Economist Intelligence Unit

The Economist

Fall guys
Risk management in the front line

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

Contents

Preface

Fall guys: Risk management in the front line is an Economist Intelligence Unit report that examines the changing role and responsibilities of risk management in business. The report is sponsored by ACE and KPMG.

The Economist Intelligence Unit bears sole responsibility for the content of this report. Our editorial team executed the online survey, conducted the interviews and wrote the report. The findings and views expressed in this report do not necessarily reflect the views of the sponsor.

Our research for this report drew on two main initiatives:

- We conducted an online survey of almost 500 executives from around the world in July 2010. The survey included companies of a variety of sizes from the banking and insurance industries. Three-quarters of respondents have a direct influence on their firm's risk management, either as CEO or board-level executive (32%), as chief risk officer or other dedicated risk executive (20%), or as a non-executive director (23%). A further sample of senior management (26%) was included to test how non-risk executives view the risk function.

- To supplement the survey results, the Economist Intelligence Unit conducted a programme of qualitative research that included a series of in-depth interviews with industry experts.

The author was Rob Mitchell and the editor was Iain Scott. We would like to thank all those who were involved in this research.

Interviewees

- Richard Apostolik, chief executive, Global Association of Risk Professionals (USA)
- Sue Carter, chief financial officer, KBR (USA)
- Brian Cummings, information risk management lead for North America, Tata Consultancy Services (USA)
- Christine Eick, executive director of risk management, Auburn University, Alabama (USA)
- Steve Fowler, chief executive, Institute of Risk Management (UK)
- Patrick Gougeon, director of the London campus, ESCP Europe (UK)
- Nicola Harvey, group risk director of Christie's, and chair of the Association of Insurers and Risk Managers (UK)
- Andrew Kakabadse, professor of international management development at Cranfield School of Management (UK)
- Hans Læssøe, senor director for strategic risk management, Lego Systems A/S (Denmark)
- Matthew Lawson, litigation partner, Mayer Brown (UK)
- Chris McGloin, vice-president for risk management and insurance, Invensys (UK)
- Eddie McLaughlin, managing director and global practice leader, Marsh (USA)
- David Millar, chief operating officer, Professional Risk Managers' International Association (UK)
- Tom Mumford, senior vice-president for commercial, KBR (USA)
- Stuart Pickford, litigation partner, Mayer Brown (UK)
- Julie Summerell, consultant, Serco Consulting (UK)
- Arnout Van der Veer, board member of the Institute of Risk Management, and chief risk officer of a London-based international FTSE-100 company (UK)
- Malcolm Zack, audit director, Brakes Group (UK)

Executive summary

Risk management can be a thankless task. Just ask Paul Moore, the former head of regulatory risk at HBOS, who claimed that he was sacked because he told the bank's board that it was taking too much risk. In the wake of the financial crisis, stories that banks would sidestep risk managers in order to get deals done were legion. Risk managers with legitimate concerns about the business were ignored and regarded as a brake on growth.

Three years on, the perception of risk management has changed. In the financial services industry, there is a clear consensus that serious mistakes were made with either risk management or risk governance. In response, banks and other financial institutions are beefing up risk departments and creating new governance structures that add to the risk function's authority and independence. Boards are creating risk committees and ensuring that non-executives are providing effective oversight of the company's risk exposure. Chief risk officers are being granted powers of veto over decisions made by executive management and reporting directly into non-executive directors.

This renewed zeal for risk management extends far beyond the banking sector. Events such as the financial crisis, and more recently the oil spill in the Gulf of Mexico, have reminded senior executives that failures in risk management can prove to be extremely costly, not just to a company's financial performance, but to their own careers and, sometimes, the lives of employees. The incentive to ensure that there is a clear and consistent approach to managing risk across the enterprise has never been greater.

However, although risk management is currently enjoying an unprecedented level of authority and visibility, it remains a function in transition. Examples of companies that take a genuinely strategic approach to their risk management remain few and far between. Communication between risk functions and the broader business can sometimes be fragmented, while an enterprise-wide culture and awareness of risk can be difficult to achieve.

To assess the current state of this transition, the Economist Intelligence Unit conducted a global survey of senior executives, from both the risk function and general management. This report presents the highlights of those survey findings, along with related additional insights drawn from interviews with industry experts and commentators. Key findings from this research include:

Strategic risk management remains an immature activity in many companies. Senior executives surveyed for this report clearly recognise the importance of strategic risk management to their business. They see major strategic threats, such as weak demand and market volatility, as the biggest risks they face over the next 12 months, and regard the identification of new and emerging risks as the key goal of risk management. But they also see this aspect of risk management as among their biggest weaknesses, with just 35% saying that their company is effective at anticipating and measuring emerging risks.

Only a minority of companies involve risk functions in key business decisions. Risk managers have long hoped to play a more prominent role in strategic decision-making, but our survey suggests that this aspiration is still unfulfilled. Less than one-half of companies involve their risk functions formally in any major strategic decision, such as evaluating new market investments or M&A opportunities. Few companies even expect risk functions to play a support role in decision-making, with just 41% saying they expect risk managers to provide analysis to help management set corporate strategy.

Risk managers want to spend more time on the constructive aspects of the role. The risk function needs to spend more time on the "enabling" aspects of the role, such as helping business managers to achieve their business objectives. Survey respondents see this as the second most important objective for risk management but, at present, they do not believe that sufficient time is allocated to it. Instead, the lion's share of the risk function's attention is dedicated to "preventative" activities, such as controls and monitoring.

There is limited appetite for investment in the risk function. Despite rising to greater prominence in many companies, risk management has not generally attracted significant financial investment over the past year. Less than one-half of companies have invested in risk processes, while less than one-quarter have allocated funds to headcount or training of managers in the central risk function. Ongoing cost constraints and company-wide budget freezes are undoubtedly helping to curtail investment, but care must be taken not to compromise the effectiveness of overall risk management.

Risk functions have increased in authority, but there is a danger that this will not be a permanent change. The financial crisis has placed risk management under the spotlight. Just over one-half of the survey respondents believe that risk management has increased in authority as a result of the downturn. There are concerns, however, that this elevated position could be temporary, with a similar number of respondents agreeing that the authority of risk management will inevitably decline when the good times return.

There are doubts about the risk expertise among non-executive directors. The board plays a crucial role in setting the tone from the top and instilling a broader culture of risk awareness in the business. However, although confidence levels in the knowledge of executive management are reasonably high, many respondents worry that the technical risk knowledge of non-executive directors is lacking. Companies should pay careful attention to the composition of their boards and make sure that they have the right level of knowledge in place in order to ensure effective oversight.

Key points

- Strategic risks dominate the list of companies' concerns over the coming year
- The ability of companies to link risk management with overall corporate strategy is in doubt
- Barriers to strategic risk management include corporate culture and the constraints of operational issues

Chapter 1: Gaps in strategic risk management

> *"Turbulence produces not only risks but opportunities and fixating on threats obscures the upside of turbulence. A recent study found that nearly half of large companies surveyed had a chief risk officer, but how many employ a chief opportunity officer?"* Donald Sull, *The Upside of Turbulence*

Uncertainty and turbulence are part and parcel of doing business. Companies have become accustomed to living with threats that could not only disrupt their operations but also destroy their business. Although the global financial crisis may be the most recent and dramatic manifestation of this, it is just one among many unexpected events that have had a major impact on business over the past decade, from the September 11th, 2001 terrorist attacks to the spectacular rise of China as a global power.

