found that 53 percent of board members believe strategic risk poses the greatest threat to the company, while only 15.7 percent identify financial risk as a key concern. Similarly, Funston's (2004) study of the 100 companies with the largest stock-price losses from 1995 to 2004 concluded that 66 percent of the companies suffered strategic risk while 37 percent were harmed by financial risk.

Having defined strategic risk, we now turn to examine how strategic risk is defined and managed in the financial industry.

4. The world's top 50 banks and strategic risk

4.1. Methodology

The analysis of strategic risk definition and management was conducted among the world's top 50 banks (source: FT Global 500, ranked by market value)[23] on the basis of their annual reports and public information .

4.2. Strategic risk definition

A preliminary analysis shows that only 56% of banks (28 out of 50) recognize strategic risk. Moreover, of these 28 banks, a mere 15 clearly define strategic risk, while the others just list it among their risk factors or mention it without further explanation.

EXHIBIT 5*:* Banks recognizing and clearly defining strategic risk among world's top 50 banks

SOURCE: Author's own analysis

A closer examination of the definitions used by these 15 banks enables us to draw up the following comparative Exhibit. The dimensions selected are based on the literature overview and include the level at which strategic risk is considered, the recognized sources of strategic risk, and the perceived extent of the impact of strategic risk on the organization.

[23] For a complete list of the world's top 50 banks analyzed in this study, see the Appendix.

EXHIBIT 6: Analysis of definitions of strategic risk among world's top 50 banks

	LEVEL		SOURCE		IMPACT	
COMPANY	Strategy Definition	Strategy Implementation	External	Internal	Impact on Value	Impact on Profits
Bank of America	•	•	•			
BNP Paribas	•				•	
Commonwealth Bank of Australia	•		•		•	
Credit Suisse	•	•	•	•		
Intesa Sanpaolo	•				•	
Toronto Dominion Bank	•	•	•		•	
UBS	•		•			
Deutsche Bank			•			•
Unicredito Italiano	•		•			
Nordea Bank			•			•
Banco Brasil	•		•		•	•
Barclays	•	•	•	•		•
Lloyds Banking Group	•	•	•	•	•	•
Bank of Montreal	•	•	•	•	•	•
CIBC	•	•		•		•
TOTAL	13	7	12	5	7	7

SOURCE: Author's own analysis

Confirming the findings of the literature overview, our analysis shows that the majority of analyzed banks (13 out of 15) place strategic risk at the level of strategy definition. Only 7 out of these 13 banks set strategic risk, additionally, at the strategy implementation level. This reflects the prevailing confusion concerning the level at which to deal with strategic risk.

With regard to the sources of strategic risk, the above Exhibit shows that of the 15 banks that clearly define strategic risk, a majority (12) view strategic risk as something arising from the external environment. Only 5 banks out of the world's top 50 banks recognize internal sources of strategic risk. This very low proportion is in line with the literature although internal sources of strategic risk can be a severe cause of value destruction, as described later in this paper.

Interestingly, most banks (5 out of 7) that include strategy implementation in their definition of strategic risk also consider internal sources of strategic risk. Furthermore, half of the banks (4 out of 8) that recognize external sources of strategic risk consider only strategy definition – and not strategy implementation – in their definition of strategic risk. These observations might be explained by the fact that strategy definition is seen by these banks as being determined by the external environment while strategy implementation is seen as an internal source of strategic risk.

Finally, the extent of the impact of strategic risk is rather unclear: 7 banks consider that strategic risk can impact the company's value while 7 consider that it can impact the company's profits (with 4 of the latter group considering the impact on profits only).

4.3. Sources of strategic risk

In line with the literature overview, we found it interesting to identify the main sources of strategic risk recognized by the world's top 50 banks. Our findings are summarized in the Exhibit below which – following the same template as for the literature overview – shows that the world's top 50 banks recognize a wide range of strategic risks.

EXHIBIT 7: Analysis of the sources of strategic risk recognized by the world's top 50 banks

Event of SR		Banks											
		Bank of America	Common-wealth Bank of Australia	Crédit Suisse	UBS	Deutsche Bank	Nordea Bank	Banco Brazil	Barclays	Lloyds	Bank of Montréal	CIBC	TOTAL
Macro-Environment	Political							•	•	•	•		4
	Economical	•	•		•		•	•	•	•	•		8
	Social		•						•	•	•		4
	Technological	•		•		•			•	•	•		6
	Environmental - Ethical								•	•			2
	Legal - Regulatory		•	•					•	•	•		5
Market Environmen	Suppliers												
	Customers	•				•				•			3
	Competition – New entrants	•	•	•	•	•	•	•	•	•	•		10
	Substitutes	•							•				2
Internal Environment	Strategy - Projects			•					•			•	3
	Style												0
	Structure												0
	Systems								•				1
	Staff			•									1
	Skills												0
	Shared Values												0
Others										•			1

SOURCE: Author's own analysis

Again confirming the findings of the literature overview, it is apparent that the surveyed banks mainly recognize external sources of strategic risk. In the macro-environment, strategic risks associated with economic factors are the most frequently mentioned category, followed by technological, legal/regulatory, political and social factors. In the micro-environment, competition is again the most frequently mentioned source of strategic risk.

