

The background of the book cover is a photograph of a person in an orange shirt and dark pants climbing a steep, dark rock face. The climber is positioned on the right side of the frame, reaching up. The sky is filled with dramatic, dark clouds, and the overall lighting suggests a sunset or sunrise. The title 'STRATEGIC RISK MANAGEMENT' is printed in large, white, sans-serif capital letters across the center. Below the title, the subtitle 'NEW TOOLS FOR COMPETITIVE ADVANTAGE IN AN UNCERTAIN AGE' is written in smaller, orange, sans-serif capital letters.

PAUL C. GODFREY, EMANUEL LAURIA,  
JOHN BUGALLA, AND KRISTINA NARVAEZ

# STRATEGIC RISK MANAGEMENT

NEW TOOLS FOR COMPETITIVE  
ADVANTAGE IN AN UNCERTAIN AGE

## **Praise for *Strategic Risk Management***

“The authors of *Strategic Risk Management: New Tools for Competitive Advantage in an Uncertain Age* have produced a well-written, entertaining, and thought-provoking compendium of ideas and stimulating insights into strategic planning and the related risk management implications. There is a wealth of interesting risk management case studies in well-known organizations to demonstrate their views. I thoroughly enjoyed reading this and believe it will be helpful to all risk managers and executives to assess and possibly rethink their own methodologies.”

—**John Fraser, former Chief Risk Officer, Hydro One Networks Inc.**

“Technology has made the world smaller and more unified, but it has also created a fragmented and complex environment for business. Volatility, ambiguity, and uncertainty face today’s business leaders. This book takes a thoughtful and insightful look at strategic risk management—specifically, the gap between those formulating strategy and those who are providing the execution layers. For any business leader looking for a competitive advantage, this book will provide you with real-life examples of those who have found a way to make it happen.”

—**Mike Petroff, business executive and MBA professor**

“A groundbreaking book for executives that provides the missing piece for solving the strategic planning puzzle!”

—**Corey Gooch, Senior Director, Ankura**

“*Strategic Risk Management: New Tools for Competitive Advantage in an Uncertain Age* is the essential text for understanding the concept and practice of strategic risk management. Through clear definitions of risk terminology and application of concepts, to engrossing real-life examples from Yogi Berra to Walt Disney and from Intel to ESPN, the well-pedigreed authors have provided a rich source of information that can help all risk practitioners add value to their organization.”

—**Ken Baker, Corporate Manager, ERM, City of Edmonton**

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Berrett-Koehler Publishers, Inc.

# Strategic Risk Management

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*For Robin—PCG*

*For Marsha—JAB*

*For Geri—EVL*

*For Kevin, Katelyn, Korryn, Kristyn, and Kameron—KLN*

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## PREFACE

This book traces its origin to the connecting skills of Kristina Narvaez. Kristina began working with John Bugalla in 2010 at an enterprise risk management (ERM) workshop. They started discussing the potential impacts that the then new Securities and Exchange Commission Rule 33-9089 and Dodd-Frank Section 165(c) would have on how the C-suite would report their risk management practices to the board of directors. What followed was a decadelong collaboration that has produced two dozen articles in a wide range of publications, including two books. The major themes of our articles are the role of ERM within corporate governance structures and need to link risk management with corporate strategy.

John and Manny Lauria share a common history, having worked together many years ago in the Chicago office of the insurance broker Marsh & McLennan. Both shared a passion for serving large multinational clients and relished the challenge of developing original, creative risk management solutions to seemingly intractable challenges. Building on that experience, the two have more recently collaborated on numerous articles and consulting projects that inform and assist firms motivated to explore the move from ERM to strategic risk management (SRM). Their work reflects the practical realities of making the linkage between corporate strategy and risk management, the importance of getting strategic risk communication right at the board level, how to evaluate emerging risks, and how SRM can narrow the strategy–execution performance gap.

Kristina met Paul Godfrey in 2015, when she began teaching strategy courses at Brigham Young University, where Paul works. They connected over the power of risk management thinking to frame and understand many of the strategic choices that executives made. Dr. Godfrey’s academic

research focused on how risk management thinking could explain and justify why firms engage in philanthropy and various forms of corporate social responsibility. These activities provide firms with something like an insurance policy, a reservoir of goodwill among stakeholder groups, which they can draw upon when bad things happen. He and his colleagues showed that firms engaging in corporate social responsibility weathered the financial shocks of crises better than firms without such insurance.

