

Best practice in risk management

A function comes of age

A report from the Economist Intelligence Unit
Sponsored by ACE, IBM and KPMG





About the research

In February 2007, The Economist Intelligence Unit surveyed 218 executives around the world about their approach to risk management and their perception of the key challenges and opportunities facing the function. The survey was sponsored by ACE, IBM and KPMG.

Respondents represent a wide range of industries and regions, with roughly one-third each from Asia and Australasia, North America and western Europe. Approximately 50% of respondents represent businesses with annual revenue of more than US\$500m. All respondents have influence over, or responsibility for, strategic decisions on risk management at their companies and around 65% are C-level or board-level executives.

Our editorial team conducted the survey and wrote the paper. The findings expressed in this summary do not necessarily reflect the views of the sponsors. Our thanks are due to the survey respondents for their time and insight.



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A function comes of age

Executive summary

As companies deepen their investment in emerging markets, extend their supply chains and face increasing pressure from regulators, investors and other stakeholders to increase transparency and disclosure, the executives tasked with risk management assume an ever-greater responsibility for the smooth running of the business. Once largely associated with insurance, compliance and loss avoidance, the risk management function has been transformed in recent years and is now firmly entrenched as a board-level concern.

The focus of the discipline has changed, too. Although more traditional risks, such as credit risk, market risk and foreign-exchange risk, remain fundamental considerations, companies from every industry and sector are now recognising the need to quantify and assess risks that lurk in areas such as human capital, reputation and climate change. The objective of this report is to assess how effectively companies think they are managing these risks, and how they are changing their approach to risk management in order to keep pace with developments in the ever-evolving business environment.

Key findings from this research include the following:

- **Risk permeates the organisation.** The risk management function has evolved to become a core area of business practice, driven by the board but embedded at every level of the organisation. The aim is no longer simply to avoid losses, but to enhance reputation and yield competitive advantage.

- **Dangers lurk in non-traditional risks.** Risk managers consider their organisations to be handling the traditional areas of credit, market and financial risk well, and reputational risk fairly well. In other areas, such as human capital risk, regulatory risk,

information technology (IT) risk and tail risks, such as terrorism and climate change, confidence is weaker.

- **There are many drivers to strengthen the function.** Efforts in risk management are being driven by internal and external factors. Principal among the first is the board, but a more complex value chain also figures prominently. The main external drivers are the demands of regulators and investors.

- **Awareness of risk is the key.** With the battle for support from the board largely won, the key determinant of success in risk management has become the need to ensure that a strong culture and awareness of risk permeates every layer of the organisation. Setting a clear risk appetite and establishing well-defined systems and processes to monitor ongoing risks are also crucial.

- **Companies create a figurehead for risk.** The practice of appointing a Chief Risk Officer (CRO) to carry responsibility for developing and implementing the risk management framework is reaching maturity, with most of those companies that favour the approach having already adopted it. The approach is most popular in the financial sector, where two-thirds of firms have appointed, or plan to appoint, a CRO.

- **An increase in investment is predicted.** Firms of all sizes and in all areas of the world are planning to increase investment in most areas of risk management over the coming years, suggesting that this business discipline, although evolving rapidly, will continue to expand and deepen its reach within organisations.



Introduction

Risk managers getting to grips with their trade in today's fast-moving business environment must feel as though they are learning to ride on a charging rhinoceros. They must come to terms with new measurement techniques and technology, more complex organisational structures, wider geographical spread, more demanding stakeholders and proliferating regulation. They are scrutinised as never before, and their failures can bring the destruction of corporate reputations, the erosion of wealth and even the collapse of the enterprise.

Despite these challenges—or perhaps because of them—the discipline has taken off in recent years, and is increasingly attractive to high-flying executives. As a result, a set of broad principles is starting to emerge that stand as a body of best practice.

To draw out some of the principles shaping contemporary risk management practice, the Economist Intelligence Unit surveyed senior risk executives at more than 200 major organisations. Their responses give a powerful insight into current thinking in one of the fastest-growing disciplines of modern business.

As the practice of risk management continues to evolve, its focus has shifted in a number of interconnected ways.

The first is in attitudes within the organisation to the discipline itself. Risk management has moved away from a narrow subset of the finance function to become an overarching discipline that demands a contribution from every level of the enterprise.

In line with this trend, risk managers have moved their way up the corporate food chain, with ultimate responsibility for risk more likely to reside in the boardroom than in the management structure of the business unit. "In my role as a non-executive director, I hear the board discussing risk on a very regular basis," comments John Algar, lecturer and consultant

in project risk management at Cranfield School of Management. "And interestingly, not because of fear, but because of the potential benefit that it can provide."

This last point is another indication of the discipline's growing maturity – namely that the role of risk management is no longer expected simply to detect and address threats to the enterprise, but to leverage those efforts to yield broader benefits. Principal among these are the objectives of enhancing reputation and improving relative position in the marketplace.

Asked to identify the key objectives and benefits of risk management, respondents to our survey scored one factor above all others: protecting and enhancing reputation. This finding illustrates an important shift in the nature and scope of risk management. A decade ago, it is likely that the most popular answer to this question would have been avoiding financial losses, but today this option appears in a lowly fourth place. Instead, there appears to be a growing consensus that risk management is now expected not just to be a tool to protect the company from loss, but also to play a role in projecting the right corporate image to clients, partners and overseers.

In another connected development, risk managers are under growing pressure to show a measurable return on the investment that is made in the function, rather than simply carrying out their traditional role of meeting regulations and preventing losses. Today, boards and investors expect more than simple compliance from their risk management frameworks.

"It is quite wrong to see risk management from the perspective of compliance and loss avoidance," says Mr Algar. "In fact, I would argue that it is possible that this perspective is the cause of the inappropriate risk attitude that many corporations still have today."



Best practice in risk management

A function comes of age

Risk Barometer

For the past two years, the Economist Intelligence Unit's Risk Barometer has tracked corporate attitudes to categories of risk along with perceptions of risk pertaining to geographical locations. Throughout this period, it has been consistently clear that the risks that corporates find most threatening to their operations are those related to human capital, reputation and regulatory compliance. More traditional, quantifiable risks, meanwhile, such as financing risk, credit risk and foreign-exchange risk, are seen as among the least threatening.

The fact that respondents consider credit risk and foreign-exchange risk to be so low on their list of priorities no doubt reflects the continuing innovation that has taken place in financial risk management. In recent years we have seen significant development in the tools to manage these more quantifiable risks, with many companies adopting hedging strategies to protect against risks such as credit defaults or swings in currency exchange rates.

Asked how effectively they thought they were managing aspects of risk, respondents expressed greatest levels of confidence around many of the same areas that they cited as being least threatening. Fully 74% thought their organisation was effective at managing financing risk, 63% thought they were effective at managing credit risk, and 56% thought the same about foreign-exchange risk.

Tony Blunden, director, head of consulting at Chase Cooper, risk management solutions provider suggests that this confidence may sometimes be misplaced. "Part of the reason that people perceive market risk and credit risk as less threatening to their organisation is because they are familiar with them and think they understand them," he suggests. "Sadly, very few people do understand these risks because there are huge assumptions inherent in them."

Respondents feel less confident, however, about their ability to manage risks that are less easily quantifiable. Human capital risk, in particular, stands out as an area that respondents find particularly challenging. This risk, which is related to loss of key personnel, skills shortages and succession issues, has consistently been rated as among the most threatening risks that companies face in the two years that this series has been running. As this survey demonstrates, it is also among the most difficult to manage, and few respondents claim that they are effective at dealing with it. These findings point to the need for closer integration between the risk function and the human resources function, as well as a clearer understanding of the risks that companies face with their location and human capital strategies.