Given that the number of banks recognizing internal sources of strategic risk is even lower, we found even fewer banks providing examples or categories. The internal sources of strategic risk mentioned are mainly related to the organization's strategy or major projects (mergers, acquisitions and growth), while strategic risks related to systems and staff were mentioned only once.

Only Lloyds provides a longer list of internal sources of strategic risks, and it is also the bank with the most comprehensive categorization of such sources: *"The Group's portfolio of businesses exposes it to a number of internal and external factors:*

- *Internal factors: resource capability and availability, customer treatment, service level agreements, products and funding and the risk appetite of other risk categories; and*

- *External factors: economic, technological, political, social and ethical, environmental, legal and regulatory, market expectations, reputation and competitive behaviour.*[24]"

Interestingly, Barclays and CIBC clearly mention that their growth strategy can induce strategic risk:

> *"The Group devotes substantial management and planning resources to the development of strategic plans for organic growth and identification of possible acquisitions, supported by substantial expenditure to generate growth in customer business. If these strategic plans are not delivered as anticipated, the Group's earnings could grow more slowly or decline.*[25]*" "Strategic risk arises from ineffective business strategies or the failure to effectively execute strategies. It includes, but is not limited to, potential financial loss due to the failure of acquisitions or organic growth initiatives.*[26]*"*

5. Impacts of growth on strategic risks

As shown in the previous section and the introduction, the surveyed banks mainly recognize external sources of strategic risk, including economic, technological, legal/regulatory, political and social factors. However, only five out of the 50 surveyed banks recognize internal sources of strategic risk, and only two banks (i.e. Barclay's and CIBC) mention growth impacts as a source of possible strategic risk in their annual reports.

Furthermore, when we look at the main risks reported in the Banking Banana Skins surveys[27] between 1996 and 2010[28], we find that concerns have changed over the period. Towards the end of the 1990s, the main perceived risks concerned poor management/strategy, competition, poor grasp of technology and poor product design. When we consider the past two years, the main perceived risks relate to more specific and external sources such as political interference, credit risk, over-regulation, credit spreads and macro-economic trends. In short, over the past decade, perceived sources of risk have shifted from strategic issues to risks originating in the external environment.

These observations illustrate that strategic risk awareness suffers from blind spots. In fact, the sustainability of an institution can be threatened because risks concerning the availability of required resources are not adequately identified and assessed in relation to strategic objectives, given the external factors that may occur. This can obviously happen when the financial system is under pressure. Growth and its management entail risk-management issues, in part because many executives see growth as something to be maximized and not to be restrained. However, experience shows that, from a management perspective, growth is not always a piece of good fortune.

[24] *Lloyds*, Annual Report 2008, p. 48.
[25] *Barclays*, Annual Report 2008, p. 74.
[26] *CIBC*, Annual Report 2008, p. 82.
[27] The surveys aim to describe the risks faced by the global banking industry, as perceived by a wide range of bankers, banking regulators and close observers of the banking scene around the world.
[28] *Lascelles D. (2010),*Banking Banana Skins 201*0. CSFI,* p.10.

Indeed, rapid growth can put considerable strain on a company's resources (financial and human) and unless management is aware of this effect and takes active steps to control it, rapid growth can lead to disasters, especially in the event of exogenous shocks, such as sudden adverse business cycles. For example, it is a common tendency to over-rely on credit institutions when markets (particularly the wholesale market) are liquid. This was the case with the Icelandic banks that relied on the unlimited availability of strong currencies.

