

In control

Realising return from risk management

Points of view for the Chief Finance Officer agenda



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'Understanding risk leads to informed decisions'.

Survey respondent

In 2007, a team from PricewaterhouseCoopers set out to interview finance directors from across a range of commercial sectors about their approach to risk management and how effectively it is embedded into their overall strategy.

The survey process was deeply revealing. Many of the companies we interviewed had invested considerable time and money to strengthen their risk management process. However, most are still finding it difficult to incorporate necessary awareness of the risks they face and how they should be addressed into the strategic planning and frontline operations of their business. Finance directors look to the dedicated risk management units to tell them how they manage risk, indicating that it is still primarily viewed as a back-office function rather than an integral part of frontline decision making.

The underlying difficulties often stem from problems of perception and communication. In particular, risk management is often seen as a series of largely compliance-driven processes that have little relevance to the day-to-day profit-generating priorities of the business. In turn, the role of the risk manager is often unclear or misunderstood within the business, while risk teams themselves can often find it difficult to communicate with the right audience at the right level.

Drawing on our research and work with clients, this publication looks at how companies could enhance the effectiveness and competitive value of risk management. Clearly, every organisation is different and their approach needs to be in keeping with the particular objectives and characteristics of their business. However, we hope that this paper can provide some helpful insights into how finance directors can manage risk better.

‘Risk management is seen as a “necessary evil” within our organisation and the group risk manager is still trying to sell the benefits.’

Survey respondent

Executive summary

Despite considerable investment in improving the management of risk, many companies are still finding it difficult to gain business buy-in for risk management as an integral element of decision making.

Risk and performance management still largely operate in silos, meaning that businesses may not only be vulnerable to unforeseen or misjudged risks, but might also be missing valuable opportunities (taking too little risk). Over the past few years, risk management has become synonymous with risk mitigation rather than delivering its broader potential benefits. A strong focus on compliance has resulted in meeting minimum imposed standards as a defacto substitute to true risk management.

On the basis of our recent conversations with CFOs and other senior management, this document highlights the following areas (see scorecard to the right) where companies are struggling to deliver the fuller risk management agenda:

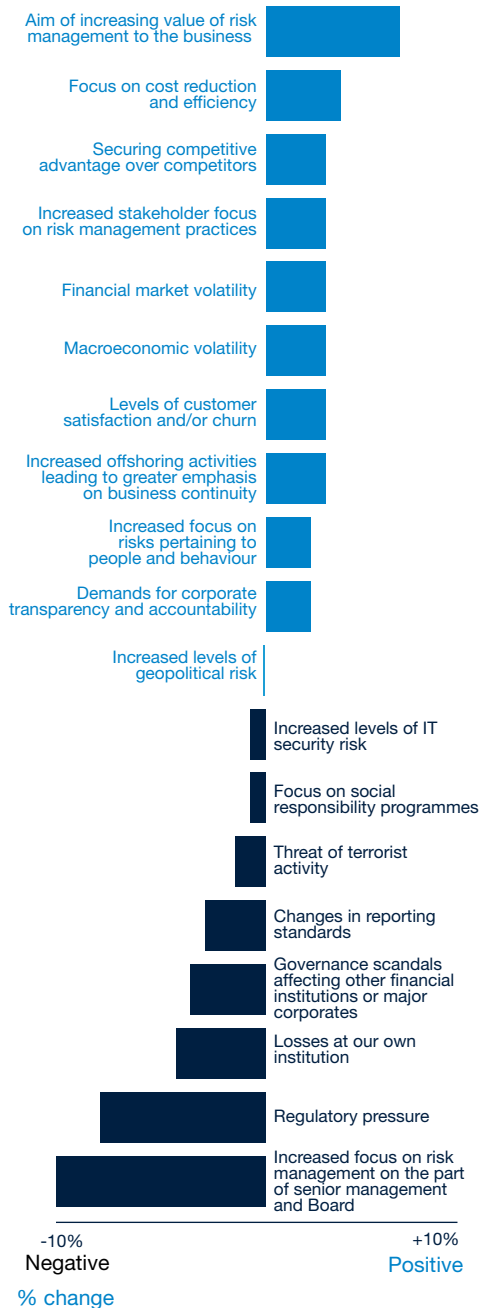
- Aligning performance and risk, particularly articulating a meaningful explicit risk strategy and appetite that ensures potential gains, threats and compliance are viewed collectively when making decisions.
- Broadening the focus of risk management and embedding and integrating the corporate risk appetite and risk strategy into the culture of the business.
- Ensuring any emerging change in the nature of risk is adequately identified, measured, communicated and managed throughout the business.
- Evolving the “risk function” beyond compliance into a more strategic function that shapes corporate objectives rather than drags corporate performance.