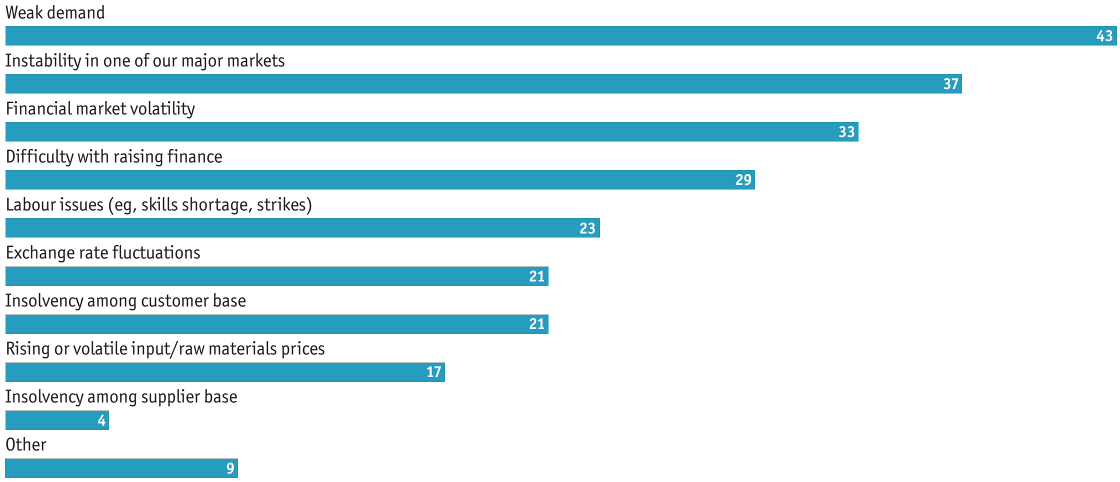
In addition to facing external threats, companies have also increased their risk exposure by their own design. Supply chains have become more fragile and outsourcing relationships more complex, while a hyper-competitive business environment forces companies to push the boundaries of what is possible. The constant need to develop new products, enter new markets or implement innovative processes and technologies helps companies to gain first-mover advantage, but it also increases their overall risk exposure.

Strategic risks—those that pose a threat to a company's ability to set and execute its overall strategy—dominate the list of concerns for many companies. Asked about the key risks that they will face over the next 12 months, survey respondents point to weak demand as the most worrying threat (see chart 1). Other important issues that keep them awake at night include instability in one of their major markets and financial market volatility.

These strategic risks can make the difference between survival and extinction but, in many cases, companies do not have a structured framework for identifying or mitigating them. This is not to say that strategic risks are being ignored—indeed, most board members and executive directors would see this as a fundamental part of their role. But often, these discussions are being held without a formal, structured process for gathering, aggregating and analysing risk information. And without this input, boards may not be making decisions from a position of full knowledge and understanding.

Respondents to our survey recognise the importance of strategic risk management, but the complexity of the task appears to prevent them from addressing it in a formal way. When asked about

Chart 1: What do you see as the biggest specific risks faced by your organisation in the next 12 months?
Please select up to three.
(% respondents)



the main objectives of the risk management function, respondents point to the identification of new and emerging risks as the most important goal (see chart 2). And yet, when asked to rate their company's effectiveness at different aspects of risk management, respondents see the identification of new and emerging risks as one of their biggest weaknesses. Equally, just 46% think that their company is effective at linking risk management with overall corporate strategy (see chart 3).

Input from professional risk managers can play a valuable role in guiding and challenging the discussion of strategic issues at board level. "If companies can introduce individuals into the strategic debate who have risk expertise, they can ensure that the board or the management team is better prepared to make effective decisions," says Andrew Kakabadse, professor of international management development at Cranfield School of Management. "It can make a very significant

Chart 2: What, in your opinion, are the most important objectives of the risk management function?
Please select no more than three objectives.
(% respondents)

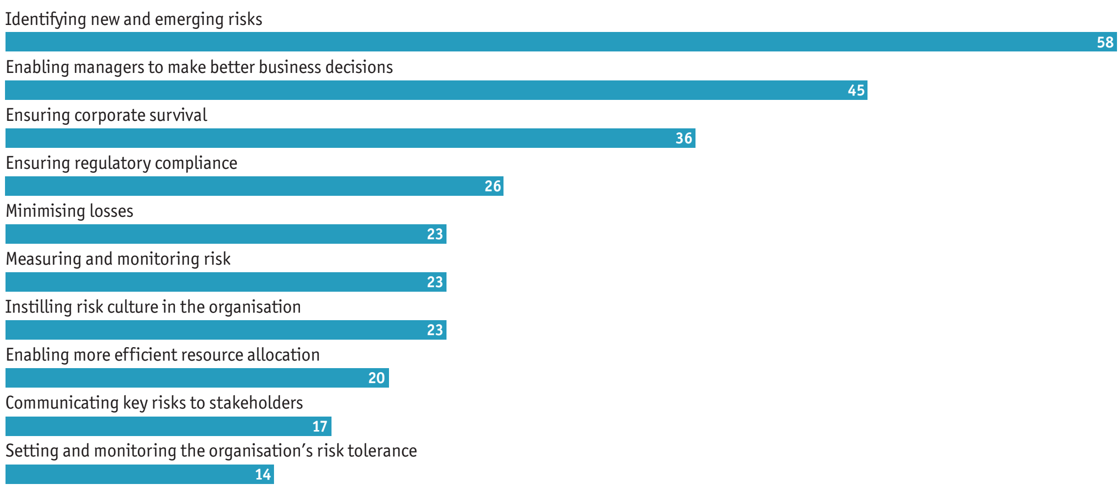
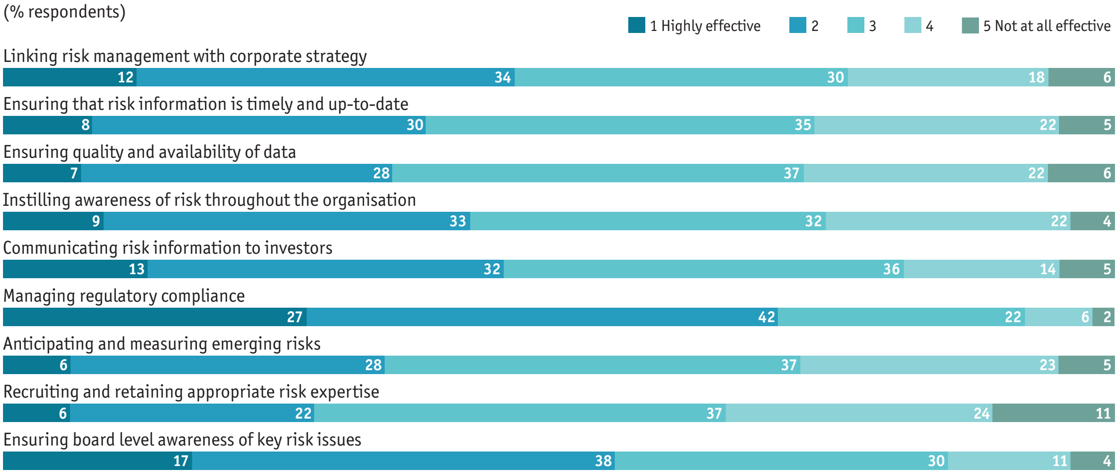


Chart 3: How would you rate the effectiveness of your organisation at the following activities?
Please rate on a scale of 1 to 5, where 1=Highly effective and 5=Not at all effective.
(% respondents)



contribution to strategy formation in terms of linking risk with the overall vision and assessing vulnerabilities to the brand and its reputation."

But in the majority of companies, the risk function remains excluded from the strategic decision-making process. For example, just 47% of respondents say that their risk function plays a formal role in evaluating new market investments, while 45% say it helps to set overall corporate strategy (see chart 4).

