Social Risk as Strategic Risk

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Corporate Social Responsibility Initiative

The Corporate Social Responsibility Initiative at the Harvard Kennedy School of Government is a multi-disciplinary and multi-stakeholder program that seeks to study and enhance the public contributions of private enterprise. It explores the intersection of corporate responsibility, corporate governance and strategy, public policy, and the media. It bridges theory and practice, builds leadership skills, and supports constructive dialogue and collaboration among different sectors. It was founded in 2004 with the support of Walter H. Shorenstein, Chevron Corporation, The Coca-Cola Company, and General Motors.

The views expressed in this paper are those of the author and do not imply endorsement by the Corporate Social Responsibility Initiative, the John F. Kennedy School of Government, or Harvard University.

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Executive Summary

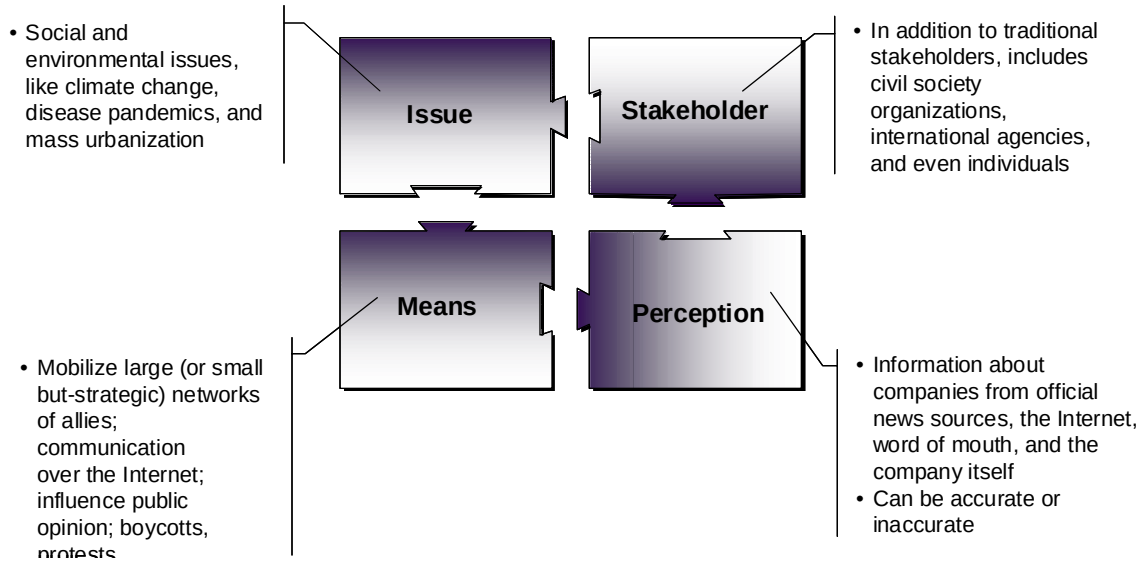
A series of spectacular corporate governance and ethical compliance failures—as well as the Sarbanes-Oxley Act and other regulatory responses—have focused increasing attention on governance and compliance risks. Equally serious are the long-term "strategic risks," such as disruptive innovation or failure to predict shifts in consumer preferences, that companies face.

Strategic risks are characterized by complex origins and equally complex, far-reaching impacts. They have the potential to jeopardize both current earnings and growth prospects. As a result, strategic risks require forward-looking risk management approaches that are integrated across the enterprise and linked with strategic planning.

Social and environmental issues are emerging as troublesome sources of strategic risk. These issues can present risks directly, by presenting direct operating constraints, or indirectly—for example, by seeding "social risk," or challenges by stakeholders to companies' business practices due to real or perceived impacts on social or environmental issues.

As Exhibit ES-1 illustrates, the emergence of social risk is characterized by four components in combination: an issue, a stakeholder or group of stakeholders, a negative perception about the company, and the means to do damage.

Exhibit ES-1. Social Risk Components



High-profile companies such as Wal-Mart, Freeport McMoRan, and Coca-Cola have found themselves in the crosshairs of social risk. Managing it is a complex endeavor, as social risk is often a function of strategic or operational decisions companies have made that affect issues stakeholders care about. In addition, the combination of issues and stakeholders means that both must be managed.

Traditional risk management programs focus on operational and compliance risks and are generally composed of point solutions: mitigation actions specific to particular sources or impacts of risk.

Point solutions can work for “point” risks, where the main objective of risk management is to avoid or prepare for a particular event and, in so doing, reduce the associated cost. However, point solutions cannot work for strategic risks, such as social risk, where complex origins and impacts demand integrated management approaches.

Social risk management, precisely because of the issue-actor combination that makes it so challenging, has a unique upside contribution to make when it is done well. Social risks flag opportunities for companies to innovate around products, business processes, and leadership methods to translate risk into opportunity and position themselves for more sustainable, long-term success. A proactive and strategic approach to social risk management can therefore lead to new shareholder value creation in addition to existing shareholder value protection.

Many companies possess, within their corporate social responsibility, public affairs, or other departments, the necessary capabilities and expertise for managing strategic risks stemming from social and environmental issues. What remains is for companies to identify the risks they face in this area, take stock of the relevant management capabilities they possess, and then integrate these capabilities where they can be most effective in protecting and creating shareholder value—across value drivers and strategic planning.