Interestingly, respondents felt that they were doing a reasonable job of managing reputational risk, with 59% considering themselves to be effective in this area. The need to protect and enhance reputation has already been established in this report as being perceived as the key objective and benefit of risk management, so it is not surprising that reputational risk receives substantial attention.

In surveys conducted previously in this series, however, reputational risk has been cited as the most difficult risk of all to manage. Andrew Griffin, managing director of Register Larkin, a consultancy that specialises in crisis management, points out that, while managing reputational risk is widely accepted as being important, doing so successfully is more challenging. "A lot of companies will say that reputation is their number one asset," he explains, "but words are cheap and you need the whole business to understand the concept of reputation and grasp the importance of reputation to the brand."

The key to successful reputational risk management, believes Mr Griffin, is having in place the right people to do the job. "Too many companies try to install a process to protect reputation," he says, "whereas in fact the most confident person will



manage the issue fine even if the process is lousy. But a poor person can't manage a good process. So people need training and they must be empowered to protect reputation."

Despite universal agreement that reputation is important, the debate continues as to whether it is a category of risk in its own right, or the consequence of a risk. "Reputational risk is not easy to isolate like a legal risk," says Alex Hindson, associate director in the enterprise risk management practice, Aon Global Risk Consulting. "It's very closely linked to what the business is about. It's also difficult in the sense that no one person in the organisation owns it – you don't have a reputation manager. There are a number of people involved: the CEO, corporate communications people, HR people, research people, depending on what the issue is."

Just over half of respondents thought that they were managing regulatory risk effectively. Although

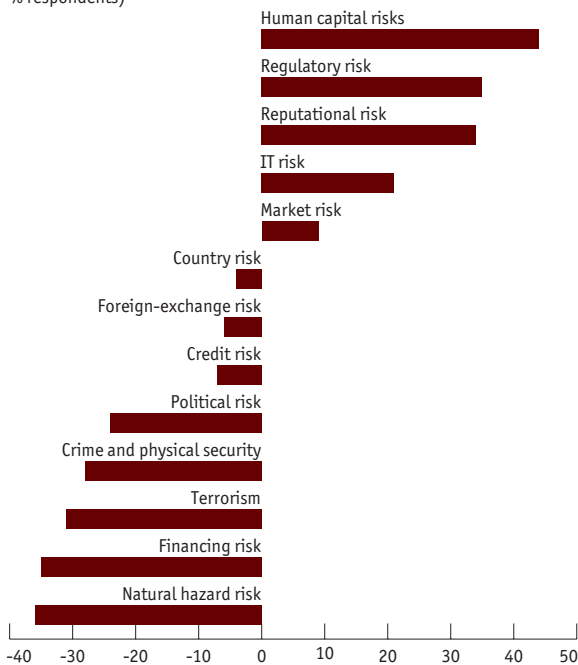
regulatory compliance has for long been seen as a vital role for risk management, and has taken centre-stage in the wake of regulations such as the Sarbanes-Oxley Act in the US, and the Basel II standards for financial services companies, it is interesting to note such a lukewarm assessment by respondents of their skills in this area. Clearly, despite having invested significant resources in staying on the right side of the regulators, compliance remains a difficult issue and one around which respondents are unlikely ever to feel comfortable.

Drivers of risk management

Risk management as a technical discipline has become a standard area of business practice in recent years. It was driven initially by recognition that an increasingly

How significant a threat do the following risks pose to your company's global business operation today?

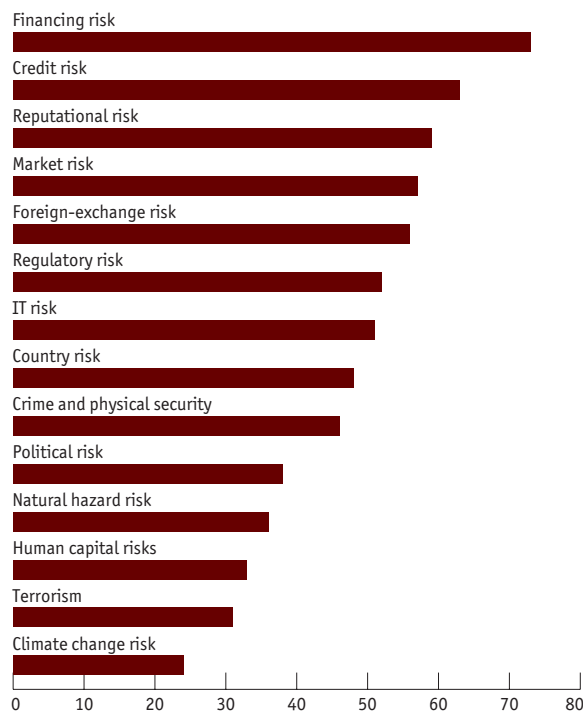
(Data are an average measure taken from surveys over the past two years, % respondents)



Source: Economist Intelligence Unit survey, February 2007.

How effectively do you think your organisation manages the following aspects of risk?

(% respondents)



Source: Economist Intelligence Unit survey, February 2007.



Best practice in risk management

A function comes of age

complex business world was ill-protected against threats from both within the organisation and the outside world. However, as the practice becomes embedded in corporate culture, the drivers and facilitators of its growth are changing.

Put simply, they are shifting from the direct task of responding to threats to the secondary aims of meeting the expectations of powerful stakeholders. Our survey strongly reflects this trend.

Internal drivers of risk management

Respondents say that the main internal driver for risk management is greater commitment from the board. Earlier in this research series, risk managers identified board “buy-in” as the key to implementing enterprise-wide risk management processes successfully. Today, boards have not only bought in, but are in turn driving their managers to master and implement good risk management practice.

Next on the list, although given considerably less prominence, is the greater complexity that organisations are experiencing in the value chain. Advanced business practices, globalised markets and technological change are multiplying the threats firms face, as well as making those threats harder to identify and track.

“The move towards sourcing from India and China and South-East Asia means there’s a lot more sourcing from suppliers, and there’s a lot more sourcing from outside the EU so there are a different set of risks,” says Mr Hindson. “There are economic risks, regulatory risks and reputational risks like sweatshops. If you’re taking the opportunity to reduce your cost base and drive down your sourcing costs then you end up having to manage other people’s risk, so you need some strengthened procurement function that can audit and evaluate the suppliers.”

Recent history is littered with examples of companies affected by risks emanating from their suppliers. Last year, for example, the computer manufacturer Dell was forced to recall 4m laptops

following incidents where batteries contained in the computers caught fire. The batteries were manufactured by Sony, but it was Dell that arguably suffered greater reputational damage as a result of a problem caused by a partner in its value chain.

Similarly, it was the UK’s British Airways that suffered the greater damage in 2005 when workers at Gate Gourmet, the company to which it had outsourced its catering services, went on strike following the compulsory redundancy of 670 unionised staff. BA workers belonging to the same union joined the strike, and more than 600 flights had to be grounded.

The fact that specific risk events, such as product recalls or fraud, come only third on the list of internal drivers for strengthening risk management and are cited by just 32% of respondents, suggests that risk is increasingly being seen as an integral part of business within organisations, and not just a function whose role is to plug holes as and when they appear.

External drivers to strengthen risk management

Regarding those factors driving risk management from outside the organisation, it is not direct threats such as terrorism, political uncertainty or natural weather events that top the list, but the increased focus of regulators on corporate practices. Regulators have been a powerful force driving the risk management agenda in recent years, and compliance will continue to play an important role in the function. “Regulation is certainly playing a part in driving risk management forward,” comments Mr Algar. “Also government, and not just politicians but civil servants, seem to be getting on board quickly with risk management. This all adds to a growing awareness of the concept.”