As she does so well, Kristina connected all of us, and we began talking about our vision of risk management and its importance for firms. Those conversations revealed two common perspectives. First, risk management logic and thinking are powerful tools for crafting and implementing better strategy. Executives who link risk and strategy create a stronger, more defensible, and more durable competitive advantage. We also posited that the risk management function, when properly deployed, provides executives with a way to execute strategy more effectively.

Our second common worldview centered on the current state of the art in risk management, ERM. Regulatory strictures such as Sarbanes-Oxley (2002), the Committee of Sponsoring Organizations of the Treadway Commission guidelines for risk (2004), and Dodd-Frank (2010) had provided organizations with incentives, both carrots and sticks, to deepen their attention to and improve their management of risks, particularly those risks that threatened the firm as a whole. John, Kristina, and Manny saw progress but were frustrated because, as the years passed, ERM morphed from advanced risk management with the potential to link to strategy into just another compliance function within the firm. ERM, rather than helping managers look out the front windshield, forced them to look in the rearview mirror.

We shared a final reality: just as risk management had become mired in past actions, so too had it fallen into the traditional trap of defining risk as all the bad things that can happen to a firm. This made, and continues to make, little sense to us, because our training and backgrounds in finance and strategy model risk as a Janus-like entity with a downside, peril face and an upside, opportunity one. The past is the wrong place to look for opportunity—it always, and only, resides in the future.

Paul helped the risk experts better understand the language, logic, and models of strategy, and they gave him a crash course in the tools and techniques of risk management, especially ERM. That was 2016. What we collectively saw then, and continue to see now, is a tremendous need to link

strategy, decision making, and risk. This is in no small measure because business is becoming riskier, both in terms of perils and of opportunities. Those conversations, as they sometimes tend to do, led to the idea that we should write a book about these important linkages, although, when the “write a book” concept comes up, the usual response is to say “What a great idea,” and then nothing happens. Writing a book is hard work. We took the opposite tack and started writing text, developing models, and synthesizing our hundred-plus years of collective experience with risk and strategy to make that conversation real. What you hold in your hands is the output of that work.

If it takes a village to raise a child, then it takes a number of colleagues, critics, experts, and friends to write a book. There are many people to acknowledge and thank for their help. For Paul, that list begins with Craig Merrill at BYU, who years ago encouraged and enabled the study of risk management as a helpful way to think about strategic decision making. The support of colleagues in the BYU Marriott School of Business, not limited to but especially members of the strategy group and management departments, has made this book possible and made it better. Neal Mallet, Steve Piersanti, Jeevan Sivasubramaniam, and the entire staff at Berrett-Koehler have worked hand in glove with us to make a readable, engaging book. Sam, Lilly, Charlie, Kate, and Grant Godfrey have proved incredibly patient through the process, and my conversations with them have added new insights and perspective. Finally, and most importantly, thanks to Robin. I am always better because of your encouragement, feedback, love, and support.

For John, whose career spans the longest time, the list of acknowledgments and thanks could run for pages. In terms of the current project, John thanks Corey Gooch. The two work together at Aon and currently work on several consulting projects.

Manny expresses appreciation and thanks to Rich Phillips and Lars Matthiassen in the J. Mack Robinson College of Business at Georgia State University, as well as his colleagues in the Department of Risk Management and Insurance and at the Risk Management Foundation. These GSU relationships directly influenced the writing of this book in no small way. Conrad Ciccotello at the Daniels College of Business at the University of Denver is a sounding board nonpareil and a mentor who always seems to sharpen his thinking. Sincere thanks to Julian Smiley, friend, partner, and leader, for his enduring support in so many ways. Jonathan, Courtney, and Ashley Lauria

ask insightful questions beyond either their years or their experience, often prompting consideration of complex issues from fresh perspectives. Geri, you are my better half by far, a constant source of wisdom, encouragement, and great faith. Your loving support means everything to me. And most of all, to God be the glory forever!

Kristina Narvaez acknowledges Steve Cain, who was her first mentor and the risk manager at Utah Transit Authority twenty years ago. Thanks go out to Jeff Rowley, who is the risk manager at Salt Lake County; Tim Rodriguez at Revere Health; Wendell Bosen; Fred Doehring at the Utah Department of Transportation; Dan Hair, who is the retired chief risk officer at Workers Compensation Fund; Carol Fox, who is the vice president of strategic initiatives at the Risk and Insurance Management Society and has organized these wonderful events; and Dr. Betty Simkins and John Fraser, for their joint work on our book *Implementing Enterprise Risk Management: Case Studies and Best Practices*, published by Wiley in 2015. A shout-out goes to Kristina's colleagues at Hanover Stone Solutions—Tim Morris, Donna Galer, Max Rudolph, and John Kelly—for their support. Last but not least, I want to thank Leo Costantino, who is the risk manager for the Los Angeles Community College District, and Carrie Frandsen, who is the enterprise risk manager for the University of California system, for the opportunity to teach courses in the UCLA Extension's Enterprise Risk Management certificate program.