Lessons: Getting Started on Social Risk Management

1. An integrated management approach is needed to address social risks
2. Clearly defined roles and responsibilities, from headquarters to local levels, are essential to timely and integrated responses to social risks
3. Existing protocols may not be suited to the issue-stakeholder combination that characterizes social risk and can yield unanticipated or undesirable results
4. Focused appropriately, proactive stakeholder engagement can be an effective social risk management tool
5. Corporate culture and leadership are important determinants in whether managers will look beyond traditional risks to anticipate risks from "nontraditional" sources, such as local stakeholders

1. Introduction

Social and environmental issues, once assumed to be the domains of government and non-governmental organizations (NGOs), continue to move up the corporate leadership agenda. Incidents of reputational damage related to the way society perceives companies’ impacts on climate change, obesity, workers’ rights, poverty, and other social and environmental issues are becoming increasingly frequent. The challenges that these issues present to companies’ traditional ways of conducting business increasingly populate the business headlines.

Companies have responded to these challenges by using a range of activities and investments categorized under the “corporate social responsibility” umbrella (e.g., corporate philanthropy, stakeholder engagement, and sustainability reporting). These investments have yielded some notable successes—yet the incidences of bad press, consumer boycotts, shareholder activism, and other negative feedback from society to business have not diminished.

The authors believe that the disconnect between actual and desired results is a product of isolated or misaligned management approaches, which, in turn, stem from an incomplete understanding of the

strategic significance of social and environmental issues or of the expectations of stakeholders who care about those issues. This paper presents an argument for managing social and environmental issues as sources of strategic risk and opportunity for companies, and concludes with a set of questions for discussion and further research.

2. Strategic Risk

A series of spectacular corporate governance and ethical compliance failures—as well as the Sarbanes-Oxley Act and other regulatory responses—have focused increasing attention on governance and compliance risks. Equally serious are the long-term "strategic risks" that companies face.

Strategic risks can take many forms. One familiar example is the failure to predict shifts in consumer preferences. For instance, McDonald's $24 billion loss in market capitalization from the start of 2002 to the end of 2003 was widely attributed to a combination of low-quality service at restaurants and failing to anticipate healthy eating trends. Other strategic risks include disruptive innovations that alter the cost structure of an entire industry[1] (e.g., digital photography replacing traditional photography; Palm Pilots or BlackBerries edging out notebook computers); shifts in public policy (e.g., trade and tariff barriers or restrictions on foreign direct investment); losses or sudden/ permanent increases in the cost of un-substitutable inputs (e.g., fuel in the airline industry); or changes in the competitive landscape (e.g., rapid-fire growth of grocery retailers like Whole Foods selling limited selections at higher prices).

The origins and impacts of strategic risk are characterized by breadth and complexity involving chain reactions that span the boundaries of the firm and have implications across earnings drivers. What strategic risks have in common—their defining characteristic—is that they have the potential to jeopardize both current earnings and growth prospects. Risk management that is integrated across the company and linked with strategic planning is required not only to mitigate the potential downside inherent in any business strategy but also to fully capture the potential upside.

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3. Social Issues as Sources of Strategic Risk

A key strategic risk that companies often miss or misdiagnose is "social risk."[2] "Social risk" is defined as challenges by stakeholders to companies' business practices due to real or perceived business impacts on a broad range of issues related to human welfare—for example, working conditions, environmental quality, health, or economic opportunity. The consequences may include brand and reputation damage, heightened regulatory pressure, legal action, consumer boycotts, and operational stoppages—jeopardizing short- and long-term shareholder value.

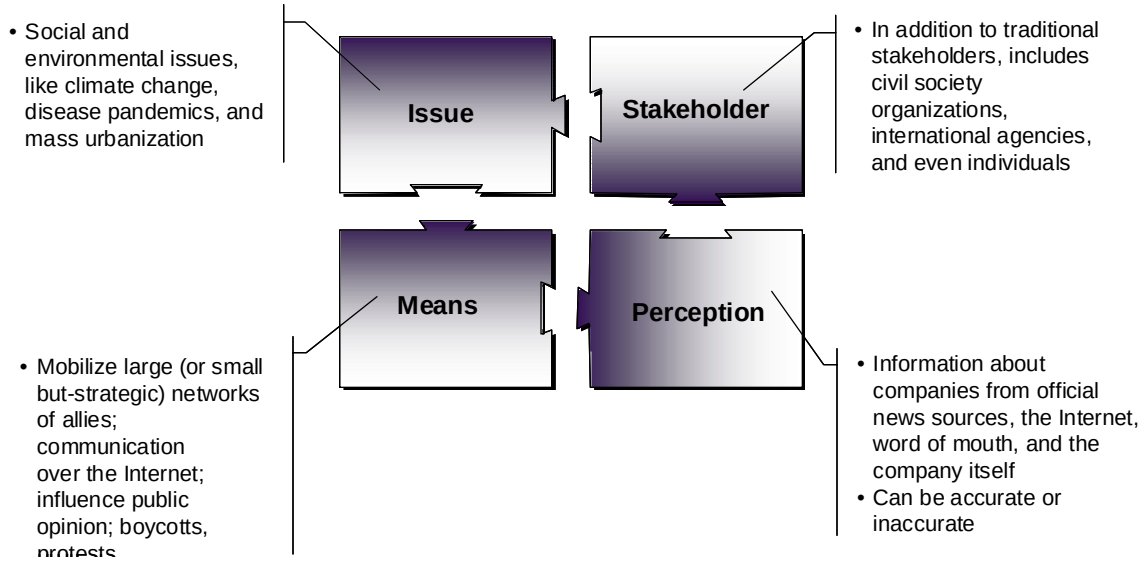
Determinants of Exposure to Social Risk

Given the complexity that is characteristic of a strategic risk, social risk can arise in numerous ways.