Next—although by some distance—come demands from investors for greater disclosure and accountability. More vocal shareholders have become a fixture for many companies and, recognising the importance of risk management for overall corporate



CASE STUDY: Pictet Asset Management

In 2002, Pictet Asset Management (PAM), the investment business of Pictet & Cie, one of the largest Swiss private banks, decided to create a separate risk function. Set up by Gianluca Oderda, head of risk control, it has demonstrably saved the business from investment losses while proving an attractive selling point to PAM's institutional investors, which provide the bulk of its SFr122bn (US\$100bn) in assets.

"During the final selection process when we pitch for business, all the big institutional clients scrutinise the risk process," says Mr Oderda. "We have to present our infrastructure and explain how it all works."

Initially, the focus of the risk function was on investment performance, the heart of PAM's activities. Without strong performance and the ability to avoid portfolio losses, PAM would soon lose the trust of investors. The risk function was therefore set up to be entirely separate from the portfolio managers, reporting directly to the managing partner. Its four-strong team is dispersed among PAM's main investment centres in Geneva, London and Singapore.

However, Mr Oderda adds that if risk control is to work successfully, it is also important to earn the trust of the investment team. "The risk managers must not be seen as policemen or the enemy. [They] must work side by side with the investment teams and convince them that focusing on risk adds value, leads to better constructed portfolios and helps avoid errors."

The system PAM put in place allows the risk managers to view the whole book of business and to spot lapses in discipline. It can deconstruct the risks in many different ways, such as into equities, bonds, sectors, regions and credit ratings, so that exposures can be measured and controlled.

This information is made available to all PAM's investment professionals via a proprietary application, called Profolio. "All positions are sent to the risk server engine and it sends back information that the managers can act on," says Mr Oderda. The portfolios are screened daily and an automatic alarm is triggered if there is excessive exposure to any risk factor.

The same is true of the individual portfolios. Many of them have target risk budgets, which refer to the amount that a manager is allowed to deviate from the benchmark, such as the S&P500. These budgets are agreed in advance with the investor and, if they are breached, the risk function would be alerted and the manager would have to explain the deviation.

"At the same time, we encourage managers to take risk," says Mr Oderda. "If they don't take risk, they can't generate alpha (outperformance)." In other words, the screening can also uncover portfolio managers who are too cautious and likely to underperform.

Each investment unit is reviewed quarterly. Meetings take place in which the processes are set out before the chief investment officer, the managing partner and the risk control unit. The risk control unit also presents data on risk factor scenarios and stress-testing. "There are plenty of questions asked and nothing is left unsaid," explains Mr Oderda.

The thoroughness of the risk process has uncovered potentially disastrous problems in the past. For instance, it was realised that the stocks in the PAM emerging-market funds had on average too little liquidity to make a timely exit in the case of a sharp market downturn. "We decided to soft-close the funds so there would be no more inflows," says Mr Oderda. "This protected existing fundholders."

In 2005, PAM added an operational risk function that focuses on workflows and processes. It was charged with setting up a database containing the history of operational problems at PAM. This has helped reduce errors such as duplication of trades, a common mistake in the fund management industry. "We can also intervene in the weakest areas of the business, such as the processing of credit derivative trades," says Mr Oderda. Since the processing of such trades is not usually automated because of their complex nature, it is harder to aggregate the risks. There could be too large an exposure to one counterparty or to the bonds of one particular company. "The limits are dictated by compliance," says Mr Oderda. "No more than 10% of the total capital of a fund can be traded with a single counterparty."

Indeed, the risk managers work hand-in-hand with the ten-strong compliance team. When PAM wins an investment mandate, the risk unit will, for instance, detail the tracking error risk in the contract, but the compliance team will make sure it is workable from a regulatory and legal standpoint. Crucially, the two functions are independent of each other and of the investment teams.

reputation, they are increasing their scrutiny of risk practices. In response, companies are strengthening disclosure to investors (something they are also being

required to do from a regulatory perspective) and are starting to include more comprehensive treatment of risk management in their annual reports.



Best practice in risk management

A function comes of age

Facilitators and hindrances

When it comes to factors that contribute to the success of risk management, things have also moved on. As mentioned, board “buy-in” has been a consistent demand in the past, but that particular battle is being won. Although support from the executive board remains important, respondents identify strong culture and awareness of risk throughout the organisation as the key determinant of success.

Mr Hindson of Aon notes that the type of risk culture adopted by an organisation should be tailored to fit the nature of the business. “We’ve done a lot of work looking at different organisations’ cultures and which approach to risk management works best,” he explains. “If your organisation is very performance-based and target-driven, taking a very procedural route is going to create a lot of problems in terms of people not working that way, and they’re just going to reject it. If you’re in a merchant bank, having hundreds of procedures is not going to work, whereas if you’re in an IT company it might fit better.”

In the past three years, what have been the most important internal drivers to strengthen risk management in your organisation?

Select up to three responses.
(% respondents)



Source: Economist Intelligence Unit survey, February 2007.

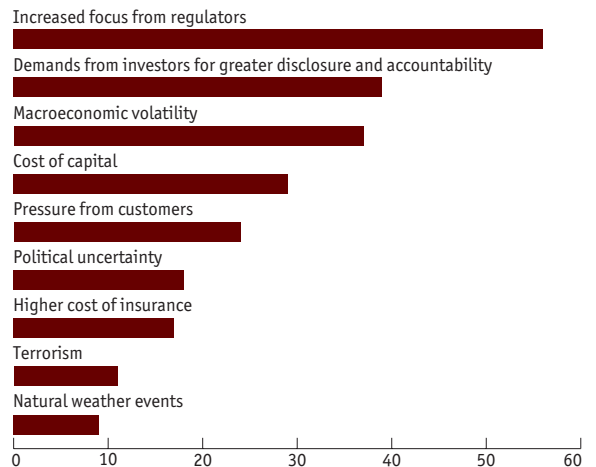
Questions of process also dominate the survey, with the need to set a clear risk appetite and establish well-defined systems and processes to monitor ongoing risks seen as crucial. This is particularly true for large, globalised organisations that have operations in a number of different locations. For these companies, the need to harmonise risk appetite and ensure that appropriate information on emerging risks is channelled to the right people in the organisation is particularly important.

“The area of risk awareness and risk appetite has certainly come to the fore in recent years,” says Mr Algar. “This requires a more sophisticated approach that focuses more on the behavioural side of risk. In my opinion, this is the right approach to take to deliver corporate value.”

Along with the risk managers’ wish list, a number of barriers can also be identified to the implementation of successful risk management systems—and it is clear that internal factors outweigh external ones. Despite acknowledging that investment in the risk management function has increased across the board in recent years, respondents cite a lack of time and

In the past three years, what have been the most important external drivers to strengthen risk management in your organisation?

Select up to three responses.
(% respondents)



Source: Economist Intelligence Unit survey, February 2007.



resources as being the biggest barrier they face. This may well be linked to the second most popular response, which is the difficulty of identifying and assessing emerging risks (particularly among non-financial sector respondents). Respondents are clearly directing considerable resources towards scanning the external environment for new and emerging risks, but they continue to see this as one of the most difficult—and potentially resource-hungry—aspects of the job.

Barriers to effective risk management

Aspects of reporting and governance are also seen as a significant barrier to effective risk management. Lack of clarity in lines of responsibility for risk management is the third most popular response (and comes top among financial sector firms). This is a striking finding, given that the survey sample mainly comprises individuals with responsibility for risk.

External barriers, including regulatory complexity and threats from unforeseen risks, figure lower down the list. Even financial services firms place the regulatory burden only third, and outside the financial sector it barely figures.