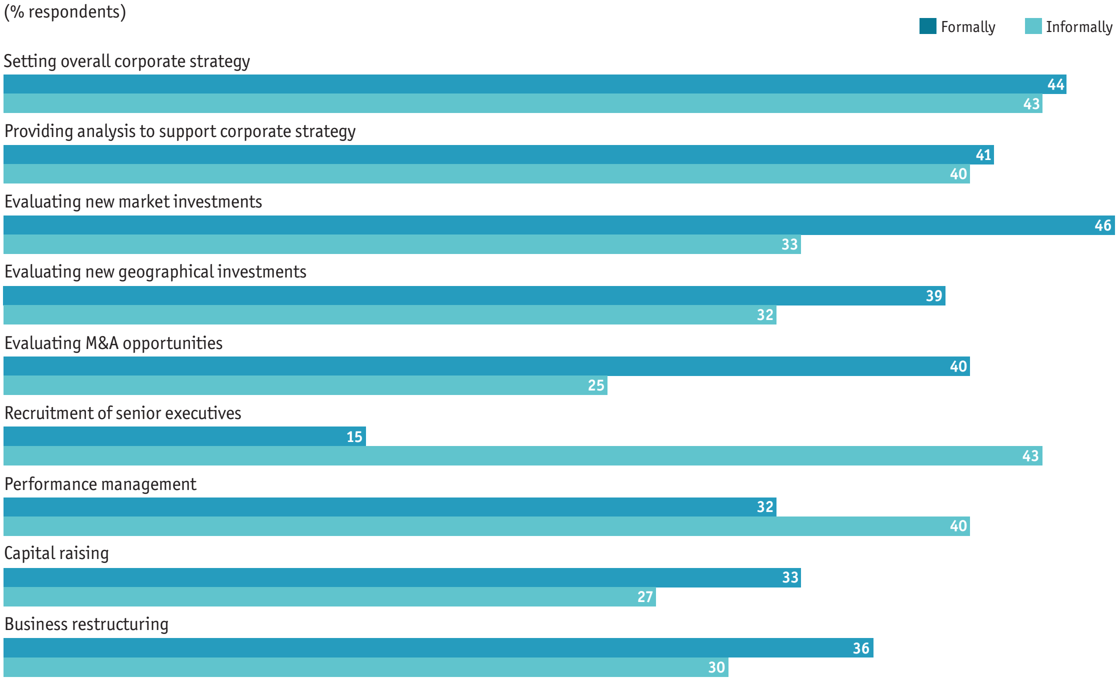
"Risk management has not been very good at focusing on strategic risks and yet these are the issues that have the biggest potential impact on shareholder value," says Eddie McLaughlin, managing director and global practice leader at Marsh, an insurance broker. "Other aspects of risk management, such as compliance, are generally much easier to manage, but if you're neglecting the threats that could really damage the business, then that's not a good use of resources."

Ongoing cultural barriers can be an important inhibitor of strategic risk management. Although risk management has developed considerably in recent years, there continues to be a perception among some senior managers that it is a support function staffed with narrowly focused specialists, such as business continuity planners, insurance buyers, or health and safety officers. Risk managers can find it difficult to break out of this mould and convince senior-level management that they have a contribution to make at the top table.

The demands of the operational aspects of the role can also prevent risk managers from taking a more strategic focus. When asked where they expected their risk management function to make the most meaningful contribution to their organisation, respondents point to conforming with regulatory requirements as the main source of value (see chart 5). There is no question that compliance is an important, and increasingly time-consuming, aspect of the risk management role. There are, however, dangers that a focus on box-ticking means that the key strategic risks facing the business can be overlooked.

Part of the solution may involve a reframing of risk management so that it focuses not just on the downside, but on the opportunities as well. Currently, 50% of respondents say that risk management

Chart 4: In which of the following activities does your organisation's risk function play a role, either formally or informally? Please select all that apply.
(% respondents)



does not play a big enough role in identifying and assessing opportunities (see chart 6). "When you look at the average company's risk registers, they contain only threats, not opportunities," says Mr McLaughlin. "In many ways, this is missing the point."

Solving this set of challenges requires input from a broad range of stakeholders, and is explored in the next chapters. The board, business and risk functions themselves must work together to rethink the cultural and organisational aspects of risk management, embedding it within the business and

Chart 5: Where do you expect risk management to make the most meaningful contributions to your organisation in the next 12 months? Please select up to three.
(% respondents)

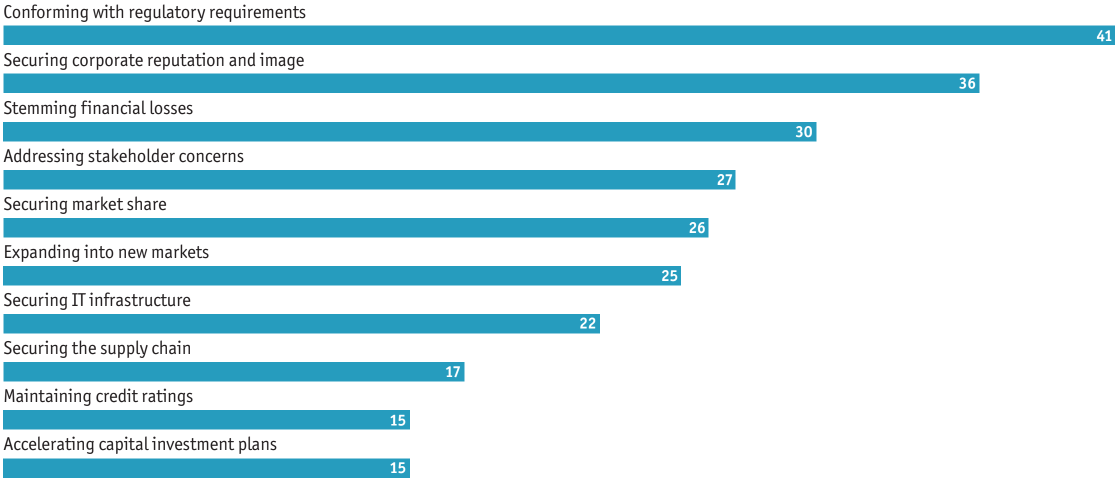
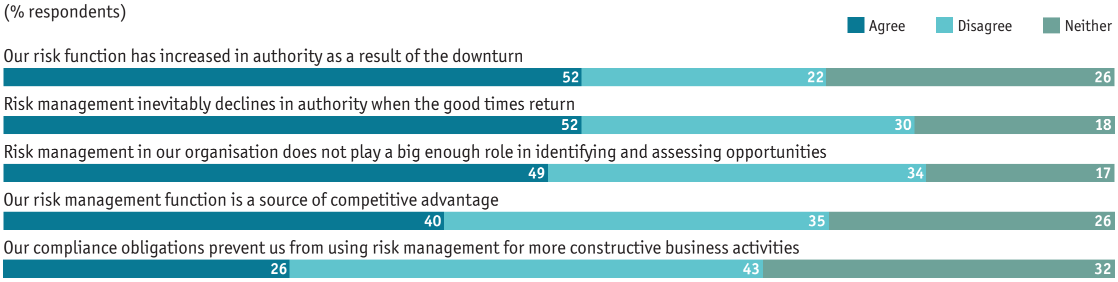


Chart 6: Please indicate whether you agree or disagree with the following statements.
(% respondents)



ensuring that it can make a genuine contribution to framing, analysing and solving strategic and business problems.

CASE STUDY Lego

The toy industry has to deal with some of the world's most fickle customers—children. Product life-cycles are short and, although some toys can become runaway successes, others can entirely fail to ignite. Supply chain management is also notoriously difficult: underestimate demand and shelves remain empty at crucial times, such as Christmas, but overestimate it and the surplus stock may be impossible to sell.

The Danish toymaker, Lego System A/S, has been more successful than most at managing these risks. Now in its 80th year, it is the world's fifth-largest toymaker and, after a rocky period early in the last decade, it has returned to strong growth.

The recognition that strategic risks, such as shifting demographics, regulatory change or the emergence of a new competitor, could derail this success has prompted the company to build a new, structured approach to strategic risk management on top of its existing operational risk processes. "We found that a lot of the most important risks that we faced were linked to changes in the competitive landscape or the business landscape in which we were operating," says Hans Læssøe, senior director for strategic risk management at the Lego Group.