Looking at another example, hedge funds can be subject to massive losses. A key source of value – and, simultaneously, a source of risks – lies in leverage increasing *de facto* with the growth objectives. In normal market conditions, leverage – including short selling or repo transactions – provides extra liquidity to the financial market and allows expansions. A survey of global prime brokers by Fitch ratings Ltd. found that leverage for some credit strategies could be as much as 20 times the assets under management. However, in times of turbulence, to meet leverage ratio, hedge funds are forced to liquidate assets and unwind positions at a rapid pace, thus generating massive losses for investors, combined with a possible contagion effect. The problem can be aggravated by the fact that hedge funds are taking illiquid positions, especially in instruments like CDOs and CDS. When they need cash to meet commitments like margin calls from creditors, hedge funds fall into a vicious circle since they are unable to liquidate their assets and cannot find additional funding. Nowadays, to mitigate these potential risks, some hedge funds are starting to look for permanent funding such as IPOs, debt offerings and committed lending facilities. Examples include GLC Partners, Blue Bay Asset Management, Fortress and Britain’s Man Group.

In order to reduce the frequency and impact of strategic risks, it is necessary to establish an effective risk-assessment and management system based on a causality-driven approach as discussed in Ayadi et al. (2008). Although it is supposed to be well-defined by regulators and risk managers, risk delimitation remains a puzzle for a number of institutions, especially when it comes to strategy formulation and implementation. One of the main problems is the definition of boundaries between the different types of risk, leading to potential inefficiencies when assessing them.

There is a case, therefore, for developing an up-to-date risk taxonomy, based on a causality methodology, to distinguish among different types of risks and thus determine at which level of the company they should be tackled. The implementation of such a framework by financial institutions would help to prevent the use of unsuitable risk-assessment and management methods that are based exclusively on the classification of events (effects) without taking into consideration neither the causes nor the possible misalignment between resources and growth objectives. This approach would have been most helpful in identifying and analyzing the risks that led to the recent failure of major institutions. For example, funding- or asset liquidity-risk was mistakenly viewed as a primary source of risk dictated by the environment instead of being dealt with as one factor impacting on the strategic risk associated with the decisions taken at the highest level of the institution. This is particularly true when asset growth is regarded as something to be maximized without looking at the availability of the resources required under various scenarios.

Uncontrolled growth leads institutions to follow a biased logic: the faster they grow, the more profitable they become from an accounting point of view, but the more vulnerable they become in terms of liquidity. Of course, leverage can be increased until investors refuse additional lending, particularly when market pressures are strong. However, all of these problems can be prevented if the management body realizes that growth above the company’s sustainable growth rate creates financial challenges that must be anticipated and managed. The sustainable growth rate is the maximum rate at which a company may grow given the possible resources available under various scenarios. Management must anticipate any gap between actual growth and sustainable growth. To manage that disparity, the

challenge is first to recognize it and, secondly, to implement a viable mitigation plan to manage it. Furthermore, it should be kept in mind that, when a company grows at a rate in excess of the sustainable growth rate, it is imperative for it to respond to the situation by adopting appropriate investment policies.

In this regard, given that the management body is ultimately responsible for the sustainability and viability of the financial institution, there is a need for an overall (strategic) assessment of resources at the management body level. Indeed, the management body should clearly define the institution's risk strategies and risk profile, which have to be translated into business objectives. The management body is also responsible for developing and supporting strong internal control and risk-prevention and management policies and must ensure that these are effectively communicated throughout the organization. Therefore, an adequate understanding, on the part of directors, of risk factors and the potential impacts faced by the institution is vital.

Once this high-level task has been carried out, it is essential to update the institution's risk-prevention and management policies continuously on the basis of effective risk assessment methods in order to optimize the implementation strategy, especially in terms of availability of essential resources. In the event that a risk assessment system proves to be flawed when faced with an uncommon (not necessary exceptional) environment, a financial institution should be able to take timely corrective actions, such as increasing its essential resources or strengthening its risk-management processes and control systems.

Of course, strategic risk management also has to rely on fair judgments from management bodies and experts within the framework of better governance structures, increased transparency and increased risk-control capabilities to meet the (standard) risk governance requirements. In addition to appropriate incentives for banks to establish institution-wide risk assessment systems, regulatory measures are required to ensure that the development of institutions can be effectively monitored and evaluated, and to impose limitations on business expansion when available resources prove to be insufficient in relation to the institution's overall risk profile.

5. Conclusion

Over the past few decades, the financial industry has experienced tremendous growth worldwide. The amount of debt and financial assets, the number of participants in financial markets, and the number of financial products have risen dramatically. Until recently, the majority of financial analysts expected financial markets to pursue their growth trend, driven by technological progress, market deregulation and globalization. However, the financial crisis that started in the summer of 2007, in the US subprime markets, has completely changed the financial landscape.

The current market turmoil is the result of an exceptional boom in credit growth and leverage in the financial system, based on a long period of low interest rates and a high level of liquidity, combined with the lack of a strategic risk-management framework. In addition to causing multi-billion dollars losses among financial institutions, the financial crisis has revealed the weaknesses and unsustainability of the long-term growth achieved by certain financial institutions. It has emphasized the importance of a resilient and stable strategic risk-management framework whose main aim should be to create the right incentives to improve the long-term viability of institutions that rely primarily on short-term funding.