# INTRODUCTION

## How We Got into This Mess, and the Need for New Tools

**H**eavyweight champion Mike Tyson once quipped, “Everyone has a plan until they get punched in the mouth.” Wise words for boxers. Even wiser words, perhaps, for executives, who face increased uncertainty when their business gets punched in the mouth by unexpected change. Most executives develop some type of longer-range strategic plan. Almost all have shorter-term operating performance objectives that demonstrate to their numerous stakeholders that they have a pathway to operational and financial success. But when punched in the mouth by shifting customer demands, competitor moves, or changes in cost, these plans can quickly prove ineffectual. Far too many companies then begin to improvise like street fighters.

Improvisation may work well in the ring, but few successful business strategies—which often require years of investment to create and implement—emerge on the fly. In what follows, we argue that, just as good boxers learn to anticipate punches by knowing enough about the sport and their opponents and to see the signals of an oncoming flurry and respond, executive teams must pay careful attention to *strategic risks*. These risks threaten or extend their core competitive advantages or viability. When these are managed explicitly, firms are better equipped to anticipate and respond to competitive or market punches. Unfortunately, plans may fail to survive because of self-inflicted wounds, too, if those responsible for creating strategy fail to fully comprehend the risks or are too distant from execution.

However, linking strategy tightly with risk management is a powerful means to drive performance improvement.

Customers, competitors, and costs aren't fixed stars in any market; they behave more like wandering planets. As they shift, they create strategic risks. Like planetary movement, many of those changes happen slowly, giving teams sufficient time to plot their trajectory and act accordingly. Strategic risk management, as we argue here, provides leaders with a modern-day astrolabe, a set of principles, processes, and tools that allow them to monitor those wanderings, gauge their position, and chart a course to continued success.

. . . . .

What we propose in this book represents the further evolution of risk management, one that differs in scale and scope from what has come before. All business entails risk. Wise managers work not just to eliminate, mitigate, or transfer risk but also to leverage it. It's been this way since the dawn of time. An ancient account of risk management appears in Genesis 41, when the Hebrew steward Joseph bought and stored seven years of Egyptian grain harvests in anticipation of a great famine. Joseph's handling of the famine saved his family and his adopted country and led to a huge promotion: a foreigner became the regent to Pharaoh. Egypt was the undisputed world superpower. Babylon was just a town between in the swampy marsh between two rivers, Greece and Rome just a collection of olive orchards. Egypt thrived for another half millennium because someone in power recognized and managed risk.

Risk management evolved from Joseph's simple stockpiling of assets in anticipation of future perils. Fast forward a few millennia, and those willing to bear risk devised ways to profit from those who loathed the threat of peril inherent in any commercial venture. Risk-tolerant entrepreneurs offered contracts that allowed risk-averse customers to transfer risk for a fee based on the probability that such perils would become real, material losses. Insurance evolved from contracts on a few oceangoing ships in the mercantilist era into a \$5 trillion dollar global industry by 2017.<sup>1</sup>

If you went to business school and took a class in risk and insurance, you learned that insurance is a tool in a larger kit we refer to as traditional risk management (TRM). Those tools include the choice to *avoid* risk by

not engaging in certain activities—think of those retailers who refuse to sell firearms. Companies may choose to *manage* risks by reducing their likelihood—think safety training programs and protocols—or by mitigating the impacts of loss when risk becomes realized—for example, installing a fire suppression system in a warehouse. Managers *transfer* much risk through insurance contracts, financial hedges, warranties, and other guarantees that shift the consequences of risk to another party. In some instances, executives choose to *retain* risk because the gains from the activity outweigh the potential losses, even if those losses can't be mitigated or transferred to others.

That class would have helped you understand two more important elements of risk management. First, risks come in two flavors: *pure* risks that bring only the threat of loss and *speculative* ones that offer potential gains as well as losses. Fire, flood, and earthquake represent pure risks for everyone except insurers. Financial strategies such as hedging or real estate investing represent speculative risks. Second, you would have learned that your willingness to pay for risk management depends on the probability of the risk being realized. If the cost of insurance or management exceeded the probability of loss, you'd retain risks. When risks can't be quantified and priced, then the tools of TRM are of little use.