‘Effective risk management can lead to improved understanding and therefore the ability to take increased risk safely.’

Survey respondent

Winds of change








A recent PwC CEO survey highlights the change in the drivers of risk management priorities for organisations over the next three years



Source: PricewaterhouseCoopers CEO Survey

Findings

This summary represents the collective results of our study on the basis that companies should be rated satisfactory in all the areas to know what might stop them achieving their strategic objectives.

How have you defined your risk strategy including risk appetite/tolerance? People struggle with risk appetite and confuse process with strategy.	
How important is risk management to the Board? Risk is important to the Board, but they lack confidence that key risks are being managed	
How have you defined and rolled out a 'risk culture' across the business? Aware, but generally informal/not measured.	
Do you undertake a structured risk assessment as part of your business or strategic planning process? Majority of companies do, the challenge is in the implementation.	
Do your risk management activities focus on the areas that most impact your strategic objectives? Companies have started to look beyond financial risks, however the focus is still not as much on strategic risks as it should be.	
Is management of the risks identified at a strategic level integrated into the operations of your business? Our sense is not.	DON'T KNOW
How comfortable are you with the accuracy, thoroughness and timeliness of your risk reporting? Risk reporting is increasing, but quality remains in question.	
How do you identify key emerging risks? What are they? How often do you update this analysis? Most companies rely on a planning process though there are examples of collaboration within industries. Some companies rely on crisis management.	

Source: PricewaterhouseCoopers 'In Control' study 2007

Key:  Satisfactory	 Requires attention	 Suggest immediate investigation
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Strategic platform: Articulating the risk appetite

‘Having spent years debating our risk appetite, we came to the conclusion that it cannot be defined.’

Survey respondent

There can be no reward without at least some risk, but too much can jeopardise the business. It is therefore essential that companies develop an agreed understanding of how much risk they are prepared to take to deliver their strategic objectives – the ‘risk appetite’. Defined well, risk appetite translates risk metrics and methods into business decisions, reporting and day-to-day business discussions. It sets the boundaries which form a dynamic link between strategy, target setting and risk management.

As our research highlighted, this is often easier said than done. While most companies have an innate sense of how much risk they are prepared to accept, they often find that this largely intuitive or high-level ‘risk appetite’ is difficult to articulate into tangible and actionable guidance for business decisions or behaviour on the ground. This is partly due to its qualitative nature and the need to combine the views of different stakeholders. More importantly, risk management is generally perceived to focus on loss avoidance rather than the return from taking risks such as increased sales or growth in profit.

One method of setting the risk appetite is to use a top-down approach in which the Board/Executives seek to identify the most serious threats to the business, their likelihood and potential impact. A top down approach should incorporate the explicit requirements of the various external stakeholders and stimulate debate in the executive team. The process can also be used to engage the Board and non-executive directors on the subject. The result is a robust framework that can be used to articulate appetite throughout the group and to external stakeholders.

Our study found that leading companies incorporate their risk appetite framework (see following page) into key business processes like the annual planning process using risk adjusted metrics. By taking the appetite measure beyond pure loss, integrating risk into business planning and then making it operational through setting limits and controls, high level priorities can be translated into something that is meaningful to staff on the ground.

Looking outside the organisation, further input from customers, investors, regulators and other key external stakeholders can help to align the risk appetite with external expectations. The table below demonstrates the potential range of stakeholder expectations and provides parameters which can be communicated to the market in comparative benchmark terms such as impact on share price or earnings per share, providing transparency and clarity over the sound management of the business.



Example of setting risk appetite

Stakeholder	Value Driver	Risk Capacity	Quantitative Measure	Qualitative Measure
Shareholder	Return on investment	Bankruptcy	Share price dividend	Ethical rating
Investment Analyst	Minimal risk of default	Unexplained performance variances	Range of share price movements	Quality of communication around performance
Regulator	Compliance	Number of exceptions	Alignment with regulatory principles	Non-compliance
Customers	Value for money	Price	Quality of Service	Faulty goods

Risk appetite framework explained

The 'top-down' analysis is a high-level view of the organisation's risk appetite, derived from the Board's strategic business plans and the understanding of key stakeholders' expectations. This is usually complemented by a bottom-up analysis of the existing risk profile. Using this approach to articulate risk appetite provides:

- Clarity over the risks that the organisation wishes to assume
- The basis for consistent communication to different stakeholders
- Explicit articulation of the attitudes to risk of the senior management.