With the full support of senior management, Mr Læssøe was tasked with developing a standardised approach to strategic management that could be embedded in the business and that would enable the Lego Group to test the resilience of its strategies against certain scenarios. "The aim is to build scenarios that do not try to predict the future, but describe possible outcomes and jog people's imagination about what could be the issues they will face."

Together with a small research team, Mr Læssøe developed four scenarios that describe possible economic, political and competitive futures up until 2015. These range from the relatively benign—slow and steady economic growth—to the near-catastrophic, which Mr Læssøe has termed "Murphy's surprise".

These scenarios were presented to the top management team, with the impact of each tested against the firm's current long-term strategy. "We wanted management to test the resilience of their strategies against these possible outcomes," says Mr Læssøe. "The idea is that they think about the prerequisites for the Lego Group to be successful in these possible futures. It also helps to frame their minds so that, when they think about strategies in 2015, they do so with that time frame in mind rather than defaulting back to the world they see in 2010."

Although separate from the firm's existing operational risk processes, the outcomes from the strategic risk management are combined together into an overall enterprise risk management database. "This means that the risk of a fire in a factory is right next to the risk of losing the Chinese market through new regulation," says Mr Læssøe. "They're both assessed and they're both addressed in some way."

As with any risk management process, the success of Lego's approach depends on integrating it within the business and ensuring that it is relevant to the senior management responsible for decision-making. "You have to embed it within the process that business managers are doing anyway," says Mr Læssøe. "You don't want to make the strategic risk management process something that they do on top of everything else, but something that is part and parcel of the normal business planning cycle."

Key points

- Risk managers need to shake off the perception that they are the "business prevention unit".
- Risk managers will need to develop better communication skills.
- Management is often reluctant to take advice from the risk function.

Chapter 2: From business prevention to business partner

The notion that risk management is a "negative" activity that is all about imposing controls and setting limits is a pervasive one in business. Risk management departments are often portrayed as "business prevention units" that get in the way of companies achieving their objectives. Stories abound of wily business development executives finding ways of stepping round risk management teams or shutting them out of the planning process.

"There is a degree of stigma about specialising in risk management," says Stuart Pickford, a partner in the litigation team at Mayer Brown, a law firm. "The challenge is to get the business to 'buy-in' so that the commercial team does not see risk as the function that says 'no' but rather sees risk management as a valuable input to help them meet their goals."

Risk managers today recognise that they must shake off this perception and be seen as a positive contributor to business. When asked about the main objectives for risk management, respondents say that enabling risk managers to make better business decisions is the second most important goal (see chart 2). "You have to prove yourself as being a useful resource, put yourself out there and become a 'go-to' person," says Christine Eick, executive director of risk management at Auburn University in Alabama. "If you understand what people are dealing with and can demonstrate that there are benefits to working with you, then the doors will open."

But other findings suggest that this role as an enabler of business is not yet being fully achieved. More than three-quarters of respondents say that the risk function should spend at least 25% of its time on "enabling" activities, such as working with business managers to achieve objectives, but only 45% say that this is the case in reality (see charts 7 and 8).

This focus on the "enabling" aspects of risk management highlights the importance of strong communication between the central risk function and the broader business. This takes risk management out of its technical heartland into a role that is much more about the "softer" skills of diplomacy, listening and communication. "Risk managers should first and foremost talk to managers to understand what they are trying to achieve, whether it's a new product launch or a new market, or just their division,"says Malcolm Zack, audit director of Brakes Group, a food service supplier. "You can then help them to identify whether the risks could prevent these objectives from being achieved, and then help them to put actions together so that those risks either go away or are reduced in their likelihood or impact."

Chart 7: Very approximately, what proportion of your time does your risk function *currently* spend on the following activities?
(% respondents)

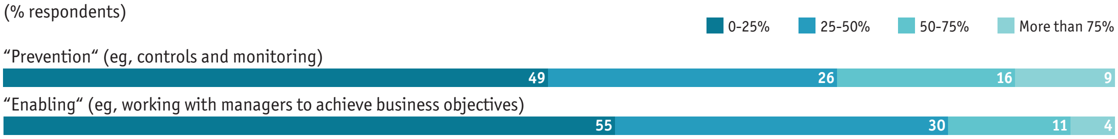
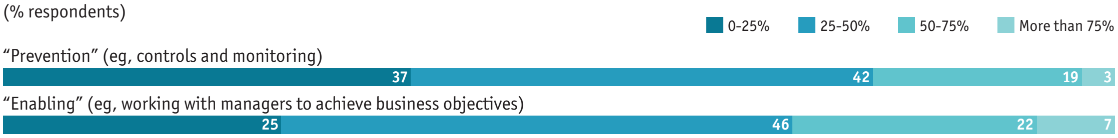


Chart 8: Very approximately, what proportion of your time do you believe your risk function *should* spend on the following activities?
(% respondents)



There is a danger with risk management—as there is with any technical function—that discussions become riddled with jargon. For that reason, it is important to develop a common understanding and language around risk that applies across the business—something that fewer than one-third of respondents agree that they have in place (see chart 9). “You can’t just come in and talk risk language, you have to talk business language,” says Nicola Harvey, who is group risk director of Christie’s, an auction house, and chair of the Association of Insurers and Risk Managers (Airmic). “It’s really important that risk managers become people who are able to get under the skin of the organisation, and talk the right language to the right people at the right level.”

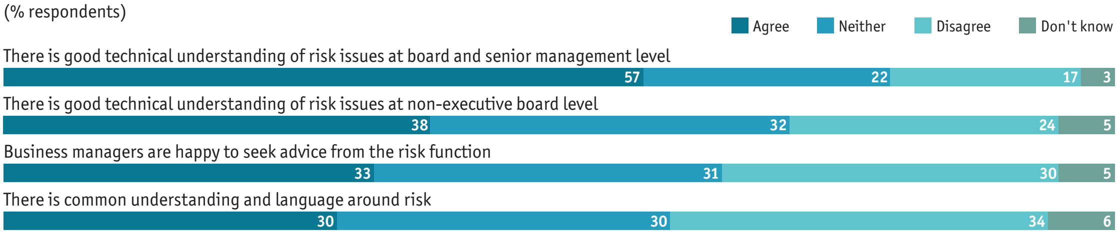
“It’s really important that risk managers become people who are able to get under the skin of the organisation, and talk the right language to the right people at the right level.”
Nicola Harvey, Christie’s

Many senior risk managers believe that there is a need for a re-education process to ensure that businesses think about risk management in broader terms. “Risk management should not be seen as being just about reducing risk,” says Ms Harvey. “It should also be about embracing risk, taking advantage of it and using that to support your business objectives.”

Clear and consistent communication between the risk function and the business is vital, but this continues to be an area of weakness for many companies. Just 41% of respondents think that their company is effective at instilling an awareness of risk throughout the organisation (see chart 3).

The extent to which business managers proactively consult the risk function is a good measure of the relationship between the two sides. Among the survey respondents, just one-third agree that business managers are happy to take advice from the risk function (see chart 9). “What has changed is that I am now consulted much more frequently by the business on certain risk issues, and that process can really help with providing a new perspective on a problem that leads towards a constructive solution,” says Arnout Van der Veer, a board member of the Institute of Risk Management, and chief risk officer of a London-based international FTSE-100 company.

Chart 9: Please indicate whether you agree or disagree with the following statements, as applied to your organisation:
(% respondents)



Steve Fowler, chief executive of the Institute of Risk Management, believes that risk managers who can make a contribution to solving business problems will find their CEO's door open to them. "The CEO doesn't want to hear from a risk manager who is all about cost and control, because he's not going to be motivated by those sorts of things," he explains. "But if you can point out solutions to a problem as well as identify the risks, you'll make yourself indispensable and be invited to top table meetings."

Key points

- The economic downturn has curtailed many companies' risk management investment plans.
- Because of the downturn, risk managers have become more important within their organisations.
- Increasing the size of central risk functions could reduce a company's overall ability to manage risk.