Insurance and other elements of TRM protect a firm against discrete, actuarially predictable risks. Companies implement TRM through specialists, such as insurance brokers, financial traders, and safety officers. Each has the skill and tools to manage downsides traceable to single activities or functions within the firm. By the middle of the twentieth century, most businesses had a formalized risk management program led by these specialists.<sup>2</sup> Today, TRM plays a vital role in most organizations of any size.

As the twentieth century drew to a close, globalization, financial market complexity, supply chain interdependencies, and cross-functional organizational structures had spawned additional categories of risk, which the tools of TRM proved unable to handle. These companywide or *enterprise* risks, whether pure or speculative, defied management by any one subunit in the firm because they originated in the interactions of different units. Consequently, companies were increasingly exposed to interconnected risks and losses for which no formal response was available. Recognizing this challenge, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a consortium of the world's leading accounting



associations, was birthed, and it issued *Enterprise Risk Management—Integrated Framework* in 2004.<sup>3</sup>

As ERM developed and matured, it brought together from various organizational silos professionals responsible for overseeing risk, often under the ultimate guidance of the board of directors and increasingly led by a new executive, the chief risk officer (CRO). A painful time of testing for the nascent ERM process came during the financial sector crisis in 2008. Consider AIG and its credit default swap (CDS) position at that time.<sup>4</sup> A CDS acts like an insurance policy on a bond or other financial instrument. If an issuer defaults on its obligation, then the holder of a CDS has the loss covered by the writer and seller of the CDS.

CDSs became increasingly popular in the years before the financial crisis. Historical evidence of financial instrument default suggested very, very low risk, and the price of a CDS was equally low. A CDS transaction provided cheap insurance against default for buyers—and a license to print money for sellers. Sellers made a tiny amount on each one but had almost zero risk of loss. CDSs played a major role in the 2008 meltdown, when defaults in the subprime mortgage and mortgage-backed security markets defied history and took off.

Most investment banks, including Bear Stearns, Lehman Brothers, Goldman Sachs, and Morgan Stanley, had divisions that sold CDS instruments, and others that bought them. There were winners and losers in the mix, depending on whether the bank was buying, selling, or both. Individual banking divisions were either paying out or were being paid when defaults occurred. Despite several high-profile bankruptcies, most of these institutions had enough diversification in their portfolios to weather the storm, although they sustained significant damage.

AIG, however, the largest reinsurer in the country, stood alone among its peers. AIG sold only CDSs. For AIG, what had been a giant revenue stream for many years now threatened not only its existence but also that of its customers. If AIG couldn't meet its CDS obligations, then its customers risked default. Stepping in to bail out AIG, the U.S. Financial Stability Oversight Council poured \$85 billion into the company to forestall a potential catastrophic market failure.

ERM wasn't foolproof, of course, and it didn't necessarily prevent banks—or, for that matter, manufacturing firms, real estate operations, or service businesses—from trouble during the financial crisis. Based on this

experience and other critical commentary, it was becoming clear that ERM was well intended but wasn't designed to properly encompass the big strategic risks that eventually threaten survival. Unless ERM linked to and operated in sync with a firm's strategy, its effectiveness would be limited.

In September 2017, COSO released an updated framework for ERM, *Enterprise Risk Management—Integrating with Strategy and Performance*. This revised framework reflects the reality that ERM too often fails to inform strategic decision making. A well-stated emphasis on “integrating with strategy” captures the hope of realizing the original vision of ERM: that effective risk management is an integral element of strategy formulation and implementation.

Why had ERM failed to integrate with strategy the first time around? What got us into this mess? We see the convergence of two factors. First, ERM came on the scene as U.S. companies adapted to a new compliance regime, the Sarbanes-Oxley Act, in 2002, which required executive teams to pay greater attention to how their financial reporting and internal audit systems worked and recorded results. It had no discernible impact on what risks those teams chose to take. By the end of the decade, executives would face additional governmental mandates, this time explicitly including risk management, in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Factor one, then, was strong external pressure for compliance, and compliance protocols are very poor at creating competitive advantage.