In some cases, companies may intentionally or unintentionally contribute to social or environmental problems and provoke stakeholders to mount challenges through whatever means they possess. In other cases, companies may be considered guilty by association, simply for operating in areas with deep social problems—with stakeholders' negative perceptions based on misinformation, misunderstanding, or simple lack of any other lever to pull to draw attention or resources to the problems that exist. This second pattern is particularly common in, but not confined to, weak governance zones (e.g., Nigeria or the Democratic Republic of Congo).[3]

Social risk incidents display a wide range of unique dynamics. Nevertheless, as Exhibit 1 illustrates, the emergence of social risk is characterized by four components in combination: an issue, a stakeholder or group of stakeholders, a negative perception about the company, and the means to do damage.

Exhibit 1. Social Risk Components



Issue

Social and environmental issues, like climate change, disease pandemics, and mass urbanization, are taking on heightened significance at a global level. Certainly, most executives recognize that these are important societal challenges. The difficulty is that many executives stop there, failing to recognize the significance of these seemingly diffuse, traditionally "public" problems to their businesses. Depending on the industry sector and location, these problems affect companies and companies affect them in various ways—for example, through supply chains, communications networks, joint venture and trading relationships, and sales and staffing strategies.

Let's take two examples from the mining industry. Anglo-American is exposed to risk associated with HIV/AIDS through its labor force (composed of male migrant workers far from their wives) and its location (southern Africa, where the disease is prevalent). Newmont, the world's largest gold producer, contributes to environmental degradation by virtue of the very business it is in. To extract minerals from the earth, thereby providing jobs and meeting market demand, it must strip and blast the land, using toxic substances to separate gold from rock and ore.

Water Issues as Sources of Strategic Risk

Less than 3 percent of the world's water is fresh and therefore fit for human consumption; the remainder is seawater and is therefore undrinkable. Of the potable 3 percent, more than 2.5 is frozen in Arctic and Antarctic glaciers. This leaves a mere 0.5 percent available to meet global water needs—including human consumption, agricultural irrigation, and industrial usage.[i] Population growth and economic development trends are expected to increase world water demand significantly in the coming years. According to the Center for Strategic and International Studies (CSIS), water scarcity will be the most serious resource challenge facing humanity by 2025.[ii]

This poses a risk for companies that depend on water as a process input (in agriculture or aluminum processing, for example), as a product in and of itself (like bottled water and other beverages), or as a complementary good (for personal hygiene products, dishwashers, or washing machines, for instance). While it may be several years before water scarcity poses a direct operating constraint, social risks stemming from water scarcity are already making themselves felt.

Water Issue: Quantity and Quality

In many parts of the world, water is chronically short. In some places, the poor quality of water adds "felt scarcity"—while some water may be available, its utility is limited, at least without extensive treatment and purification. As a result, it is effectively unavailable, particularly to domestic users with low incomes.

The Coca-Cola Company experienced the impact of these issues starting in early 2000, when it opened a bottling plant in Kerala, India. In mid-2002, the region entered a 3-year cycle of moderate-to-severe drought. In 2003, BBC Radio aired a report claiming that bio-solids from the plant contained unsafe levels of cadmium and lead. In 2004, activists began to claim that the Coca-Cola bottling plant in Kerala was depleting the aquifer by unreasonably withdrawing groundwater. Associated reputational difficulties are still ongoing.

Bans on the sale of Coca-Cola products at 6 U.S. colleges further underscored the need for the company to comprehensively and strategically address its water use and growing negative perceptions thereof. A key challenge is that The Coca-Cola Company does not own a majority of its bottling plants, which are independent businesses. This leaves Coca-Cola in the position of needing to convince local bottlers to prioritize issues such as water use and community relations.

To better understand and address these challenges, the company, in partnership with its bottlers, launched the Environment and Water Resources department in 2004.[iii] The department is staffed by hydrologists, wastewater treatment experts, corporate quality managers, environmental engineers, and anthropologists. It reports to the Senior Vice President of Stewardship, and works cross-functionally with public affairs and marketing and the corporate innovation group.

So far, the company has completed more than 800 plant-level water risk assessments worldwide, the results of which are being incorporated in local and regional strategy. The company has also begun to develop a company-wide water strategy. Through this and its water scarcity mapping work—by which the company overlays data on water scarcity by region with the location of its bottling plants—Coca-Cola has developed a business tool with which managers can make decisions on project growth and design based on water availability and scarcity data. In addition, the company is working with NGOs to better understand and manage stakeholder perceptions about water issues.

Water quality and quantity are not the only water-related issues to present sources of social risk for companies. Others include water privatization and water depletion and transfer.

Water Issue: Privatization

Proponents of water privatization claim that only the private sector's research, technology, and financial capacities will be able to extend clean water and sanitation services to the world's poor.[iv] Many indigenous communities and civil society groups, on the other hand, link privatized water with high costs, unfair treatment by large foreign companies, and oppressive or imperialistic international financial institutions.[v]

Bechtel came into the crosshairs of these concerns after being granted a 40-year water privatization lease in Bolivia. When the company doubled water rates, protesters took to the streets. The Bolivian government insisted that Bechtel leave the country. The company sought $50 million in lost profits, but agreed to settle for

a token payment of 2 bolivianos (about 30 cents) in January 2006.

Water Issue: Water Depletion and Transfer

Bottling and resale of water, particularly when it involves a transfer of water from resource-poor to resource-rich regions or from developing to developed countries, is a growing point of contention for civil society groups. The bottled water industry typically sources, purifies or enhances, and bottles groundwater—accelerating rates of groundwater depletion significantly.

Nestlé/Perrier has come under scrutiny for its groundwater extraction practices in both Brazil and the United States. In Michigan, the civil society organization Michigan Citizens for Water Conservation filed a lawsuit to prevent the pumping of water for bottled water. In Brazil, the BBC reports, the company over-pumped water for its Pure Life Brand, resulting in long-term damage. The Citizens for Water movement turned to authorities and a federal investigation was opened, resulting in charges against Nestlé/Perrier.