Typically organisations start with a top-down assessment of the maximum risk they can bear and this provides an upper boundary to appetite.

Risk capacity: an assessment of the maximum risk an organisation could bear without serious impairment to its business capability, and thus provides an upper boundary to appetite. It is typically based on financial information and external assessment.

Risk appetite: the risk that the organisation tolerates or desires. It is determined iteratively as part of key business processes, within current strategic and longer term operating plans.

Risk profile: the target profile represents the allocation of appetite to risk categories and the actual profile represents risks that are currently assumed.

'My appetite is the amount I want to eat, my risk appetite is the amount of risk I am willing to swallow!'

Survey respondent



Examples of how companies articulate their risk appetite

As part of our investigation, here are some examples of risk appetite approaches currently undertaken in the market place.

Balanced profit and loss

The risk committee of a leading technology company has formulated an integrated risk strategy, policy and appetite based on a defined scoring system using impact and probability. This was then signed off by the Board.

A media organisation has taken this approach one stage further by defining the risk appetite in financial terms as a profit not made or loss taken. Anything less than £500,000 is not considered material. This figure has a tangible basis. It was chosen following the discovery of an incident of fraud, which did not receive strong Board attention until on further investigation it transpired that the loss was likely to exceed £500,000.

Another company has refined this numerical basis still further by equating the risk appetite up or down to 10% change in earnings per share.

Capital allocation

A global financial institution is using its strategy and the views of external stakeholders as the starting point for a new assessment of its risk appetite and will then seek to embed these parameters into its risk and business management framework.

Risk appetite will feature as a key determinant in the allocation of capital across the business whether as part of a planning process or a specific project initiative.

The architect of this approach is the strategy team, with risk management ultimately responsible for execution.

Intuitive threshold

In common with many companies, a leading retailer does not formally define its risk appetite. Instead it compares the impact of potential sources of loss against their probability and uses this as a rule of thumb to identify and regularly review its approach to potential risks. The review includes judging whether enough has been done to reduce/mitigate the highest level risks and what action should be taken over the following six months. 'An experienced Board member will implicitly know the potential bottom line exposure and how best to mitigate it', said the company.

Aligning growth risk and return

One of the world's largest financial institutions is looking to increase its market capitalisation by more effectively linking growth, risk and return. While it already has strategic planning processes and sound risk management, it feels it can do more to drive performance. The institution will explicitly describe how it will manage its business activities to create consistent and predictably growing returns at an acceptable level of volatility. The strategy will address an entity performance management framework, risk management objectives and governance structure and processes.

This will allow the institution to define and communicate its objectives and risk appetite to:

- Build comprehensive risk assessment into all business processes
- Minimise earnings volatility and support efficient use of capital and the performance evaluation processes
- Report a comprehensive risk profile and facilitate calculated risk taking
- Channel resources to the areas of highest growth and highest potential returns
- Control expected and unexpected losses
- Increase its market capitalisation over a number of years.

In the hot seat: The evolving role of the risk manager

‘A top-down process would probably result in articulation of the 20 most serious risks, but it is definitely helpful to have a bottom-up process as it forces management to think about risk.’

Survey respondent

The role of the risk manager within a company, is a good measure of the maturity of risk management and how well it is embedded into the wider business operations.

Dual demands of increased business complexity and lowering the cost of internal commodity services are driving the chief risk officer (CRO) and CFO to move to a “business partner” role. This role seeks to provide more significant value across the entire business, as well as influencing the forward looking corporate agenda, rather than solely reporting on backward looking data.

In our experience risk management, well beyond those companies we interviewed, is largely process-driven, with limited alignment with the needs or priorities of people on the ground. As a result, it can be seen as a chore or, worse still, an irrelevant distraction by frontline business teams. Whilst there is an appetite to align with further value adding activities, this will not be achieved by risk management operating in a silo. Together risk and finance can effectively influence and inform the business.