Chapter 3: Embedding risk in the business

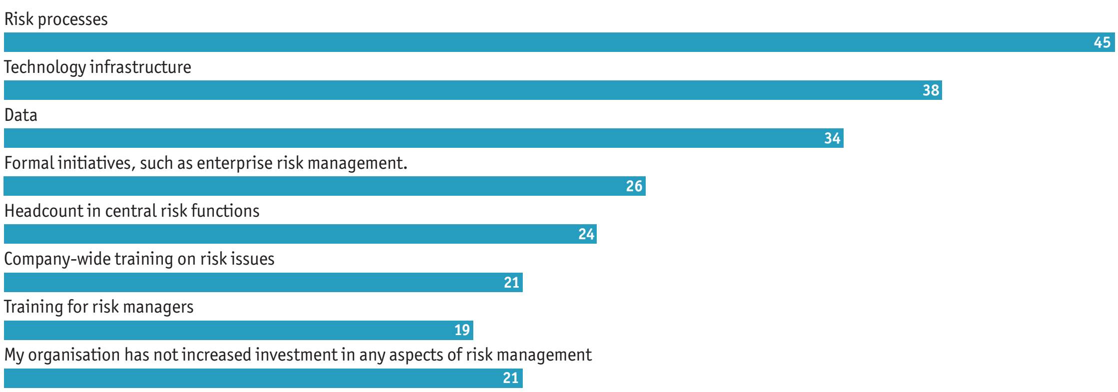
A greater awareness and focus on risk might suggest that companies are looking to beef up their risk functions, recruit specialists and invest in new technology and data infrastructure. Yet curiously, this appears not to be the case. The most popular area for investment is risk processes, but even here, only 45% of companies say that they have increased their expenditure in the past year. Less than one-quarter are increasing headcount in central risk functions, while a similar proportion say that they are ramping up training—either of central risk functions or the business at large (see chart 10).

The economic downturn is undoubtedly a factor in this reluctance to invest. Many companies continue to maintain a highly disciplined approach to capital expenditure and recruitment, and risk management is no exception to this pervasive climate of cost-consciousness.

The common perception of risk management as a back-office cost centre does little to help the cause for greater investment. The result, in a growing number of organisations, is that companies are looking to scale back headcount in certain areas. "We're beginning to see companies laying off teams of traditional, old-fashioned risk managers or outsourcing those functions to specialist organisations," says Mr Fowler.

But although traditional risk managers—business continuity experts, health and safety officers, insurance buyers and a range of other roles—may be facing a squeeze, this does not mean that risk

Chart 10: In which of the following aspects of risk management has your organisation increased investment in the past year?
Please select all that apply.
(% respondents)



management as a whole is being downgraded. Increasingly, companies are looking to embed risk management more deeply in the business and this often means that traditional, centralised risk functions are either static or shrinking in size. "There is no question that the risk management role has increased in profile and has a much stronger voice than it had prior to the crisis," says Mr McLaughlin. "The size of the function is not necessarily greater but the footprint within the firm is much more significant."

Although investment in risk functions is static or even declining, the voice of risk management in general is becoming louder. Just over one-half of respondents agree that their risk function has increased in authority as a result of the downturn (see chart 6). Among financial services respondents, this figure rises to 70%. There are some doubts, however, that this new level of authority can be sustained over the entire economic cycle, with 52% believing that it will inevitably decline when the good times return. In other words, the pressure of generating sales, profits and shareholder returns could ultimately override the concerns of risk managers, and cause them to be sidelined in the rush to beat the competition.

"We're all risk managers now, and that education process is not complete unless you have provided the tools that allow staff throughout the organisation to be able to identify, manage and control risk."

Tom Mumford, KBR

Many risk managers are aware of this problem and are doing all they can to embed systems and frameworks in their organisations that will ensure that risk management becomes more integrated in the fabric of the firm. "Risk management is not just an activity and a reporting process that you create and update," says Sue Carter, chief financial officer of KBR, an engineering and construction company with 42,000 employees worldwide. "It is something that you actually live every day within the business and it's incorporated into all of your business processes."

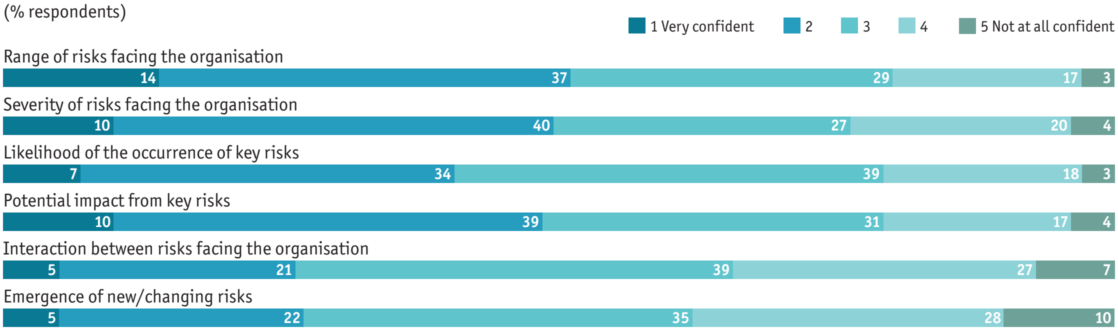
Embedding risk management within the fabric of the business depends on a constant process of education to ensure that managers have an understanding and awareness of risk. "You need to drive home the concept that we're all risk managers now," says Tom Mumford, senior vice-president for commercial at KBR. "And that education process is not complete unless you have provided the tools that allow staff throughout the organisation to be able to identify, manage and control risk as they're conducting their work."

Respondents to our survey are somewhat ambivalent about the level of understanding and awareness among the broader business. In general, around 50% or less consider that there is a good understanding throughout the organisation of measures such as the range, severity and likelihood of risks (see chart 11). Levels of understanding related to the emergence of new risks and the interaction between risks are particularly low. Equally, just 41% think that their organisation is effective at instilling a company-wide awareness of risk (see chart 3).

Taken together, these findings suggest that companies must maintain a focus on education and dialogue in order to ensure that a robust risk culture is built across the organisation. "The only way to find out whether a company has a good risk culture in place is to go out and speak to people on the ground, understand the systems that are in place and find out whether they are being used," says Julie Summerell, a consultant at Serco Consulting.

A careful balance must be struck between a centralised risk function that can provide a consistent framework for enterprise-wide risk, and the need to encourage ownership of risk among the broader business. Intense competition, combined with the complexity and scale of the modern multinational,

Chart 11: How confident are you that there is broad understanding throughout your organisation of the following?
Please rate on a scale of 1 to 5, where 1=Very confident and 5=Not at all confident.
(% respondents)



has made delegation to decentralised business units essential in order to achieve the kind of rapid decision-making that companies now require. "Delegation is a necessity in a flexible and efficient organisation," says Professor Patrick Gougeon, director of the London campus at ESCP Europe business school. "But when you delegate, you take the risk that some people will not follow the procedures, will go beyond what they should do, and it's very difficult to control."

This highlights the need for a centralised function that provides the framework and sets the parameters for risk-taking. "You can see a scenario evolving where you've got a chief risk officer who works with the board to put the risk management framework in place to develop the organisation's risk appetite," says Mr Fowler. "And that's implemented through a much more risk-savvy group of line managers who understand the subject. Looking forward, ordinary managers and business leaders ought to have a higher level of education in what's becoming an emerging, important discipline."

Risk functions, then, do not need to be large, just effective at putting in place frameworks and having a constructive dialogue with senior members of the business units. "It's almost instinctive to some of the best organisations in the world to have very small risk teams," says Mr Fowler. "They might just have a chief risk officer with a small support staff, but that's because they're not doing risk management. What they're doing is implementing a risk management framework throughout the DNA of the firm. That's a better approach than giving the job of identifying and dealing with all of the firm's risks to a group of technicians who sit in a darkened room somewhere."