References

[i] World Business Council on Sustainable Development (WBCSD), Water Facts and Trends. (Geneva: WBCSD, August 2005).

[ii] Center for Strategic and International Studies, "Seven Revolutions." <www.7revs.org/sevenrevs_content.html> accessed July 12, 2006.

[iii] Information based on discussion between Tamara Bekefi and Harry Ott, Director of Global Environmental Assurance, The Coca-Cola Company. 26 May 2006.

[iv] World Bank website < http://www.worldbank.org> accessed July 12, 2006.

[v] Sierra Club website <http://www.sierraclub.org> accessed July 12, 2006.

Stakeholder

Companies have traditionally considered as stakeholders their shareholders, employees, customers, suppliers, business partners, and other key influencers (e.g., regulators and Wall Street analysts). But many others—civil society organizations, international agencies, and even individuals—now claim "stakes" in companies because they have stakes in the issues to which the companies are connected. As Nike stated in its 2001 Corporate Responsibility Report,

> *A few years ago we did not look beyond our corporate walls for much input on anything we were doing… Input into business decisions was limited almost exclusively to those stakeholders with whom we had some type of financial relationship—employees, consumers, retailers, suppliers, investors and recipients of corporate giving. We learned the hard way that our view of the world was not as informed as it should have been.*[4]

Nike now engages with environmental organizations, human rights groups, students, colleges, trade unions, socially responsible investor groups, and academia, in addition to its traditional stakeholders.[5]

Perception

Stakeholder perceptions are based on various information sources, including official news media, the Internet, word of mouth, and the company itself. Negative perceptions may stem from anti-corporatist or anti-capitalist sentiment. Furthermore, negative perceptions are more likely to arise in the absence of regular information or communication from the company itself, leading to a partial understanding of the company and its business.

Negative perceptions of a company can be accurate or inaccurate, and both can lead to challenges against the company. In 2001, for example, a coalition of 13 NGOs challenged McDonald's about the overuse of antibiotics in animal feed in its supply chain. The World Health Organization and American Medical Association had linked this practice to increasing antibiotic resistance in human bacterial infections. In response, McDonald's acknowledged that its heavy use of growth-stimulating antibiotics threatened human health.[6]

In contrast, in 1995, Greenpeace challenged Shell for plans to dispose of its Brent Spar oil storage buoy by sinking it in deep ocean water. Greenpace claimed that it still held over 5,000 tons of oil and would be an immense environmental hazard if sunk.[7] Amid protest and facing boycotts and a decline in its share price, Shell decided instead to pull Brent Spar ashore. Greenpeace later acknowledged publicly that its estimate of the oil remaining in the buoy was incorrect. An independent analysis showed the actual number was between 75-103 tons, closer to Shell's original estimate of around 53.[8]

Most cases are not clear-cut. Sometimes the truth is disputed, as in the case of Shell in Nigeria. In this case, the company is accused of environmental degradation and human rights abuses. In other cases, trade-offs are involved, and "right" and "wrong" are interpreted differently by different parties. Say, for example, that a garment manufacturer moves to establish low-wage factories in Africa. An American student group might consider these factories "exploiters of the poor." For these factories' employees, however, so-called "sweatshop work" may be considerably better than available alternatives.[9]

Means

A stakeholder may possess a variety of means to affect corporate conduct, not necessarily linked to money or organizational size. For example, even small grassroots nonprofits may be able to mobilize large (or small-but-strategic) networks of allies very quickly. For example, many local NGOs are linked through international aggregator organizations (e.g., Oxfam, Greenpeace, or Amnesty International) and can disseminate information or escalate dialogue to the global level very quickly. Funding relationships can create similar international networks.

Civil society as a sector enjoys a higher level of trust than does government or business. Edelman's 2005 Trust Barometer, for example, showed that "NGOs are now the most trusted institution in every market except China."[10] The advent of cheap information and communications technologies (e.g., the Internet and mobile phones) gives such organizations unprecedented influence over public opinion, which may encompass traditional stakeholders like customers and regulators.

Some Examples

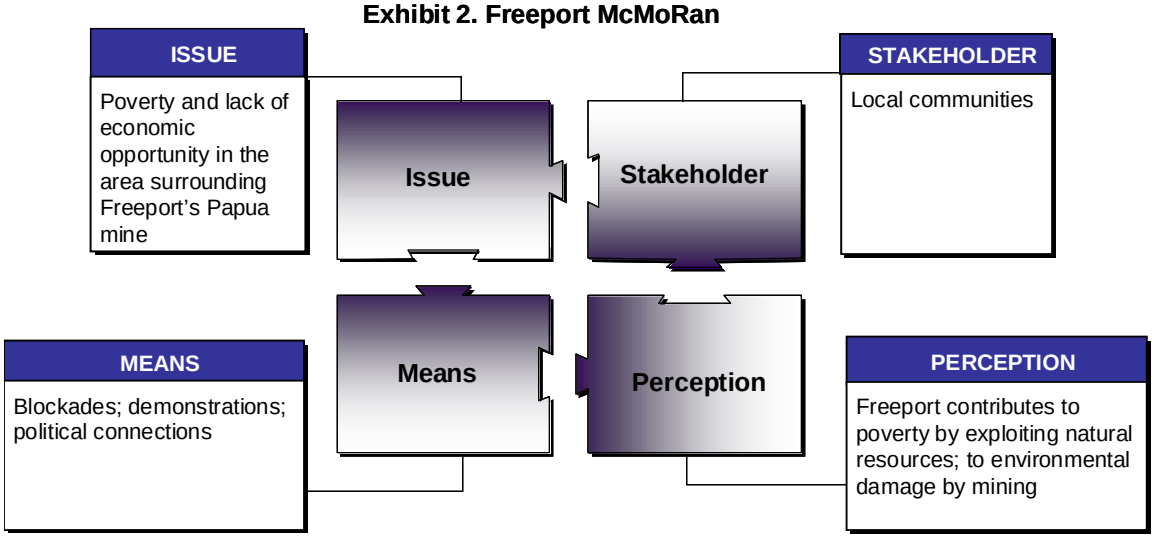
Social risk incidents have become staples in the news media. In a recent example, U.S.-based Freeport McMoRan lost between $40 and $60 million as a result of a social risk incident in the Indonesian province of Papua (see Exhibit 2).[11] Rich in natural resources, Papua sustains much of the Indonesian economy. However, average Papuans enjoy little benefit from the various mining operations or logging and fishing industries in the region, due to a combination of regulations and governance in addition to industry practices.[12]