As explained in this article, the sources of strategic risk are multiple. However, the key focus of this study is the strategic risk of financial institutions whose growth objectives and business models imply a high dependency on short-term wholesale market funding and high leverage. The sudden drying up of liquidity in markets has had serious consequences for these financial institutions. We suggest that financial institutions may have suffered from a tragic short-sightedness in the rapid-growth environment of the pre-2007 era.

Indeed, beyond "growth targets" and "growth achieved", the key challenge for long-term success is the ability to identify the relevant external and internal drivers of risks, including specifically those linked to the availability of the resources required in various stressed scenarios. To manage and thus sometimes to limit growth in order to meet sustainability objectives in the event of a stressed scenario is a difficult exercise for board members, executive managers and operating managers.

In our view, ensuring that strategic risks are managed at the highest level of the company is the main prerequisite for sustainable growth. We suggest that strategic risk-management should rely on a methodical approach for coping with internal and external sources of uncertainty and should be a process at the core of decision-making. In fact, the primary aim of strategic risk-management is to support the achievement of the mission and the objectives of the organization while at the same time ensuring its long-term viability. The methodical approach aims to mobilize sufficient resources and time from the management body to ensure that significant strategic risks are effectively identified and appropriately managed. The response to strategic risks should consist of decisions taken by the management body on the basis of careful consideration of each situation, rather than result from a strong focus on economic capital allocation.

Finally, based on these conclusions, we strongly recommend calling on the relevant EU institutions and bodies to work towards developing sound and legally-binding principles for strategic risk management and its governance. In our view, supervisors should provide high-level guidelines on the implementation, validation and assessment of strategic risk to ensure that it is adequately dealt with, instead of focusing inadequately on technically complex systems to assess capital levels, since such systems and their underlying approach do not ensure the availability of the required resources and may themselves generate additional risks, as apparent from the current crisis.