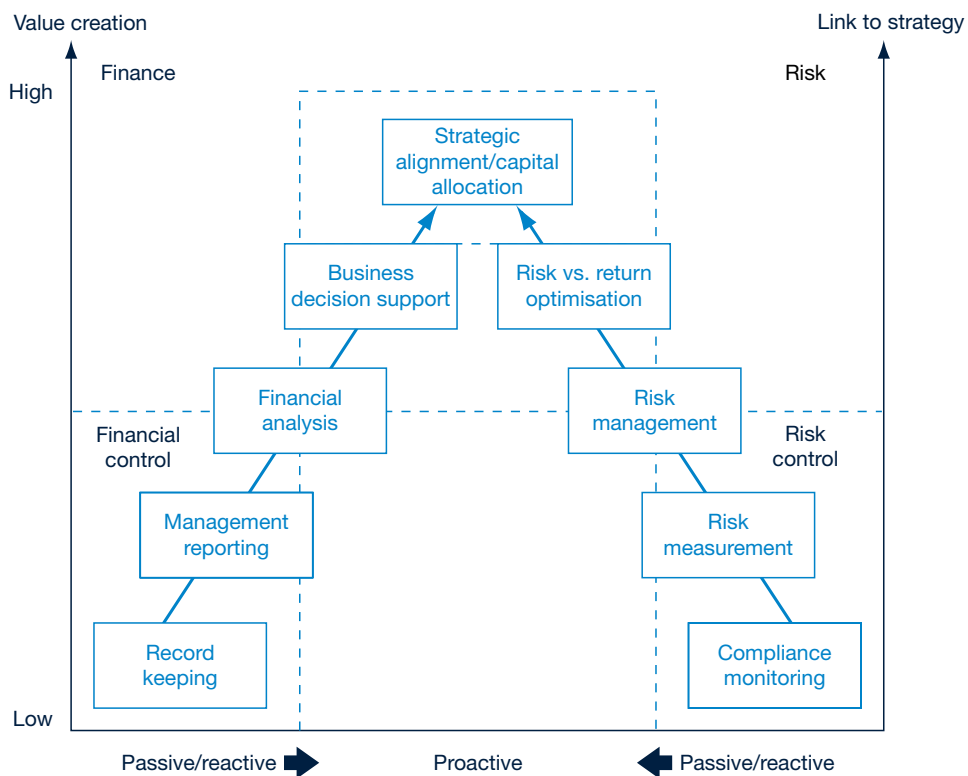
Risk managers should play a key role as ‘business partners’, advising on key decisions and helping to improve the efficiency of their delivery. To achieve this aim, however, risk teams may need to shift the perception of risk management within their organisations, while developing a broader set of business and communications skills.

From our discussions, some risk managers are already thinking about how the information and support they provide for the business is relevant, valued and acted upon. This includes liaising more closely with business teams to find out more about their objectives, operational challenges and what kind of assistance would be most beneficial. In turn, the move from process driver to partner will convince frontline teams that risk awareness is a key component of good business practice rather than simply compliance.

Being business partners clearly demands commercial and strategic awareness. It is also important for risk teams to understand how decisions are made and enacted around the organisation. What are risk teams doing to gain the ear of the Board? Are risk teams asserting their viewpoint at the right time and to the right people? Is the information risk teams provide acted upon and if not why not?