Faced with a lack of alternative economic opportunities, poor residents of the area surrounding the mine had taken to prospecting for gold in the waste rock Freeport McMoRan left behind. The company moved to prohibit this, stationing private security guards around the site, allegedly allowing

them to fire rubber bullets on anyone attempting to prospect.

Despite investments by Freeport of over $200 million in educational, medical and employment initiatives since 1996, the local community lashed out against the company.[13] Demonstrators moved in, shutting the mine down for days—at a cost of between $10 and 12 million per day.[14] The company argued that the waste rock might have contained hazardous chemicals and that its added security was a health and safety issue. Public perception, however, was that this was a poor attempt to cover up for the injustice inherent in a wealthy multinational corporation preventing poor locals from increasing their incomes by scavenging through its trash.

Exhibit 2. Freeport McMoRan



Although Freeport ultimately resolved the dispute by allowing community prospecting to resume, peaceful demonstrators continued to gather daily at the mine site. Protests spread to provincial and national capital cities, where police used water cannons and tear gas against demonstrators. The demonstrators' complaints also expanded, including the terms of Freeport's mining concessions and its environmental impacts. Although the government has vowed that the mine will remain open, the Indonesian president has committed to investigating numerous grievances that are potentially more far-reaching than the original prospecting issue. These include allegations that Papuans do not receive enough of the mine's economic benefits and that the mine causes environmental damage and risks to community health.

In Freeport's case, what might have seemed like a minor, isolated decision triggered unexpected cascading effects.For Wal-Mart, social risk is systemic, and its implications are still emerging.

Wal-Mart has grown at breakneck speed, opening about 200 stores annually since 2000. The company has achieved success because it excels at meeting customers' needs, offers variety and convenience at affordable prices, and, according to one study, saves the average customer household more than $2,000 annually.[15]

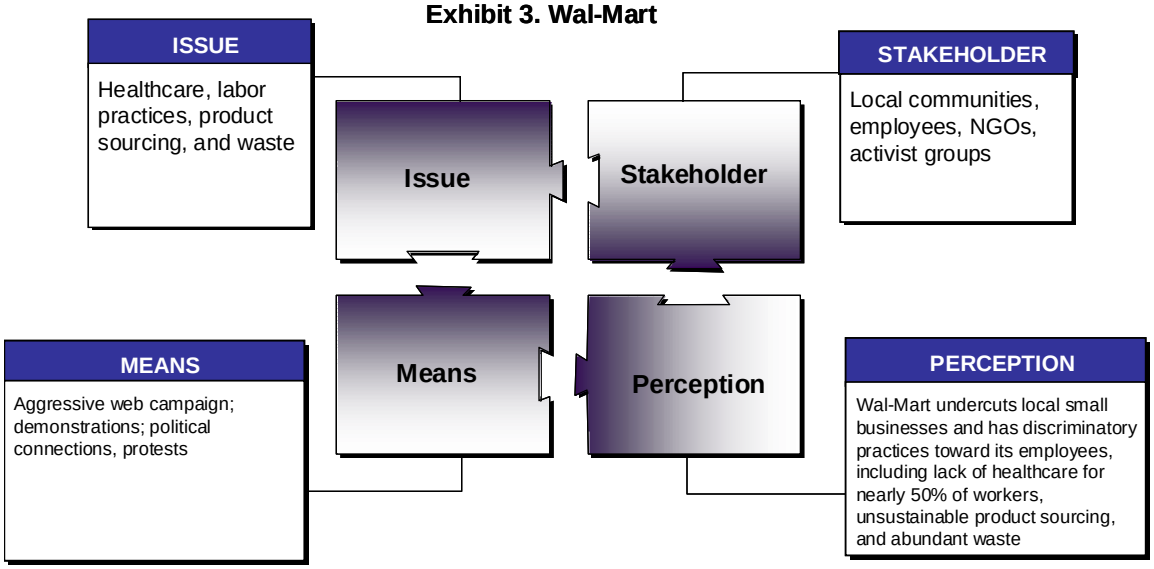
However, Wal-Mart developed its strategy for delivering value to customers and shareholders with what many perceive to have been relatively little regard for its impacts on other stakeholders within its operating environment—employees, suppliers, local communities, the environment. These impacts have caused the company reputational difficulties that have become acute. Despite being named the "Most Admired Company in America" by Fortune magazine for 2003 and 2004, Wal-Mart

faces a chorus of critics, including organized labor, human rights activists, environmentalists, and local businesses, all of whom "revile the retail giant for its business practices. The result has been a growing negative consumer perception of Wal-Mart's corporate citizenship."[16] Fortune itself asked in 2004, "Which should we believe in: good Wal-Mart or evil Wal-Mart?"[17]

The company has recently gone to lengths to overhaul its policies and practices in many of these areas—for example, providing health insurance for most of its full- and part-time employees (about 73 percent of associates are eligible), rewarding environmentally friendly suppliers, limiting energy use, and urging Congress to raise the minimum wage. Unfortunately, not all stakeholders' perceptions have turned around (see Exhibit 3).