With a strong culture and awareness of risk cited as being the most important factor in determining the success of risk management, close integration between risk and other functions in the organisation is clearly important. At present, however, progress on embedding risk in other parts of the business appears to be patchy. This finding supports the earlier conclusion that, although risk management has become established in mainstream business practice, instilling a culture of risk at every level of the organisation remains a central challenge. “It is vital that risk becomes a very natural part of the business unit,” says Mr Blunden, “as well as of the central functions, such as the board.”

Integration between risk and the finance function is seen to be most advanced, with 69% of respondents saying that their organisation has been effective at building bridges between these two departments. This is not surprising, given that the finance function is usually the starting point in most organisations for systematic risk management. In line with a theme running throughout this survey, integration between the risk function and the board is also seen as reasonably strong, with 57% of respondents rating it as effective.

Links between risk and human resources are less successful, however, with only 25% of respondents considering integration between these two functions as effective. Given the severity of the threat that respondents have noted from human capital risks, it is clear that closer interaction between these two functions would be beneficial.

Centre versus periphery

The strategy of centralising enterprise risk management under a single dedicated board-level executive has grown in popularity over the past decade, but there is evidence that it is now approaching maturity. CROs are already in place at 38% of those organisations represented in this survey, and a further 21% have plans to appoint an individual to this role over the next three years.

The remaining 41% are pursuing other strategies, which does not mean that they have abandoned the centralised enterprise-wide approach, just that the role is not to be made the sole responsibility of a single individual. It may mean that the CFO is adding this layer of duties to his or her current portfolio, or that the CEO is taking on the role. Alternatively, it may mean that responsibility is being given to a multidisciplinary risk committee.

The financial sector, which pioneered the role of the CRO, is the main adopter of the model, with 57%



Best practice in risk management

A function comes of age

of respondents already boasting a CRO and a further 10% planning to take this step in the future. Outside the financial sector, adoption is less widespread, with 31% saying they have appointed one and 25% planning to recruit.

“The role of the CRO is now becoming established practice, especially in large financial institutions,” notes Mr Blunden. “The challenge is for the CRO to become a natural board appointment – to be seen as someone who brings value to the institution and is not just a cost-cutter. The CRO should be someone who can advise the institution on the allocation of resources and controls so that it is getting the best bang for its buck.”

Despite the overall trend towards appointing CROs, it is not always necessary to have one person accountable for risk. “It depends on what kind of organisation you are,” explains Mr Hindson of Aon. “In some organisations you have to manage risk through one person in order to make it happen because people won’t network; they won’t work through informal means. In other organisations,

you don’t escalate things; you have to influence and negotiate and bring people on board, and probably a CRO is not essential. The danger is when people see it as a sexy trend and it’s not appropriate. Where it’s appropriate it will work well, but it’s not universally applicable.”

At a broader level, there is an emerging consensus that overarching decisions regarding risk appetite and risk management strategy should be set centrally in the organisation, but that the local knowledge of individual business managers should be relied upon to implement those policies in day-to-day operations.

“Most organisations are implementing a structure where there are a small number of people in the central, or group, risk function, and then embedding ‘risk champions’ in the business units,” says Mr Blunden of Chase Cooper. “Those risk champions are the first line of defence for the organisation in terms of risk. They understand risk, at least enough to know when to call in the specialists from head office.”

But however an organisation chooses to manage risk, the important thing, according to Mr Hindson, is that a company’s approach fits with the overall structure of the company. “You shouldn’t try and manage risk differently from the way you manage other things,” he explains. “In some organisations the divisions have a lot of independence; in others things are very tightly managed. Risk management will fail if it’s different; it has to be part of the mainstream.”

Mr Algar of Cranfield School of Management agrees. “Whether risk should be centralised or decentralised depends on the organisational structure of the company. A monolithic structure, inefficient though it may be, needs a centralised model. That said, it may well be pointless investing in such a model given the inefficiencies of the monolithic model in today’s marketplace. By contrast, consider a weak matrix or project structure. Here, a decentralised risk management function would produce more benefit for the company.”

The case for adopting an enterprise-wide

What do you see as the greatest barriers to the effective management of risk in your organisation?

Select up to three responses.

(% respondents)



Source: Economist Intelligence Unit survey, February 2007.



approach to risk is one that Mr Hindson supports. “In the financial services sector, [banks] have to do operational risk for Basel II, and then they do Sarbanes-Oxley a separate way, and then they do corporate governance for Turnbull a separate way. There’s a great opportunity in trying to link these things up and turning it around and saying ‘I have a number of external drivers, we have a governance and risk management process, how does that adapt to meet these needs?’ That way, you have one process with a series of inputs and outputs, not four or five processes that run independently through the organisation.”

In some cases, the advantages of taking a consolidated view of an organisation’s risk exposure are fairly straightforward. For instance, consider a company with divisions set up as separate profit centres in different geographical locations. Each division uses currency derivatives to hedge its exchange-rate risk. But it may be that exchange rate movements that are damaging to one division are favourable to another. In this case, separate hedging by individual divisions is a wasted expense, and one that could be avoided by adopting a centrally co-ordinated hedging strategy. Given that such hedges can easily cost 1% of the overall transaction value, there is much to be gained from looking at this kind of activity from an enterprise-wide perspective.

The implementation of a centrally co-ordinated but

operationally decentralised system requires success in many other areas: communication throughout the organisation must be fluid and reliable; a single “risk culture” must be embedded at all levels; senior management must be fully committed to the risk management framework; and risk appetite must be set appropriately and clearly.

Perhaps this succession of hurdles explains why, according to our survey, adoption of this model is most common at the top of the earnings tree. It is also more widespread among Europe-based companies than elsewhere in the world—and far more than in North America. A tentative interpretation of this finding is that Europe’s single market facilitates communication between centre and periphery in organisations, whereas a US company’s greater concentration on the domestic market means centralised control is less at odds with diversity among business units.

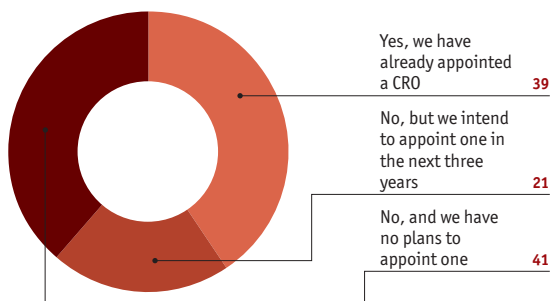
The big spend

The picture of a maturing risk management discipline responding to a world in which risks are perceived to be on the rise is confirmed by indications of firms’ investment plans over the coming years. Asked where they intend to increase spending, respondents report greater investment right across the function.

Mr Blunden of Chase Cooper suggests that investment of risk should be divided into three main areas: people; processes and software. “In terms of investment in people and upskilling to a ‘business as usual’ level, I think much of that has happened and we’re now moving from a salary-based investment to a training investment,” he explains. “In addition, the imperative for risk management is now changing from a regulatory imperative to a business one that is based around process improvement.”

Respondents to our survey cite the improvement of data quality and reporting as being a key area

Do you have a CRO or have plans to appoint one?
(% respondents)



Source: Economist Intelligence Unit survey, February 2007.



Best practice in risk management

A function comes of age

for investment. This reflects a problem for many companies around the accurate quantification of risk: underestimation may lead to unnecessary losses if the risk event occurs, whereas overestimation may lead to unwarranted risk aversion or excessive expenditure on risk control. Hitting the correct number, however, is notoriously difficult, and successful data collection and measurement remains among the biggest challenges for risk managers.

Despite the increasing sophistication of qualitative risk measures, data derived from the organisation's processes and operations remains the principal raw material for risk analysis. More complete and reliable data means less room for data error when risk measurement and control processes are run. For many organisations, generating good data remains the holy grail of risk management.