Evolution of risk and finance

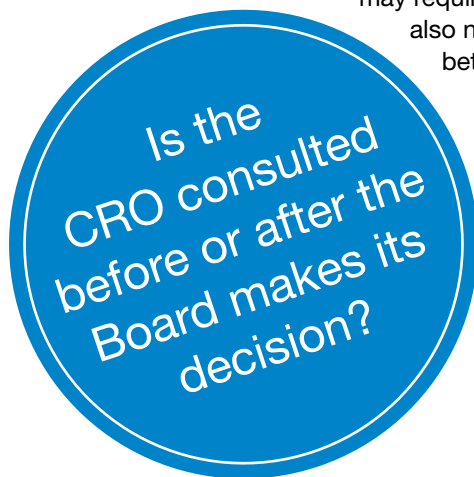


Source: PricewaterhouseCoopers

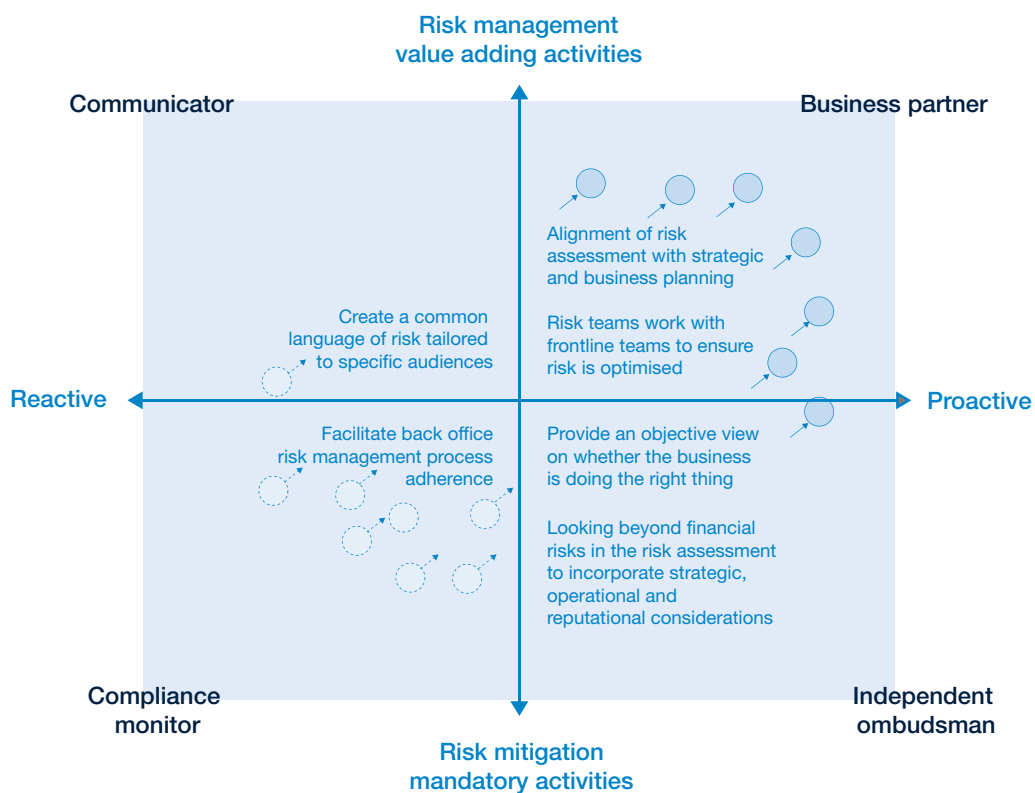
Risk teams also need to consider how best to communicate with a particular audience. For example, a company may have high level policies on customer protection. The challenge is how to relate this to the day-to-day activities of call centre operatives. Are they trained or incentivised into thinking whether the product is suitable for the customer, rather than simply meeting sales and profit targets?

As the risk function develops, CROs are likely to play a more prominent role in the management of the business. This includes gaining seats on the Board and senior executive committees. At a time when companies are coming under ever increasing ethical and environment scrutiny, the CRO may be well placed to act as an 'independent ombudsman', capable of hearing and dealing with any staff concerns about lapses in integrity, patterns of behaviour or any other risk-related issues that cannot be resolved by line management. With investors, regulators and rating agencies taking an ever keener interest in risk, the CRO can also act as a risk 'ambassador' for the company.

While broadening the scope and opportunities of risk careers, these evolving roles may require different recruitment or training priorities. Companies will also need to look at how to manage potential conflicts, for example between business advisor and independent ombudsman.



The evolving role of the risk manager



Source: PricewaterhouseCoopers

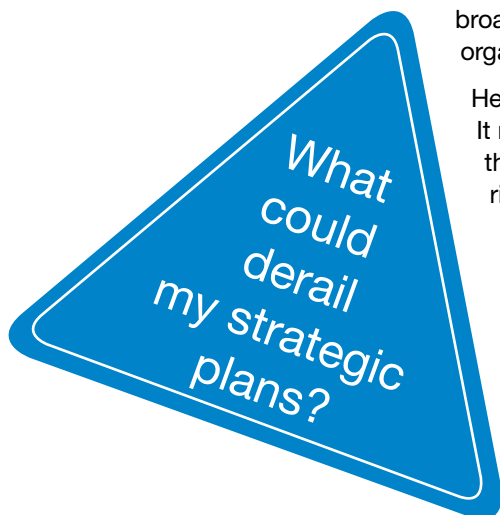
The bigger picture: Broadening the focus of risk management

Our research found that risk management is still primarily focused on familiar and more readily quantifiable risks. This approach may miss the less visible, though still critical risks that can often have the most dramatic impact on value and market perception.