Stakeholders' perceptions about the social, environmental, and economic impacts of Wal-Mart's business practices now constitute a strategic risk for the company: they have the potential not only to increase costs in the short term but also to constrain its options for creating shareholder value. Neighborhoods from Arizona to New York have banded together to fight Wal-Mart's arrival into their communities, viewing the stores as detrimental to homegrown business and quality of life. In the 7 years since 1999, even though profits have grown by more than $4 billion, the company's stock price has been flat.

Exhibit 3. Wal-Mart



Why is social risk emerging now?

Numerous global trends have converged to make social risk incidents like these an increasingly prominent part of the corporate strategic landscape. One is increasing interconnection and interdependence. Linkages such as trading relationships and supply chains, international financial flows, migration, and information and communications technologies are bringing down boundaries on a global scale. Today, one blogger can reach as wide an audience as a large ad campaign. Previously isolated issues and trends are no longer necessarily confined to a single region, discipline, or economic sector; rather, they spread and evolve quickly, affecting business, government, and civil society organizations alike. These issues are like glue, binding together organizations, including companies and activist NGOs that previously would not have had much in common. Moreover,

these actors' spheres of influence and responsibility with respect to the issues and trends are no longer defined by sectoral boundaries but by mutual expectations, which are still evolving. For instance, the government might look to corporations to help provide public goods like education and security, or corporations might look to NGOs for sources of business and political intelligence, or NGOs might look to corporations to ensure basic human rights.

A related trend contributing to the emergence of social risk is the rise of civil society. In the past, governments were, for the most part, the ones empowered to set the rules. Today, governments no longer enjoy a monopoly on rulemaking; rather, they share this power with multilateral institutions and a growing number of transnational corporations and non-governmental organizations. NGOs have been proliferating very rapidly. As the relative power of government to solve social and environmental problems has declined, NGOs are looking to corporations to take additional responsibility. Simultaneously, increasingly low-cost information and communications technologies have given these NGOs unprecedented visibility into corporate operations and unprecedented leverage with which to challenge them.

The net result is a new kind of operating environment in which traditional strategies are no longer optimal and are increasingly penalized. What seem like sound business decisions (e.g., to outsource production to a developing country to save on labor costs) can run into unexpected resistance, often in the form of bad publicity, reputation damage, and demand for accountability to previously unknown stakeholders with unanticipated expectations.

Why the surprise?

Companies are accustomed to framing their strategic decisions with reference to shareholders, employees, customers, suppliers, business partners, regulators, and competitors—all traditional inhabitants of a "business ecosystem."[18] But new sets of players now have the power to support or impede companies' strategic success. It is time to think about a new, expanded business ecosystem. Companies must begin to monitor, assess, and manage strategic risk and opportunity in the context of a broad suite of social and environmental issues and stakeholders.

4. Strategic Management of Social Risk

Traditional risk management programs are narrowly focused on operational and compliance risks and consist of point solutions: mitigation actions specific to particular sources or impacts of risk. It can be more efficient and cost effective to adopt a coherent, enterprise-wide approach, particularly where operational or compliance risks arise in multiple places. Point solutions can work for "point" risks, where the main objective of risk management is to avoid or prepare for a particular event and in so doing reduce the associated cost. However, point solutions cannot work for strategic risks, where complex origins demand integrated management approaches. Social risk is an illustrative case.

One dimension of social risk's complexity is that it is often a function of strategic or operational decisions companies have made that affect issues that stakeholders care about. For example, a hypothetical clothing retailer may set aggressive growth targets and structure its performance incentives for buyers accordingly. Consequently, buyers implement a demanding procurement process, causing suppliers to break their codes of conduct by using forced overtime. This runs afoul of NGO

watchdogs' expectations, and the negative publicity these NGOs instigate causes company headaches.

The combination of issues and stakeholders adds another dimension of complexity, meaning that both must be managed to effectively reduce social risk. It can be difficult enough to understand, monitor, and address social and environmental issues from a strategic business standpoint. Empowered stakeholders alter that equation, as they themselves require understanding, monitoring, and addressing. A company's approach must address not only the root cause of the stakeholders' perception, but also the perception itself.

Complexity of impacts, in addition to origins, reinforces the need for integrated approaches to strategic risk management. Strategic risk can affect multiple earnings drivers, such as cost advantage in production; brand; customer loyalty; premium product status; capacity for innovation; and growth trajectory. Strategic risks can also scale rapidly in geographic terms. Hence, what looks like a local public relations issue might turn from a one-time cost into a corporate reputation issue, jeopardizing customer relationships on a global level and potentially even seeding change in regulatory or concessionary regimes as regulation catches up to societal opinion.

Note that when linked to strategic planning, integrated risk management approaches can serve not only to protect value but also to help create it. This is because for strategic risks, in contrast with traditional compliance or hazard risks, risk and opportunity are often two sides of the same coin. A strategic risk that is anticipated early and mitigated well can be converted into a new market, a competitive advantage, a stock of goodwill, or a strategic relationship. A quality strategic risk program will therefore adopt a forward-looking perspective geared as much to prevent missed opportunities as to prevent negative earnings surprises.

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A key function of such a program is to provide sensing and awareness about changes in the external environment that have the potential to affect the company's business model. When this information is linked to strategic planning, it can be used to course-correct, drive innovation, and even identify entirely new sources of growth.