In a similar vein, firms also plan to spend on strengthening their risk assessment process, which is the next stage in numbers-based risk assessment and management after collecting the data. Training managers and developing risk frameworks are other popular areas for investment.

Mr Algar of Cranfield School of Management stresses the importance of training and skills development. "One of the biggest challenges to successful risk management is developing the human and organisational competencies to deliver sustainable competitive advantage," he explains. "It is essential to convince those with the power that tools and software are not enough."

From risk to reward

Given the commitment being made to future investment in risk management, it is unsurprising that firms are increasingly concerned to ensure they get a measurable return. This is further underlined by the shift in focus from avoiding damaging events to yielding indirect benefits. It is no longer enough to argue that losses would have been incurred without the risk managers. Instead, executive boards and investors want to know what the practice is delivering in terms of tangible benefits.

"It's a trend that risk managers need to pick up the baton and run with," suggests Mr Blunden of Chase Cooper. "It was apparent at a recent conference that the industry still has to be nudged and coaxed into admitting that process improvement will be a major part of operational risk management in bringing real value."

The survey points to a number of areas where these rewards are felt to accrue. Top of the list—and matching the objectives of the function that they identified above—was a better overall corporate reputation. Add in the responses for a better reputation with customers and improved investor relations, and success in the reputational objective of risk management appears secure. A related issue, better relations with regulators and rating agencies, is second on the list overall.

Both areas—reputation with stakeholders and standing among those providing oversight—have the potential to deliver strong benefits. A better reputation encourages clients and partners to continue doing business with the organisation. Crucially, it also provides a competitive advantage that may result in an improved market share over time.

An important barrier to greater recognition of the power of reputation, however, is the difficulty in measuring its benefits, which can dissuade senior



executives from giving it adequate focus. “Senior people always say reputation matters because they think it sounds good,” says Mr Griffin of Register Larkin, “but in reality their priorities are focused on other, more tangible assets. There is always a problem getting people to see the link with the bottom line.”

Looking good to stakeholders is not the only competitive advantage to be gained from good risk management systems. Being better than competitors at detecting and understanding risks can be crucial in gaining early access to what may be limited resources when a crisis hits. The first organisation to recognise an impending crisis will get the best price on insurance, the first bite at alternative partners or the best rates on additional facilities, such as warehousing or shipping. Firms lower down the chain will have to pay more, or may find that all alternative capacity has already been consumed.

A good example of this is the strike by dockworkers that affected ports on the west coast of the US in September 2002. In total, 29 US ports were locked down for ten days, and container ships destined for these ports could do little else but wait in open water for the strike to end. The lockdown followed

months of deteriorating relations between the union involved and the Pacific Maritime Association, which represented the port users. Some large retailers, such as Wal-Mart and Costco, recognised this impending threat, and took steps to ramp up imports prior to the shutdown to minimise the risk that they would be left without stock. Other companies were less prescient, and could only wait for the lockdown to end before they could resume the transportation of their vital pre-Christmas stock.

Understanding and managing risks of this nature can have a strong positive impact on reputation and can therefore be considered an important source of competitive advantage. This notion is strongly supported in the survey. Asked whether they agreed or disagreed with a series of statements, 97% of respondents—a higher percentage than for any other indicator in the survey—agreed with the proposition that good risk management is an important source of competitive advantage.

Other operational benefits identified in the survey include: improved strategic decision-making (helped by better communication between business units and good operational data); greater profitability from business units; and reduced earnings volatility. Most respondents also felt their risk management operations were enhancing shareholder value.

In all of these factors, more than half of respondents claimed success for their organisations, and the proportion that thought their firms were failing was very low.

What changes do you expect to your organisation’s investment in the following aspects of risk management over the next three years?

(% who expect increase)



Source: Economist Intelligence Unit survey, February 2007.



Best practice in risk management

A function comes of age

Conclusion

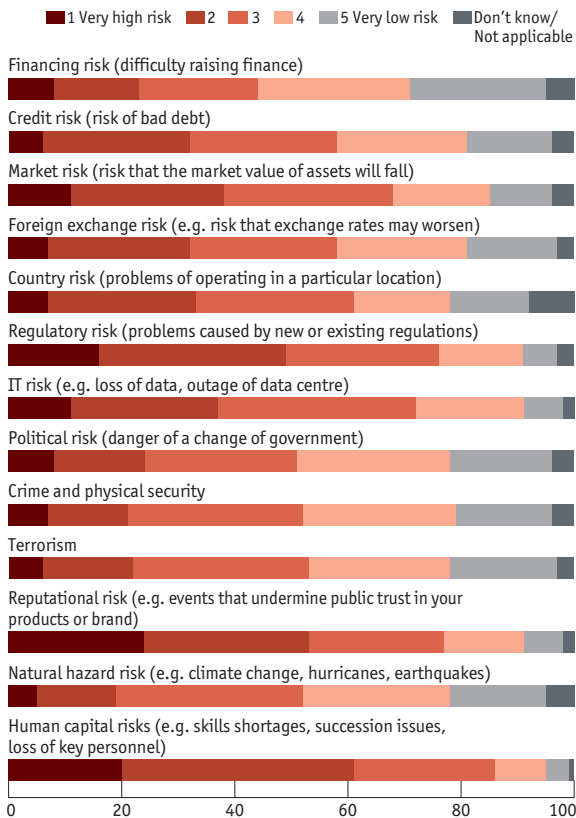
This research suggests that the discipline of risk management has moved on from mere loss avoidance to become a key contributor to market advantage, via improved corporate reputation and a better standing among those charged with oversight, such as regulators and rating agencies. Certain approaches, such as decentralised risk management with centralised co-ordination, have become accepted best practice, and a range of organisational frameworks is being adopted according to the conditions and preferences of each firm. The discipline is coming of age, and has found its way into the mainstream of business practice.

Is that to say that risk managers have answered all the questions? Not at all. In the years ahead, they face a broad range of hurdles to overcome. Technology is on their side, and they will be helped by a growing body of academic research. But they are taking aim at two moving targets simultaneously. First, business is changing, both in terms of how it is done and where it is done, and this requires constant readjustment of the aims and priorities of risk management. Second, the defining characteristic of risk, that it is unknowable in advance, remains as true as ever, and stands as a permanent challenge to those who are charged with managing it.

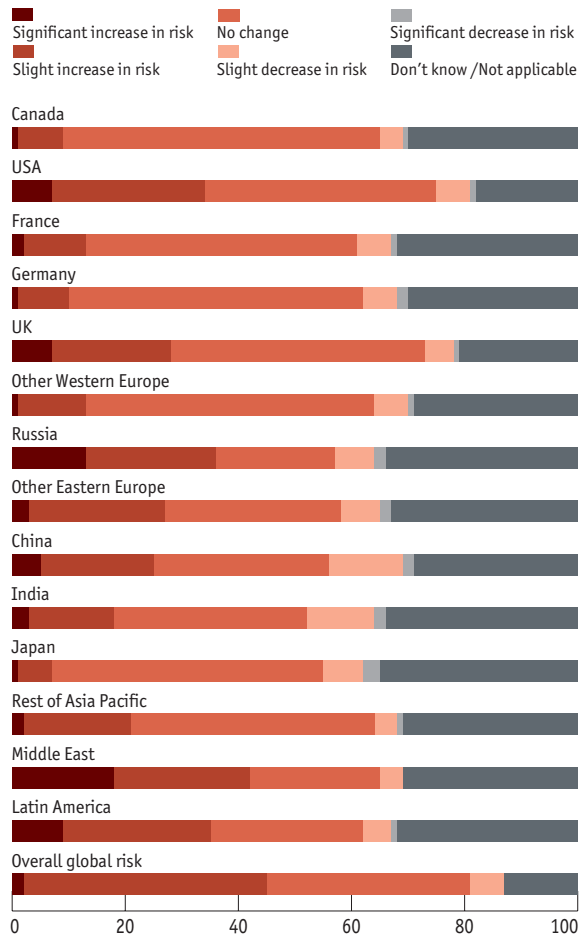
Appendix

In February 2007, The Economist Intelligence Unit surveyed 218 executives around the world. Our sincere thanks go to all those who took part in the survey. Please note that not all answers add up to 100%, because of rounding or because respondents were able to provide multiple answers to some questions.