As the chart adjacent highlights, strategic failures ranging from poor customer retention to ineffective post-merger integration are the most likely causes of share price falls. The chart also highlights the danger of legal issues, systems breakdown and other operational lapses that can do irreparable damage to reputations and market confidence.

The importance of striking the right balance between financial and non-financial risks underlines the need to align risk management with overall business objectives. Direction from the Board has helped companies with a more developed approach to risk management to broaden awareness of the spectrum of risks they face, how they affect the business and how they can be better controlled. They have also sought to ensure that risk reporting has an actionable impact on behaviour, rather than being buried in a back-office 'black box'. The potential benefits of this broader approach to risk are not just loss avoidance, but improvements in the organisation's capacity to take risks and capitalise on opportunities.

Here the CRO function has an important part to play in overall risk management. It must seek to step back from simple causal risk analysis and understand (with the business) how complex or intangible risks are best managed, for example; risks associated with change, organisational behaviour or complexity.



Reasons for falls in shareholder value



Source: PricewaterhouseCoopers analysis of falls in share price in the FTSE 100

‘While not simply a box-ticking exercise, risk management is not supporting our strategic thinking.’

Survey respondent

The CFO and CRO are natural partners in this regard, as risk appetite bridges both financial and operational volatility inherent within the operating plan. Strong financial analytics and clear guidance on acceptable risk limits will provide improved clarity on performance and therefore allow more precise forecasting and planning.

Likewise, the CFO and CRO have a shared agenda to better influence and inform the “front office” functions like R&D, sales, marketing and partnering, where the largest variances in performance are likely to occur. A recent survey undertaken for PwC by CFO Europe* found that whilst the responsibility for non-financial information remains unclear, many CFOs believe they play a pivotal role in making sure non-financial indicators contribute to informed business decisions. Robust non-financial information is a key component of the suite of tools required to broaden the focus of risk and support decision making, developing a culture that values risk and reinforcing risk as a clear element of business strategy rather than a “necessary evil”.

*Management information and performance: CFOs face new demands for high-quality data that drives decisions. CFO Europe.

Bringing strategic, operational and reputational risk onto the radar

A number of companies are developing effective ways to quantify and benchmark their strategic, operational and reputational risks. For example, systems breakdown or business interruptions can be measured as profit losses. In relation to reputational risk, several companies now monitor their stakeholder 'contracts', e.g. customer service charter and the likelihood of failure and the resulting impact.

Another way to identify potential 'hot spots' is to assess what has happened to similar organisations. The company can then rate its preparedness by playing out scenarios to see how it would react if placed in a similar predicament. Some organisations are also now attempting to put hard numbers on these risks as part of their operating financial reviews.

Ultimately experience suggests that operational lapses and reputational damage tend to stem from an accumulation of problems rather than a bolt from the blue. It is therefore essential that companies seek to identify and prevent the kind of corner cutting, sharp practice or other behaviours that could cause progressive problems.

'Risk management works well in some areas such as IT, but can be very difficult to quantify and apply in areas such as marketing.'

Survey respondent



Does
our risk
information
change
behaviour?

Everyone's job: Embedding risk into the culture of the business



Our research found that risk management is often separated into standalone process-driven silos that can be seen as divorced from the priorities and operations of frontline business teams.

To realise return on risk senior management need to ensure risk awareness is embedded into the culture of the business. This includes its consideration in key decisions, preparedness among staff to take ownership of risk within their operations and ultimately the development of integrated metrics (a common 'language') that seek to align risk and performance management across the business. While this can clearly be a challenge, many leading companies are now developing such an approach.

The diagram opposite indicates how risk management culture can be understood in terms of four key levers of organisational behaviour: leadership and strategy, accountability and reinforcement, people and communication, and risk management and infrastructure. Ultimately, it is these practices that will shape the risk management culture and tone within an organisation.

Leadership and strategy

Successful companies have been able to set the tone from the top, both in promoting awareness of risk and by conforming to exemplary standards of ethics and integrity – being seen as role models. In turn, decisions are made in an open way, while information, be it good or bad, is readily shared so that the lessons can be learned and acted upon.

Accountability and reinforcement

Opportunities to embed risk into individual staff thinking and behaviour include alignment with performance reviews and incentives. A mobile telephone manufacturer has taken this further by including risk awareness in the induction of new staff and making it an individual's recognised personal responsibility to report risks to managers. The result is a strongly embedded understanding of risk, along with extensive dialogue and consultation across the organisation about how best to manage particular risks.