Second, COSO was a creation of the accounting industry. Its vision of ERM was naturally biased toward that profession, resonating particularly well with the Big Four accounting firms. Firms already relied on their auditors, external and internal, to help navigate reporting requirements, so adding ERM to the burgeoning list of tasks made sense. Most companies outside of financial services didn't have a formal ERM program or internal audit, and the office of the chief financial officer (CFO) provided a ready place for these. Factor two, therefore, was a strong tendency to default ERM to accounting and internal audit.

Accounting professionals—and we have many who are former students and current colleagues—echo and reinforce this next statement: accountants, and the tools they employ, are well suited to looking backwards, not forward. Those wearing the proverbial “green eyeshades” do a great job of calculating the current score, yet they lack the skills to predict what the score might be later. Most ERM programs are able to provide postmortems on previous

actions. They create lengthy registers of current risks and they do a yeoman's job of meeting the demands of regulatory compliance. ERM in its original form tells executives where they've been, through the rearview mirror. But executives really want to know what threats and opportunities lie ahead.

Success today and tomorrow requires driving while looking squarely out the front windshield. We employ the language, mind-sets, and tools of strategic management to create a simple notion of strategic risk. We also offer a set of strategic tools and organizational actions that allow executives to assess and respond to future risks—the big ones that imperil or enable strategic health. How would you rather drive?

Strategic risk management helps executive teams think coherently and effectively about strategy and risk. SRM inextricably links the two. When leaders design and implement a strong SRM program, they help to address another major reason why strategies fail: the gap between strategy and its execution, the difference between a formulated strategy's projected benefits and the ones it actually delivers. This gap is *prima facie* evidence that plans rarely withstand a solid punch in the mouth, and this results in organizations realizing about two-thirds of their stated financial objectives.<sup>5</sup> Some may argue that attaining 60% to 70% of performance objectives is acceptable. To us, it sounds like an excuse for accepting competitive mediocrity. After all, 70% on a college exam is roughly a gentleman's C grade.

The strategy–execution gap has many causes, including faulty structural arrangements that lead to a unidirectional handoff of strategy from those responsible for its formulation to those tasked with its implementation. A communication chasm can develop between the two groups that precludes effective execution. Next, strategists too often fail to recognize and plan for new assets and processes essential to on-the-ground execution of the strategy, or they dramatically underestimate the scale of investment needed to build those capabilities. Implementers are then subjected to budget fights that further stymie execution. Executives driven by short-term thinking assume and adhere to an unreasonable time horizon for implementation, which ensures mediocrity at best and outright failure at worst. Finally, strategy makers may presume the existence of knowledgeable and skilled human, social, and organizational capital that may not exist. Execution hits another pothole if the talent doesn't materialize. The list of execution failures goes on and on.

We wish we could eliminate the strategy–execution gap in its entirety. We can't, though; it's just too big and too multifaceted. At the risk of overselling

our ideas, our experience suggests that linking the strategy and risk management processes in a firm goes a long way toward closing the divide. SRM processes, done effectively, overcome the major driver of the gap, which is the disconnect between those making and those implementing a strategy. SRM helps to pierce the hierarchical layers and bureaucratic rigidities that isolate executives and keep them from seeing how their competitive environment is, and may be, evolving in ways that create strategic risks. SRM includes a set of structural arrangements that weave strategy formulation and implementation together in the assessment of and response to strategic risks. Supporting these arrangements requires communication pathways and protocols that enable two-way feedback between the C-suite and those on the ground. Consistent and meaningful communication between these groups closes the gap. Most importantly, we'll describe how to align culture around both strategy and implementation in a way that harmonizes the two.

Why do we need new ways of managing risks, particularly strategic ones? Because, in the words of Yogi Berra, which summarizes our experiences over several years, "The future ain't what it used to be." Far more frequent and often unexpected punches in the mouth are commonplace. Business is more volatile, uncertain, complex, and ambiguous than ever before. We see managers taking more, not fewer, punches. The best way to win in this environment is to drive with both eyes focused out the front windshield. Though the future can't ever be perfectly predicted, smart leaders using SRM are far better positioned to anticipate and shape it wherever possible.

As the drama of our book unfolds, you'll encounter several characters, concepts and themes. Before we dive in, we'll take a moment to introduce them.

**Chief risk officer.** A corporate executive charged with responsibility for all the risk management functions of the organization. Usually a member of the senior executive team.

**Chief strategy officer.** A corporate executive responsible for strategy development, strategic planning, budgeting, and resource allocation. In many companies, this role is played by the chief executive officer (CEO).

**Enterprise risk management.** A set of knowledge, skills, and tools that allow firms to manage organization-wide risks.