Counter-intuitively, perhaps, increasing the size of central risk functions could even have a negative impact on the company's overall ability to manage risk. "If you increase the size of risk functions, and introduce more and more systems and processes, you may be suggesting to people who are actually making the business decisions that risk is something they no longer need to worry about," says Matthew Lawson, a partner in the litigation team at Mayer Brown.

CASE STUDY Invensys

As a company that provides technology, software and consultancy to oil refineries, nuclear power stations and rail systems, Invensys cannot afford to take risk management lightly. Over the past two years, it has introduced a new structure and process for managing risk that relies on embedding risk management within its functions and divisions under a framework controlled by a central risk function and committee.

"You have to make risk management a living part of the business so that operational divisions don't see it as an add-on but an integral part of their day-to-day job," says Chris McGloin, vice-president for risk management and insurance at Invensys. "Risk management has to be part and parcel of their normal way of managing and reviewing their business."

Divisions and functions within Invensys are responsible for maintaining their own risk registers and updating these on a regular basis. These are then reviewed on a quarterly basis and consolidated into a group risk report. A risk committee, which reports into the audit committee, is responsible for overseeing the risk management process and also monitors the risk mitigation process undertaken by the individual operations.

The success of this programme depends on developing a system that managers see as adding value to their job. "If you just give managers a form to fill in and ask them to tick some boxes, they'll ignore it and see it as extra bureaucracy," says Mr McGloin. "But if they see it as something that helps them to make decisions and focus their priorities, then they'll do it. It's all about making it simple, streamlined and linked into the business."

Risk managers at Invensys communicate regularly with operational and functional managers in order to educate them about the process and help them to understand the benefits. In addition to technical skills, risk managers need a deep understanding of the business and the ability to make connections between different parts of the business. "The people in the central risk function who are facilitating the management of risk need to have a proper understanding of what the guys out in the business are doing and how they're trying to do it," says Mr McGloin. "You're taking part in the business at a slightly higher level than the experts, but in a way that is informed enough to be able to translate and deal with issues in a non-jargonistic, consistent way."

In addition to helping the business develop a broader risk awareness and culture, the process also facilitates an environment in which business managers are encouraged to share information with each other about their risk priorities. This helps to disseminate best practice and builds up knowledge about the interaction between risks across the business. "Managers very quickly recognise that sharing and communicating risk priorities means that they receive information in return, and that helps to inform the process and add value," says Mr McGloin.

Key points

- Boards and risk management are vitally important to each other's operations.
- Many boards—especially non-executive directors—do not always get the full picture of companies' risk strategy.
- Stronger reporting lines between risk managers and boards would help to enhance the status of risk management.

Chapter 4: The role of the board

The board has a crucial role to play in building a culture and awareness of risk, embedding risk processes throughout the organisation, and enabling a more consistent and thorough assessment of strategic risk. Without the support and commitment from the top of the company, any efforts to strengthen risk management will fail. Risk functions, meanwhile, play a vital role in supporting the board's decision-making process by aggregating, analysing and communicating key risk information to board members.

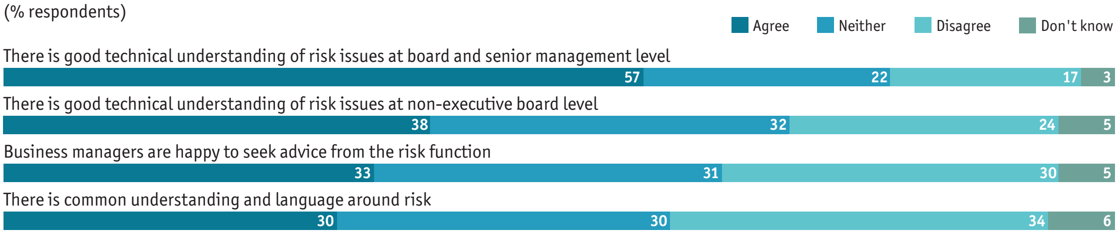
There are demands on both sides to optimise the relationship. Boards are under scrutiny from shareholders, regulators and other external stakeholders to provide assurance that proper oversight of risk management is being undertaken. They are therefore looking to risk functions as a source of accurate and actionable information.

Risk functions, meanwhile, are under increasing pressure to respond quickly to board requests for information and to provide "deep dives" into specific areas of enquiry. "There's a huge amount of work to be done in how you present risk to the board," says David Millar, chief operating officer of the Professional Risk Managers' International Association. "First, how you present risk to the board; second, how you educate the board in risk; and third, how the resulting decisions that are being taken are themselves recorded and monitored."

The need for an aggregate picture that presents risk to the board in a clear and consistent way is driving increasing interest in an enterprise risk management approach. In many organisations, this sits on top of the existing risk function and is tasked with collecting risk from across the company, aggregating it, standardising it and presenting the results to the board. "The move to enterprise risk management has happened in large part because boards were simply not getting what they wanted in terms of risk information," says Brian Cummings, information risk management lead for North America at Tata Consultancy Services. "I think we will continue to see an elevation of the enterprise risk manager role."

Despite the importance of this relationship between the risk function and the board, not every company seems to give it the focus that it requires. For example, only 55% of respondents think that their organisation is effective at ensuring that the board is kept aware of key risk issues (see chart 3). There are also doubts about the technical risk understanding that exists among board members. Non-

Chart 12: Please indicate whether you agree or disagree with the following statements, as applied to your organisation:
(% respondents)



executives, in particular, are seen as a weak link. Just over one-half of respondents agree that there is good technical understanding of risk issues at board and senior management level, but only 37% offer the same assessment of the non-executive directors (see chart 12).

The part-time nature of the non-executive role inevitably means that these directors are not fully immersed in the decisions of the business, but this raises questions over how exactly they perform their oversight and how they combine this with other responsibilities. Although there are few legislative requirements limiting the number of directorships that an individual board member holds, there are growing calls for a maximum number to be imposed. "While the number of boards may be qualified by their specific type, any individual who sits on more than three would raise questions as to whether the member is doing a disservice to the companies on whose boards they sit," says Richard Apostolik, chief executive of the Global Association of Risk Professionals. "A non-executive

The role of boardroom dynamics

Non-executive directors who are aware of their company's risk exposure and who receive timely, relevant information about the business are in a good position to ask the right questions. But knowledge, along with the protocols and procedures that form the basis of corporate governance, can only go so far. Often, it is boardroom dynamics that constitute the biggest barrier to effective risk oversight.

"The corporate governance protocol is simply that – a protocol," says Professor Kakabadse, who has amassed a database on boards that covers 10 nations and many thousands of private and public sector organisations. "It allows boards to demonstrate that they have gone through the motions, but it doesn't get to the underlying problem. What we have found is that even when non-executives know there is a major concern, the boardroom dynamics are not conducive to conversation. There are high levels of inhibition."

Tensions between executive management and non-executives can exacerbate this situation. In our survey, board-level executives express limited confidence in their non-executives, with just 37% agreeing that they possess a good technical understanding of risk issues. Professor Kakabadse says that his database reveals similar findings. "Executive managers who sit on boards down-rate their non-executive colleagues on every measurable performance," he says. "Managers often think that the chairman doesn't know the company very well and hence doesn't know the reality of what's happening."

The part-time nature of the role is undoubtedly a factor is this assessment. To remedy this situation, Professor Kakabadse suggests that business needs to re-think carefully the scope and responsibilities of the non-executive role. "We have not thought creatively enough about what it means to be a board director and who should be coming into the pool of talent," he says. "It is a specialised role now and you need specialised skills."

A move away from the "cosiness" of boardroom relationships would help, as would a limit on the number of directorships an individual non-executive should hold. Specialised training, perhaps through a non-executive trade association, would also help to formalise the role, believes Professor Kakabadse.

But ultimately, the problem will always come back to the dynamics of the boardroom. "Specialist skills and understanding risk help, but it's the ability to be able to speak up that really makes the difference," says Professor Kakabadse. "Board directors simply find it very difficult to speak out, particularly in companies where there is a combined CEO and chairman role."

directorship requires time and commitment in order to understand the nature of the company and the risks that it is taking. Without that kind of understanding, non-executives will not be able to give the advice that they are being asked to provide."