Social risk management, precisely because of the issue-actor combination that makes it so challenging, has a unique upside contribution to make when it is done well. Many companies are dealing with social risks that have already manifested themselves, working with stakeholders to rebuild trust and reputation, limit the damage, and in some cases engage on the issues to help prevent future incidents.

Companies should note this potential, regardless of whether they have yet suffered from social risks, and proactively seek to understand the full range of the social and environmental issues that affect them and on which they in turn have an impact.These companies should then move from understanding the issues to identifying fellow stakeholders in those issues—understanding their motivations, assets, and objectives. At any given time, some stakeholders will present risks and some will present opportunities. Companies should engage strategically with both categories of stakeholders. The

objective is not to get them to go away, although with some stakeholders, that might be the best a company can hope for. The real objective is to build relationships that are conducive to managing the risks and opportunities arising out of the issues in which both parties have common stakes.

Building relationships can help companies obtain and sustain "license to operate," or freedom from stakeholder challenges to their business practices. It can contribute to a reputation for good corporate citizenship, which could give a company an advantage with ethical consumers or investors, or facilitate a bid next time the company competes for a concession or requests regulatory approval for an investment.

Moreover, strong relationships that are built and maintained over time with stakeholders could be a good form of insurance or option value for a company. These relationships can buy time and patience from those with the power to challenge the business if it causes a negative social impact. These relationships can be good sources of sensing and awareness about emerging risks and opportunities—helping to identify the issues, understand the dynamics behind them, and track them as they evolve.[19]

Occasionally, these relationships may form the basis of more collaborative, operational partnerships, with stakeholders actively helping companies mitigate risks and capture new opportunities over the long term.[20] For example, SC Johnson combined forces with the social enterprise KickStart to manage risk in the quantity and quality of supply of pyrethrum, a key ingredient in insecticides. Its strategy was to market manually operated pumps to farmers to help them irrigate their crops affordably, which not only met the company's goals of ensuring long-term availability, quality, and lower cost of pyrethrum but also raised household income levels among the farmers.[21]

The advantages of good social risk management will vary from company to company based on each organization's unique business model, the issues to which it is exposed, and the stakeholders to which it is connected. In a "new business ecosystem" world, however, the imperative is increasingly clear. As global trends bring issues and actors ever closer, social risk management becomes increasingly important as a tool for strategy development and execution—allowing corporate leaders to anticipate, plot a course, and navigate successfully through changes and challenges in their rapidly evolving, increasingly global, operating environments.

Many companies have, within their corporate social responsibility, public affairs, or other departments, the necessary capabilities and expertise to manage strategic risks stemming from social and environmental issues. What remains is for companies to identify the risks they face in this area, take stock of the relevant management capabilities they possess, and then integrate these capabilities where they can be most effective in protecting and creating shareholder value—across value drivers and strategic planning.

5. Questions for Discussion

1. How does your company determine which social, environmental, or international development issues are "strategic" from a business perspective?

2. How do you communicate the strategic nature of these issues at or up to the CEO or Board level? How do you communicate it at or down to the business unit or operating level?

3. Who (e.g. business unit, department head) has responsibility for tracking, raising, and/or managing social issues? Is the process explicit or ad hoc?

4. What organizational or cultural barriers, if any, does your company face in raising or managing social issues at the strategic level? For example, are social issues treated "differently" or "separately" from other business risks? Are there incentives for longer-term thinking?

One Company's Approach to Exploring Social Risk as a Strategic Risk: Water Scarcity Simulation Exercise at an International Brewer

Situation

The brewer is one of the largest in the world. A publicly traded company, it is has a diverse portfolio of brands, particularly in emerging markets, and has employees across the Americas, Europe, and Asia Pacific.

99 percent of beer is water. As a large consumer of water, with operations in a growing number of developing countries, the company's business model exposes it to potential risks stemming from water scarcity issues.

Key Issues and Challenges

Unlike many of the companies profiled in this report, the brewer has not yet been hit by a major social risk. Nonetheless, the company wanted to be proactive in examining the causes and management of such risks. In particular, the company wanted to better understand how such a risk could arise, the parts of its business model that would be vulnerable if this were to occur, and how well positioned the company would be to respond to such risks.

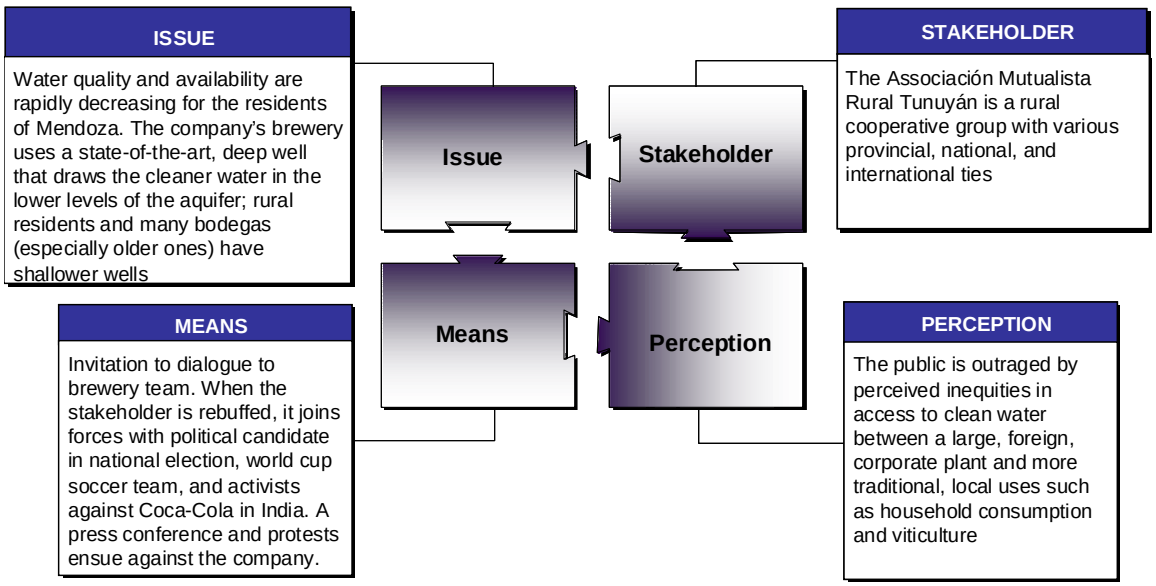
The company wanted to know whether a social risk could be a "game over" risk—for example, if stakeholder concerns about the company's water use were to heighten, could the company eventually lose access to its most important raw material in important markets? The company also wanted to anticipate the internal and external barriers it might face in executing a response.