People and communication

Resourcing and skill levels are adequate to ensure that risk and compliance related requirements can be fulfilled and clear communication channels are in place to enable open dialogue between management and staff.

Risk management and infrastructure

Controls are in place to mitigate and monitor risk and employees periodically identify risks in their area of responsibility and communicate these to management.



Creating a risk management culture



A utility company has a clearly embedded process whereby key business managers routinely discuss risks and opportunities at business unit monthly management meetings and ultimately report up to group management a subset of the key risks and planned mitigating actions. In addition, risk management workshops are held annually to remind individuals of their responsibilities including the procedures for reporting and monitoring risks.

‘The problem is that we have no common language of risk across the business.’

Survey respondent

Bolt from the blue: Dealing with emerging risks

‘Recent fraud did provide a wake-up call for the Board about risk management. Previously they had not been very supportive.’

Survey respondent

From product recalls to the recent credit crunch, unforeseen events and sudden changes in the market environment can strike at any time and exact a heavy price. However, our research suggests that many companies are not as well prepared as they could and perhaps should be.

While bad news cannot always be predicted, it is important to have plans in place to assess and address the impact swiftly and decisively. This includes dealing with the media and market reaction before it can escalate and cause lasting damage. However, our research indicated that preparations are in many cases informal at best.

So where is leading practice headed? Activities can be defined under three key headings: detection, escalation and response.

Detection

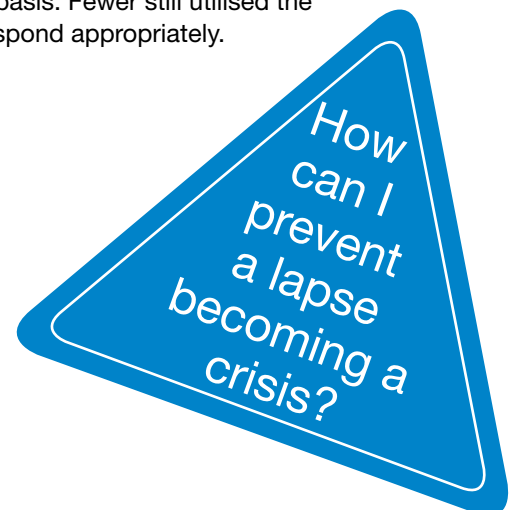
Detection covers the use of external and internal data sources, deploying predictive indicators based on historical data and remodelling risk and performance data to spot interdependencies or concentrations of risk not flagged up through existing organisational structures.