In the UK, the 2009 Walker Review of corporate governance in financial institutions suggested that banks should set up specialised risk committees with responsibility for oversight of risk issues. To date, there is little evidence that this approach is spilling over into the broader corporate world. But even if it does, some experts worry that it would be inappropriate for many corporates. "Companies need to be very careful to avoid the idea that the management of risk is something that can be kicked off into a committee," says Mr Lawson. "There's a real danger that this reinforces risk as a separate silo, rather than an integral part of running the business."

Reporting lines between the risk function and the board have also come under scrutiny. Although it is rare in the corporate world, a chief risk officer reporting into a non-executive director, perhaps the chairman, may one day become best practice to ensure the independence of the risk role. To date, however, progress on changing governance structures has been relatively slow. "If companies really wanted to enhance the status of risk management in the organisation, they would look at these reporting relationships more carefully," says Professor Kakabadse. "This means that the chief risk officer should only report to the chairman or to the board to ensure that they have an independent voice and can challenge executive management. But with a handful of exceptions, this is not happening at all."

Dual reporting lines to both the chief executive and chairman are not enough, believes Professor Kakabadse. "A joint reporting line doesn't make that much difference because it is the CEO that runs the show in the first place and many chairmen will not challenge their CEO," he says.

Conclusion

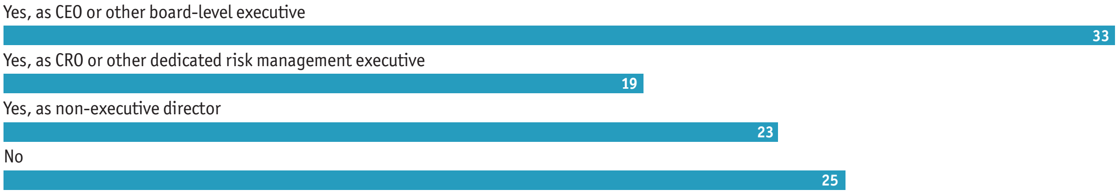
The financial crisis and ensuing economic downturn have bought risk management into sharp focus. Senior executives facing volatile and uncertain environments want greater insight into what the future holds. For risk managers, this presents a rare window of opportunity to elevate their function and play a more prominent role in key business decisions.

But for many risk managers, obstacles still remain. Some find it difficult to shake off an outmoded perception of the function as the "business prevention unit". Many remain shut out from the key business decisions, despite the benefits that companies would gain from a more structured approach to considering available options. Boards, although under pressure from external stakeholders to beef up their oversight of risk, can lack the necessary knowledge and understanding.

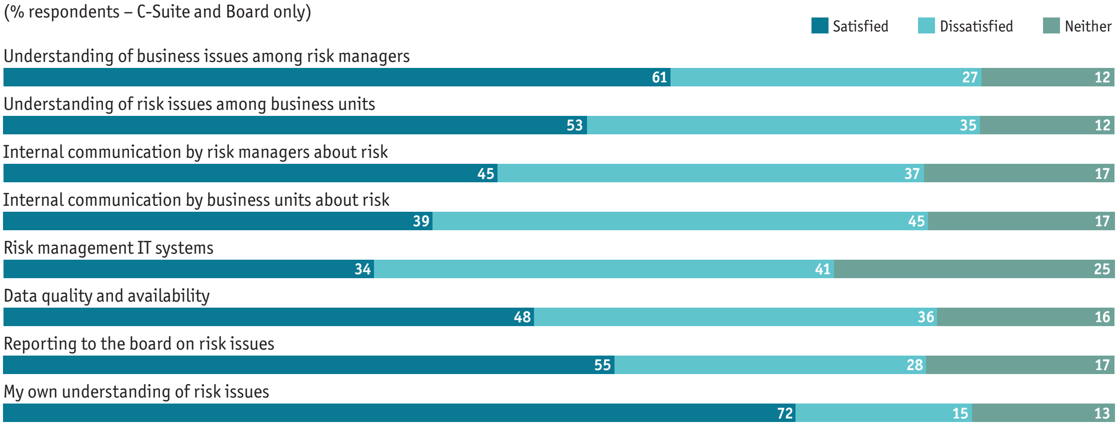
There are, however, positive signs of change. Risk management is gaining in authority and wielding greater power than at any time in recent memory. Boards are asking risk managers to expand their remit beyond operational issues to tackle bigger strategic risks. And some companies are embedding a broader culture and awareness of risk and encouraging a more structured approach to the consideration of both threat and opportunity.

Appendix: Survey results

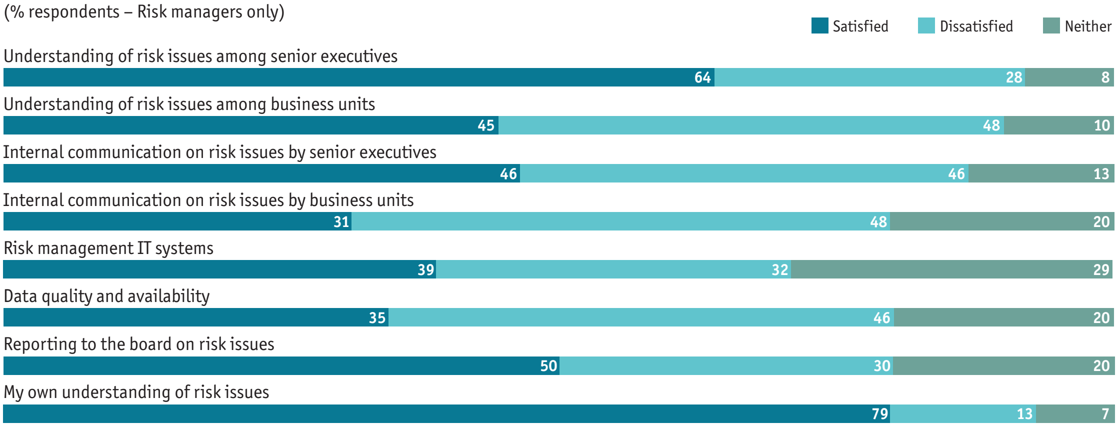
Do you have responsibility for, or influence over, strategic decisions on risk management in your company?
(% respondents)



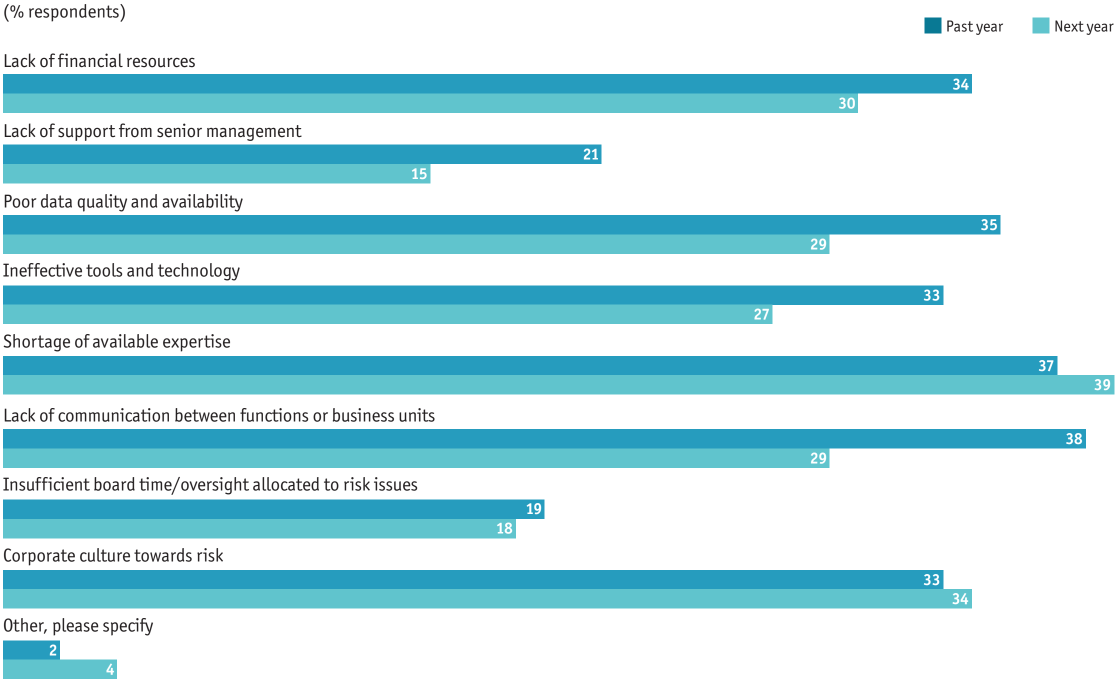
Are you satisfied or dissatisfied with the following elements of your organisation's risk management over the past year?
(% respondents – C-Suite and Board only)