How significant a threat do the following risks pose to your company's global business operation today?
 Rate on a scale of 1 to 5, where 1=Very high risk and 5=Very low risk.
 (% respondents)



How has your organisation's assessment of risk in each of the following countries and regions changed over the last three months?
 (% respondents)



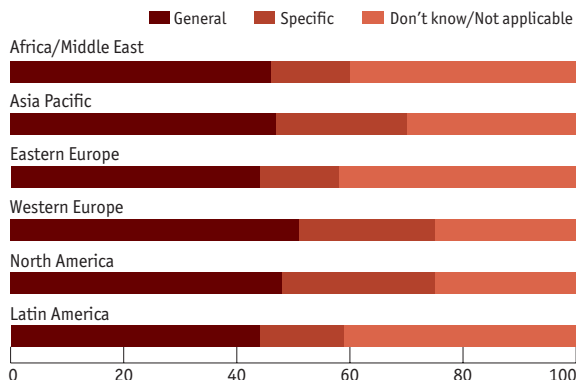
Appendix: Survey results

Best practice in risk management

A function comes of age

In each of the following regions, are the majority of risks to your business considered to be general (e.g. likely to affect many other companies operating in the same location or industry) or specific (e.g. relating to your company's internal systems, processes or people)?

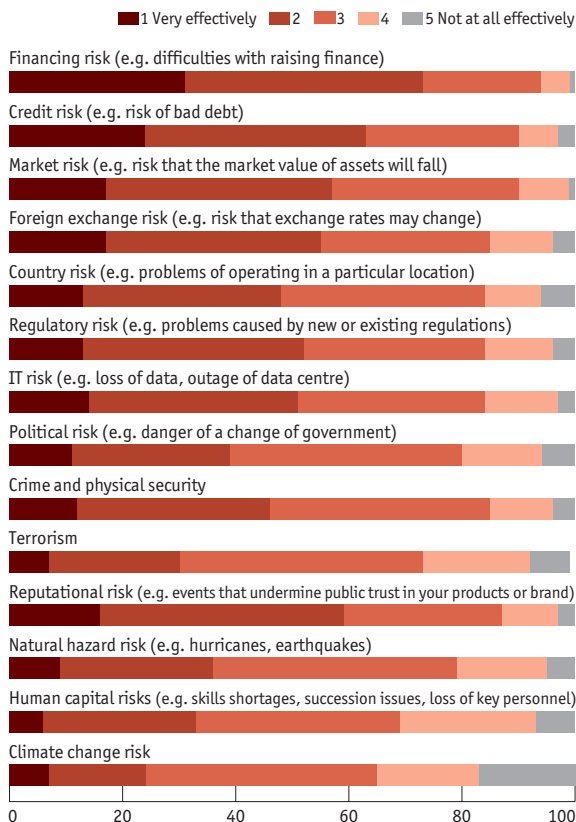
(% respondents)



How effectively do you think your organisation manages the following aspects of risk?

Rate on a scale of 1 to 5 where 1=Very effectively and 5=Not at all effectively.

(% respondents)



What does your organisation consider to be the most important objectives and benefits of risk management?

Select up to three responses.

(% respondents)



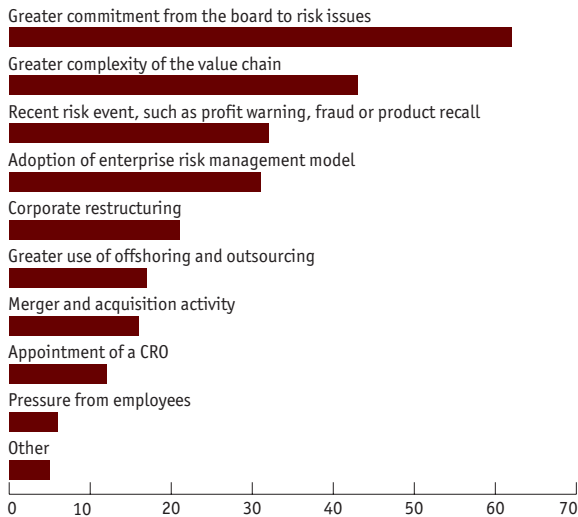
What changes do you expect to your organisation's investment in the following aspects of risk management over the next three years?

(% respondents)



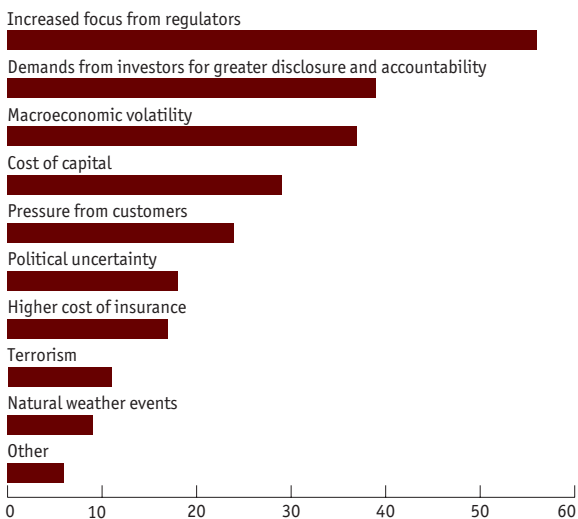
In the past three years, what have been the most important internal drivers to strengthen risk management in your organisation?

Select up to three responses.
 (% respondents)



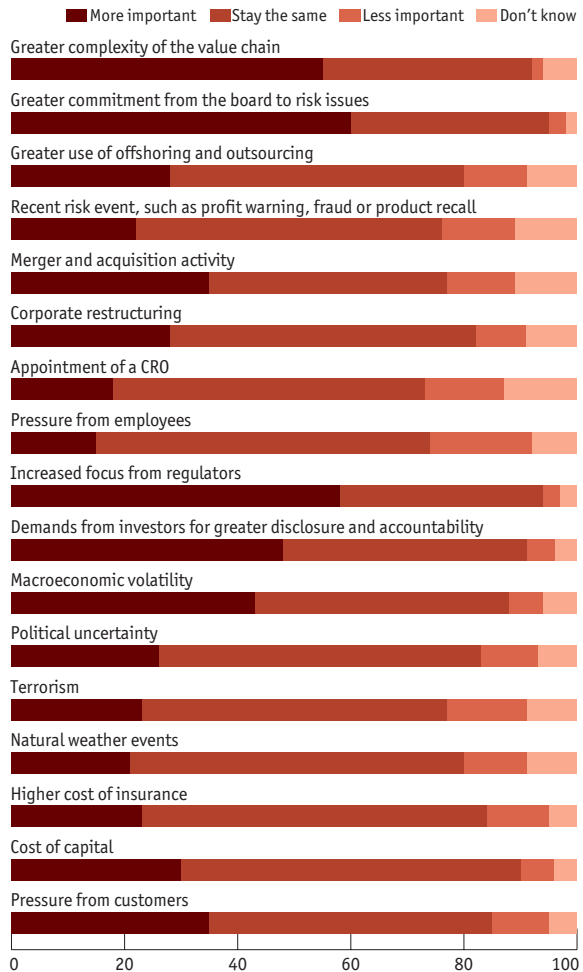
In the past three years, what have been the most important external drivers to strengthen risk management in your organisation?