Approach

The brewer's senior leadership decided proactively to examine its vulnerabilities to and capabilities for responding to social risk via a strategic simulation on the topic of water scarcity, conducted in conjunction with Booz Allen Hamilton and the Corporate Social Responsibility (CSR) Initiative at Harvard University's Kennedy School of Government.

In early 2006, more than 20 senior managers from the audit, legal, and corporate affairs departments gathered, along with representatives from the CSR Initiative and the International Business Leaders Forum, to explore a hypothetical social risk incident related to the company's water use in Latin America.

Exhibit 6. Social Risks Facing the Company in Hypothetical Simulation



The Booz Allen team designed a realistic scenario to be played out over the course of 5 hours. The joint Booz Allen-Harvard-Brewer team agreed on five key questions to explore within the simulation:

1. How is strategic risk comparable to other strategic risks that the company faces?
2. What are the impacts of the social risk incident in the simulation on the company's value drivers?
3. How is water a strategic risk for the company?
4. How would we respond to a social risk? 14
5. What are the opportunities for and barriers to an integrated response?

Results

Through the scenario, the company was able to identify its own internal barriers to responding to the strategic risk. Key learnings for the company were as follows:

- Social risk displays the characteristics of a strategic risk (breadth, with potential impacts across multiple business units; complexity, requiring cross-functional management capabilities; multi-stakeholder natures, often involving competing viewpoints; and implications for both short- and long-term shareholder value)
- A management approach that is integrated across functions and levels is needed to address social risks
- Protocols, or lack thereof, can hinder timely and integrated response to risks
- Internal processes are also important to the response; the company needs to know who within it (e.g., Corporate Affairs, Brewery, Business Unit) is responsible for leading an integrated response to social risks and give the local team the mandate and tools to act
- Addressing a social risk may help a company identify other strategic risks or uncover opportunities
- Stakeholder engagement can be used as a proactive risk management tool; at the global level, it helps identify industry-wide issues and potential collaborators; on the local level, it can help to form community bonds and guard against negative community perceptions
- Corporate culture and leadership support are important determinants of whether managers will go beyond traditional risks and be open to sensing risk from "non-traditional" sources, such as local stakeholders.

Since the simulation, the company has shared lessons learned with senior leadership and board members. The company is now using the learnings from the simulation to justify and help frame the development of an overarching and integrated strategic risk management program that will help the company in the future to identify and account for all strategic risks, including social risks.

Endnotes

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About the CSR Initiative and Booz Allen Hamilton

Corporate Social Responsibility Initiative

The Corporate Social Responsibility (CSR) Initiative at the Kennedy School of Government is a multi-disciplinary program that seeks to study and enhance the public role of the private enterprise. It explores the intersection of corporate responsibility, corporate governance and strategy, public policy, and the media. It bridges theory and practice, builds leadership skills, and supports constructive dialogue and collaboration among different sectors. It was founded in 2004 with the support of Walter H. Shorenstein, Chevron Corporation, The Coca-Cola Company, and General Motors.

Booz Allen Hamilton

Booz Allen Hamilton has been at the forefront of management consulting for businesses and government for over 90 years. Booz Allen Hamilton, a global strategy and technology consulting firm, works with clients to deliver results that endure. With more then 17,000 employees on six continents, the firm generates annual sales of over $3 billion. Booz Allen provides services in strategy, organization, operations, systems, and technology to the world's leading corporations, governments and other public agencies, emerging growth companies, and institutions. To learn more about the firm, visit the Booz Allen website at www.boozallen.com.

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Acknowledgements

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Beth Jenkins

Beth Jenkins is Director of Policy Studies for the CSR Initiative. Before joining CSRI, she was responsible for developing and disseminating risk management concepts and capabilities at Booz Allen, with special emphasis on the strategic risks companies face as a result of social, environmental, and international development issues. She also spent four years working on "bottom of the pyramid" growth strategies for companies in the technology and housing sectors at the World Resources Institute and Ashoka. She is a graduate of Yale University and Harvard's Kennedy School of Government.

Beth Kytle

Beth Kytle was formerly an associate at Booz Allen Hamilton, a global strategy and technology consulting services firm. At the firm, she was part of a team working to shape the firm's intellectual capital related to risk management and globalization, with an emphasis on social risk. She was also the project manager for the firm's pro-bono support for the Kennedy School's Corporate Social Responsibility Initiative. She co-wrote "Corporate Social Responsibility as Risk Management: A Model for Multinationals," the first working paper in the series on social risk, with Professor John Ruggie. She received her A.B. in Government from Harvard University and is currently a 2008 MBA candidate at Stanford's Graduate School of Business.