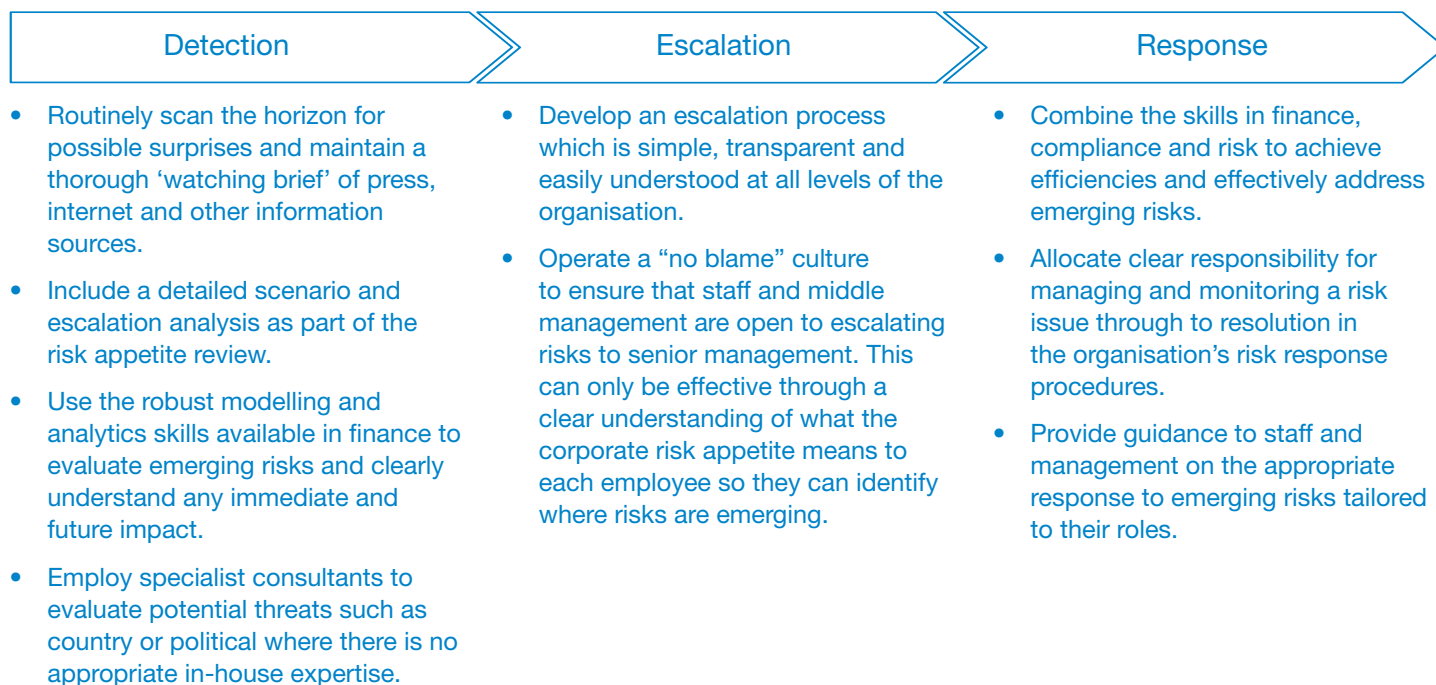
Escalation

Companies that have been able to manage potential crises and surprises and the ensuing bad news have developed systematic procedures for escalation that are well understood and communicated across the organisation.

Response

Most companies seemed to be able to articulate how they would respond to a crisis or business continuity issue, but very few seemed equipped to efficiently deal with emerging risks on an ongoing basis. Fewer still utilised the combined skills of finance and risk to respond appropriately.





Examples of how companies deal with emerging risk

‘Effective risk management is a ticket to stay in business. It helps us to respond more quickly and resiliently to external change.’

Survey respondent

Detection

One organisation operates a “risk radar” which combines external data and potential business impacts for Board level consideration. Similar to this, another operates a “regulatory pipe” which consists of an external feed of regulatory data from across the business’s geographic footprint. This allows the business to address regulatory risk early and seek competitive advantage rather than just compliance through their response.

Partially due to the regulatory complexity when operating cross border, one company has developed a risk dashboard that integrates all risk and control information. Finely set risk tolerance levels (based on corporate risk appetite) allow the organisation to spot variances quickly. The dashboard can also be taken off line so that scenarios can be run to assess the resilience of the business to changing circumstances.

Some companies have established mechanisms for collaboration and information exchange with other businesses in their sector. For example, the insurance sector has developed the Operational Risk Insurance Consortium, which enables companies to share data as part of the Consortium’s aim to enhance understanding and the basis for decision making. Leading European insurers have also formed a CRO Risk Forum, which provides an opportunity to develop best practice and provide input into EU legislation.

Escalation

One leading UK corporation has built a consistent centrally controlled communications response into its business continuity plan. Everyone in the company knows when and how to escalate issues to managers, who can in turn alert the appropriate people in senior positions and media relations teams. Senior personnel are also briefed and a list of at least three contacts is available for media interview at all times around the clock.

Another global institution has turned risk on its head looking at the potential business impact and opportunity presented when considering escalating the emergent risk. Whilst this approach may not work for all risks, certain commercial, economic and commercial risks might allow competitive advantage if responded to effectively.

Response

The previously mentioned organisation with the risk and controls dashboard had a defined response procedure based on shared responsibility between business management, the risk owner and the risk management function. The dashboard aggregated risk data, including its associated financial implications, calibrated this with risk appetite and demonstrated a variance. Both finance and risk collectively tracked the risk issue until satisfactorily resolved.

A notable example of a rapid response mechanism was cited within a financial services organisation. The three assurance functions developed a combined assurance plan and when the liquidity crisis occurred they presented a joint report to the Audit Committee on the issue, the potential impacts, known mitigations and residual risk areas. This provided additional risk assurance to the Board and was received extremely well.

One company provided risk management training for operational management to help them determine appropriate response through their day-to-day activities. This response procedure mandated operational management consulting with both risk and finance to quantify potential business impact and recommend a take, treat or transfer response.

What's
lurking
around the
corner?

Contacts

For more information on this report, to meet a risk specialist, or enquire about latest market best practice, please contact your PricewaterhouseCoopers contact or:

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