Select up to three responses.
 (% respondents)



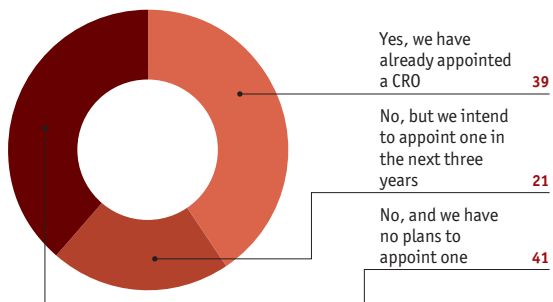
In the next three years, do you expect these drivers to become more or less important?

(% respondents)



Do you have a CRO or have plans to appoint one?

(% respondents)



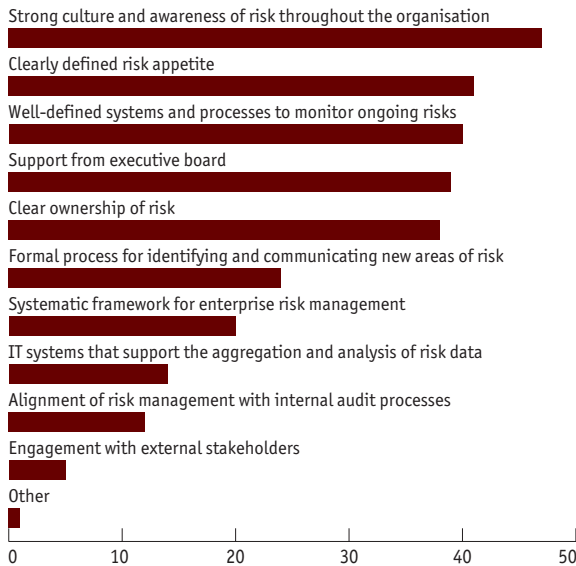
Appendix: Survey results

Best practice in risk management

A function comes of age

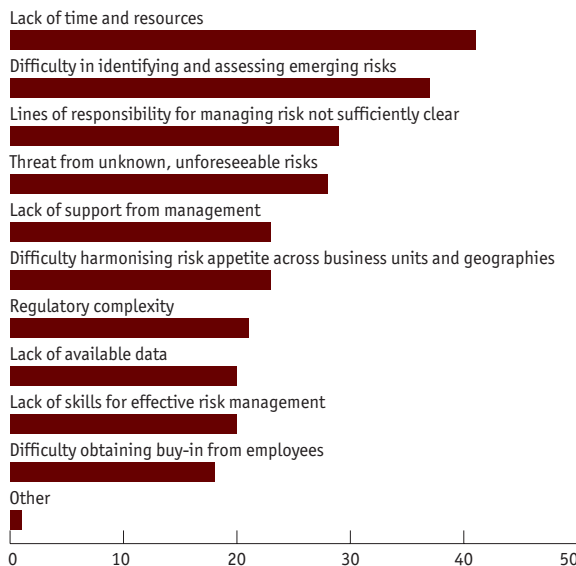
What do you consider to be most important to the success of risk management in your organisation?

Select up to three responses.
(% respondents)



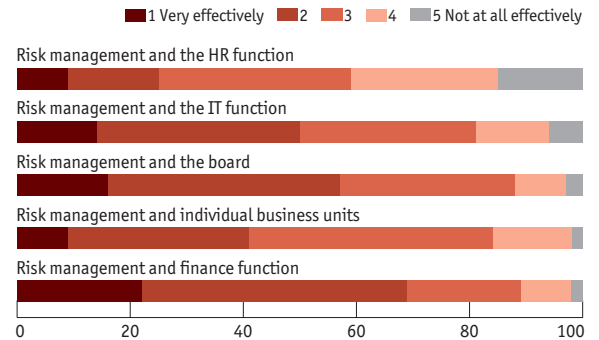
What do you see as the greatest barriers to the effective management of risk in your organisation?

Select up to three responses.
(% respondents)



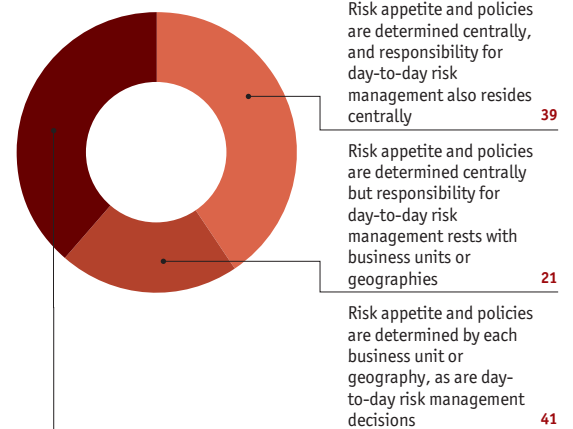
How effectively are the following functions integrated in your organisation?

Rate on a scale of 1 to 5 where 1=Very effectively and 5=Not at all effectively.
(% respondents)



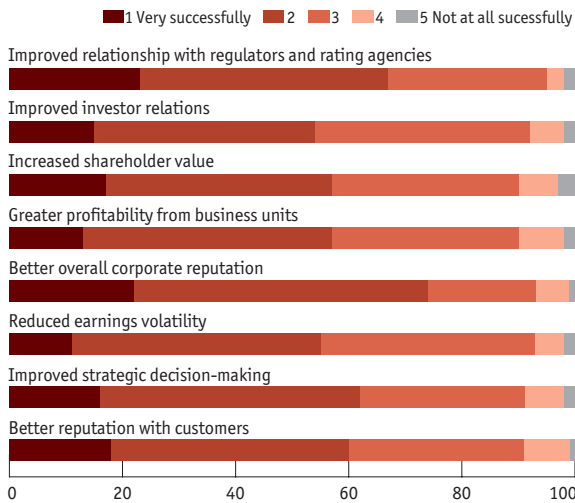
Which of the following statements best describes your organisation's approach to risk management?

(% respondents)



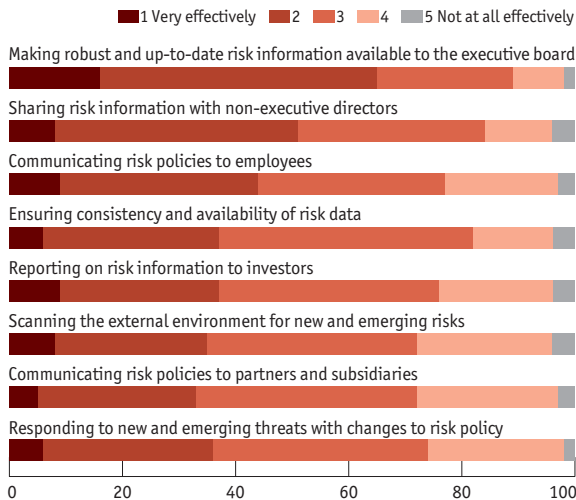
How successfully do you think risk management in your organisation adds value in the following areas?

Rate on a scale of 1 to 5 where 1=Very successfully and 5=Not at all successfully.
 (% respondents)



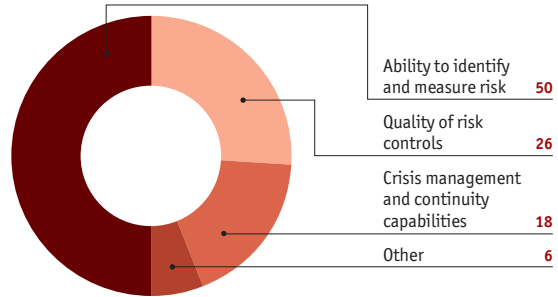
How effectively do you think your organisation manages the following aspects of reporting and communicating risks?