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ANNEX: World's top 50 banks

Sector rank	Global rank 2009	Global rank 2008	Company	Country	Market value $m	Net income $m	Total assets $m	Employees	P/E Ratio	Dividend yield (%)	Year End
1	4	6	Indl & Coml Bank of China	China	187,885.4	16,196.2	1,425,722.0	385,609	10.8		31/12/2008
2	13	20	China Construction Bank	China	133,228.6	13,530.6	1,104,009.0	298,581	9.7	5.0	31/12/2008
3	21	26	Bank of China	China	115,243.1	9,404.3	1,015,785.0	249,278	9.1	5.7	31/12/2008
4	27	31	JP Morgan Chase	US	99,885.4	5,605.0	2,175,052.0	224,961	30.9	3.2	31/12/2008
5	29	15	HSBC	UK	97,408.9	5,728.0	2,527,465.0	331,458	12.0	12.6	31/12/2008
6	54	64	Wells Fargo	US	60,345.9	2,655.0	1,309,639.0	158,9	20.3	9.1	31/12/2008
7	62	40	Banco Santander	Spain	56,198.9	11,671.4	1,380,206.0	170,961			31/12/2008
8	64	67	Mitsubishi UFJ Financial	Japan	56,136.7	6,340.7	1,922,182.0	78,302	7.9	2.9	31/03/2008
9	83	23	Bank of America	US	43,657.4	4,008.0	1,817,943.0	243	12.2	8.2	31/12/2008
10	88	142	Itau Unibanco	Brazil	42,580.8	3,577.6	290,079.8	108	12.8	3.6	31/12/2008
11	91	114	Royal Bank Canada	Canada	41,129.2	3,711.3	589,775.3	73,323	10.5	5.6	31/10/2008
12	94	105	Bank of Communications	China	40,409.7	4,148.8	392,034.4	77,734	8.2	4.2	31/12/2008
13	100	204	Westpac Banking	Australia	38,605.0	2,765.8	315,033.1	28,302	9.0	7.7	30/09/2008
14	107	68	BNP Paribas	France	37,686.4	3,631.9	2,729,231.0	154,069	10.2	3.2	31/12/2008
15	108	157	Commonwealth Bank of Australia	Australia	36,649.6	3,433.8	349,452.8	39,621	9.3	7.9	30/06/2008
16	110	118	Credit Suisse	Switzerland	36,110.3	-7,097.2	1,010,317.0	47,8		0.3	31/12/2008
17	113	69	Intesa Sanpaolo	Italy	34,360.0	3,357.0	836,478.6	110,021	10.5		31/12/2008
18	122	103	China Merchants Bank	China	32,729.7	2,227.3	191,499.0	28,971	11.5	2.3	31/12/2007
19	132	78	BBVA	Spain	30,404.7	6,601.0	713,553.8	111,936	4.6	8.1	31/12/2008
20	137	186	Toronto Dominion Bank	Canada	29,363.1	3,123.0	458,887.3	58,792	8.7	5.6	31/10/2008
21	141	143	Bradesco	Brazil	28,301.7	3,493.6	208,329.6	86,622	8.8	0.4	31/12/2008
22	145	113	UBS	Switzerland	27,596.3	-18,038.4	1,740,274.0	77,783			31/12/2008
23	149	152	Sumitomo Mitsui Financial	Japan	27,242.7	4,596.8	1,115,064.0	46,429	58.4	0.3	31/03/2008
24	153	179	National Australia Bank	Australia	26,789.9	3,251.0	470,741.3	39,729	7.4	10.0	30/09/2008
25	163	131	U.S. Bancorp	US	25,642.6	2,946.0	265,912.0	57,904	9.0	11.6	31/12/2008
26	170	182	Bank of Nova Scotia	Canada	25,002.6	2,558.4	413,595.3	69,049	9.9	6.3	31/10/2008
27	171	115	Deutsche Bank	Germany	24,976.9	-5,128.3	2,895,504.0	80,456		1.6	31/12/2008
28	176	149	Credit Agricole	France	24,569.8	1,346.5	2,173,890.0	88,933	16.3	5.4	31/12/2008
29	185	70	Unicredito Italiano	Italy	23,683.3	7,838.6	1,343,554.0	156,155	2.3	20.7	31/12/2007
30	186	214	ANZ Banking	Australia	23,616.5	2,378.8	337,592.6	36,925	9.0	8.9	30/09/2008
31	187	163	Standard Chartered	UK	23,565.6	3,408.0	435,068.0	73,802	6.1	5.5	31/12/2008
32	190	260	China CITIC Bank	China	23,317.1	1,216.0	147,755.3		11.2	2.1	31/12/2007
33	198	127	Societe Generale	France	22,745.6	2,401.1	1,485,890.0	160,43	8.8	4.0	31/12/2008
34	210	199	Mizuho Financial	Japan	21,278.1	3,099.7	1,537,921.0	49,114	7.5	5.2	31/03/2008
35	222	264	Al Rahji Banking	Saudi Arabia	20,697.7	1,719.8	33,300.9	8,036	10.8	3.6	31/12/2007
36	236	194	Nordea Bank	Sweden	19,986.7	3,512.2	623,380.3	33,944	3.7	5.3	31/12/2008
37	240	97	Royal Bank of Scotland	UK	19,794.4	-34,449.9	3,514,578.0	197,1	89.7		31/12/2008
38	246	249	Hang Seng Bank	Hong Kong	19,254.1	1,819.4	98,356.0	9,764	10.6	8.1	31/12/2008
39	252	259	Banco Brasil	Brazil	18,797.1	4,035.8	238,982.1	89,369	4.7	7.1	31/12/2008
40	269	422	Shanghai Pudong Dev Bank	China	18,159.9	803.1	133,697.7	14,128	17.4	0.7	31/12/2007
41	277	119	Barclays	UK	17,783.6	6,412.6	3,004,331.0	151,5	2.4	8.8	31/12/2008
42	292		Industrial Bank	China	16,814.0	1,224.4	121,411.2				31/12/2007
43	297	153	Lloyds Banking Group	UK	16,563.9	1,198.5	638,090.7	58,756	4.8	18.4	31/12/2008
44	327		Resona Holdings	Japan	15,119.4	3,016.0	397,558.9	16,344	56.2	0.1	31/03/2008
45	349	411	Bank of Montreal	Canada	14,178.8	1,611.6	338,983.2	37	8.5	8.7	31/10/2008
46	350	419	China Minsheng Banking	China	13,992.8	925.7	134,401.4	17,766	10.6	1.0	31/12/2007
47	355	373	CIBC	Canada	13,897.1	-1,678.4	288,369.9	39,698		7.8	31/10/2008
48	358	53	Citigroup	US	13,854.8	-27,684.0	1,938,470.0	326,9		44.3	31/12/2008
49	371		Northern Trust	US	13,367.4	794.8	82,053.6	12,2	16.9	1.9	31/12/2008
50	372	365	State Bank of India	India	13,346.4	1,792.4	205,482.0	179,205	6.2	2.0	31/03/2008