Rate on a scale of 1 to 5 where 1=Very effectively and 5=Not at all effectively.
 (% respondents)



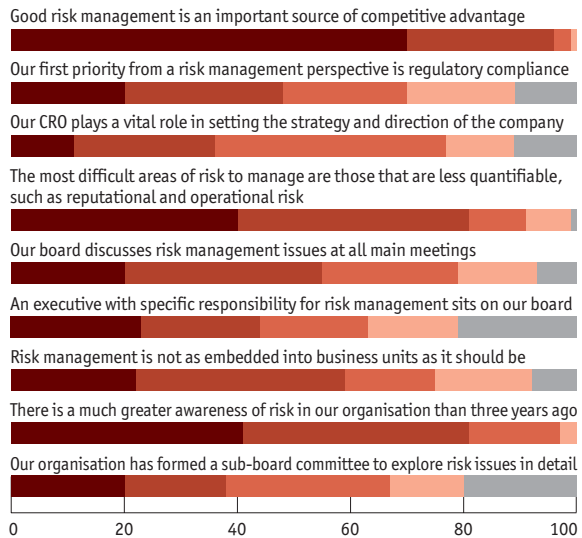
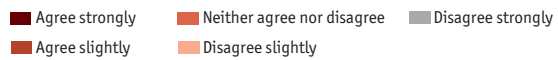
Which of the following aspects of risk management is most in need of improvement in your organisation?

(% respondents)



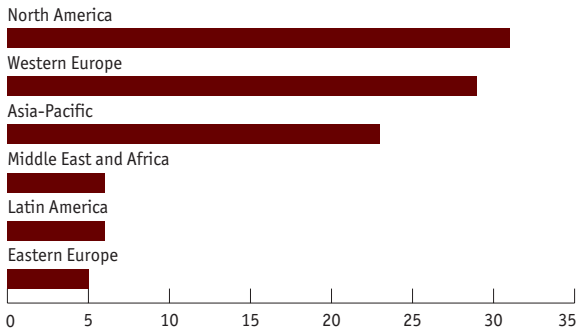
Please indicate whether you agree or disagree with the following statements:

(% respondents)

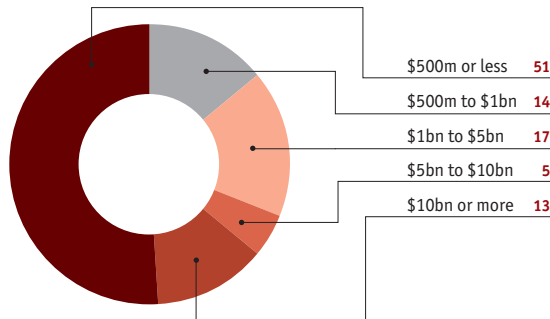


About the respondents

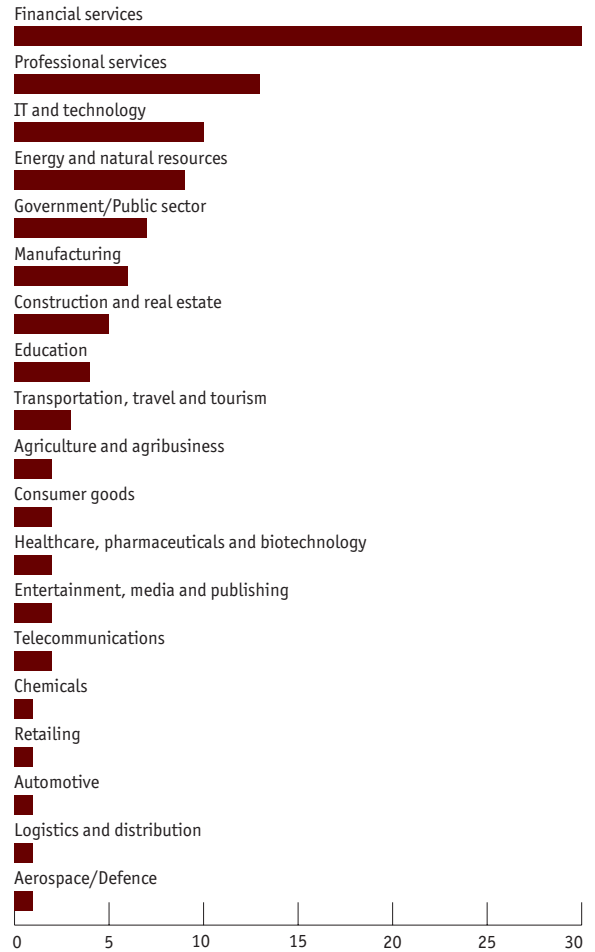
In which region are you personally based?
 (% respondents)



What are your organisation's global annual revenues in US dollars?
 (% respondents)

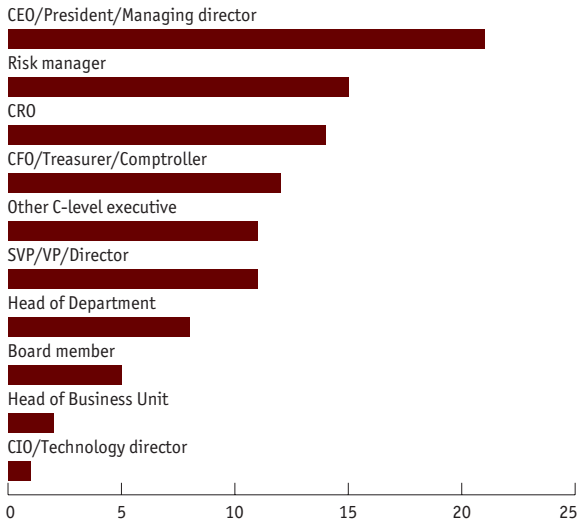


What is your primary industry?
 (% respondents)



Which of the following best describes your title?

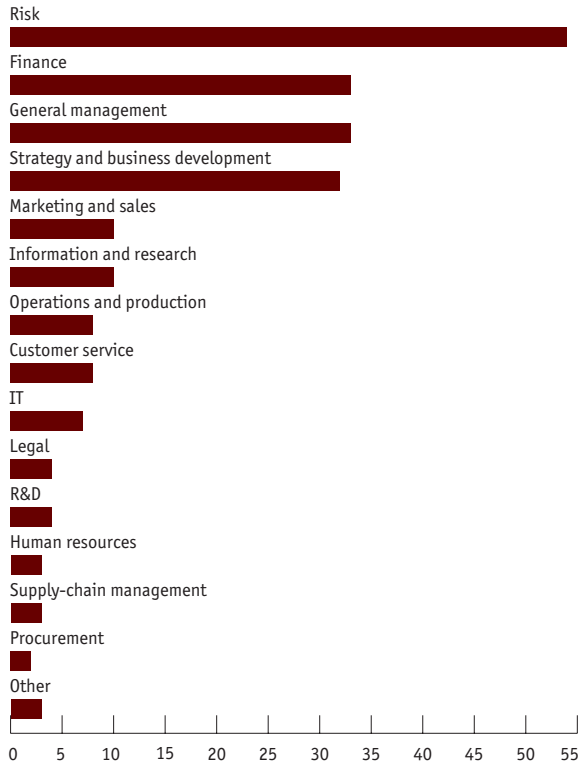
(% respondents)



What are your main functional roles?

Please choose no more than three functions.

(% respondents)



Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

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