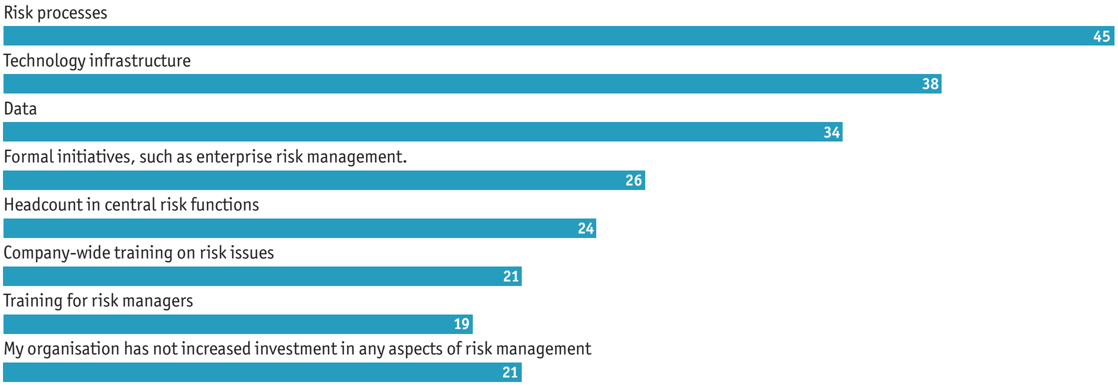
Are you satisfied or dissatisfied with the following elements of your organisation's risk management over the past year?
(% respondents – Risk managers only)



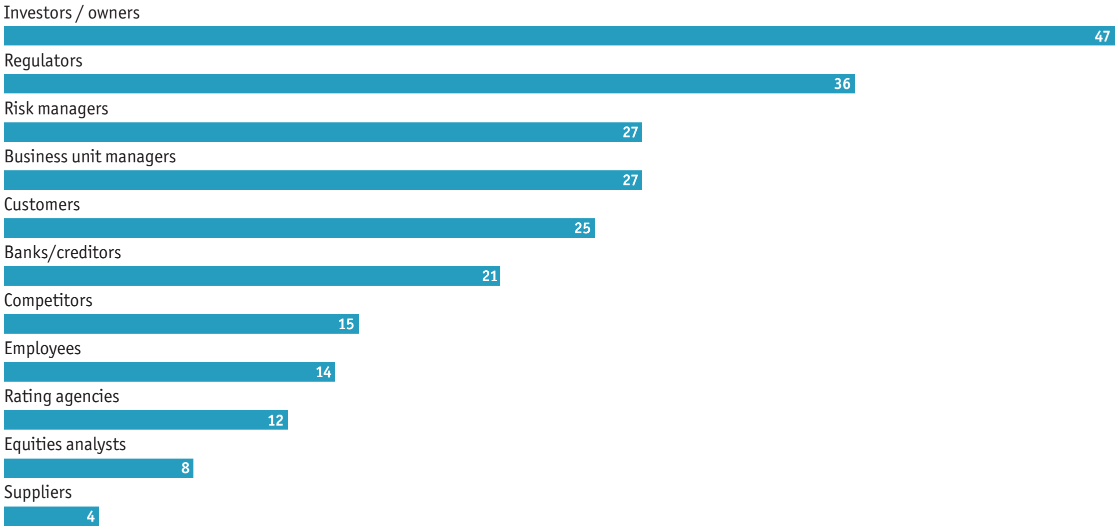
In the past year, what have been the most significant barriers to effective risk management in your organisation, and what do you expect to be the most significant over the coming year? Please select up to three in each column.
(% respondents)



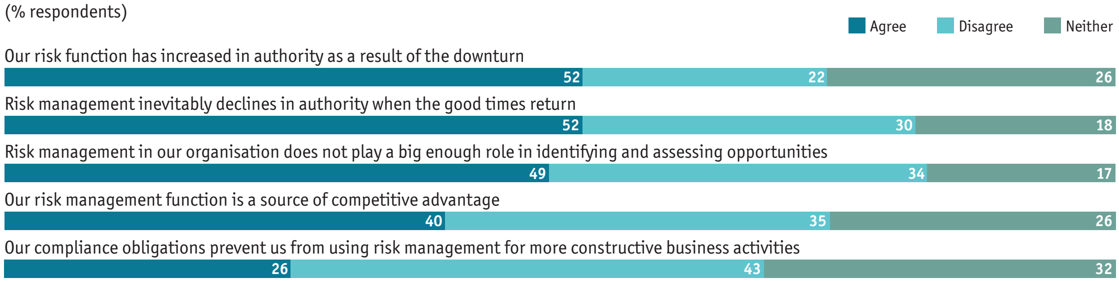
In which of the following aspects of risk management has your organisation increased investment in the past year?
Please select all that apply.
(% respondents)



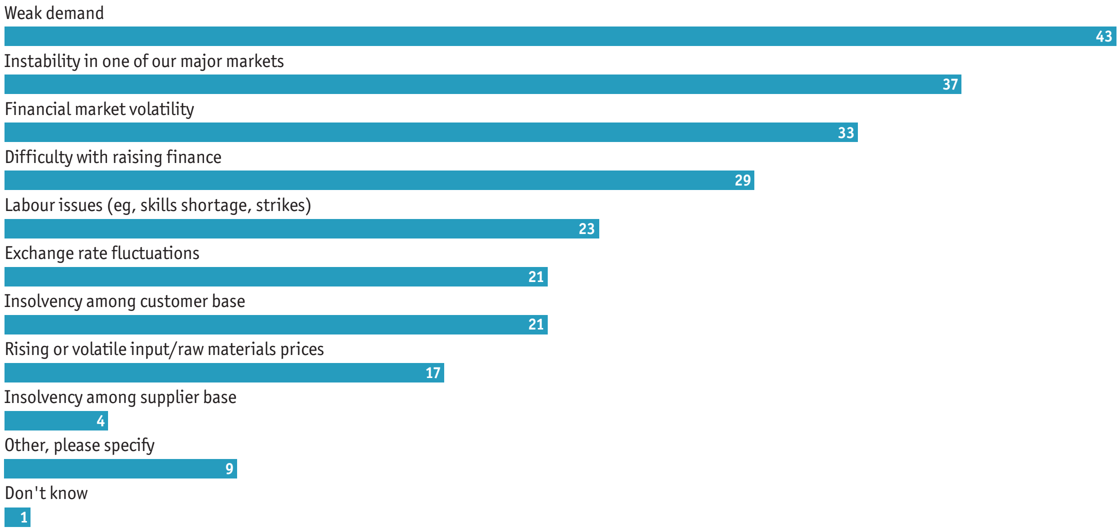
Which of the following stakeholders have the strongest influence on your organisation's approach to risk management?
Please select up to three.
(% respondents)



Please indicate whether you agree or disagree with the following statements.
(% respondents)



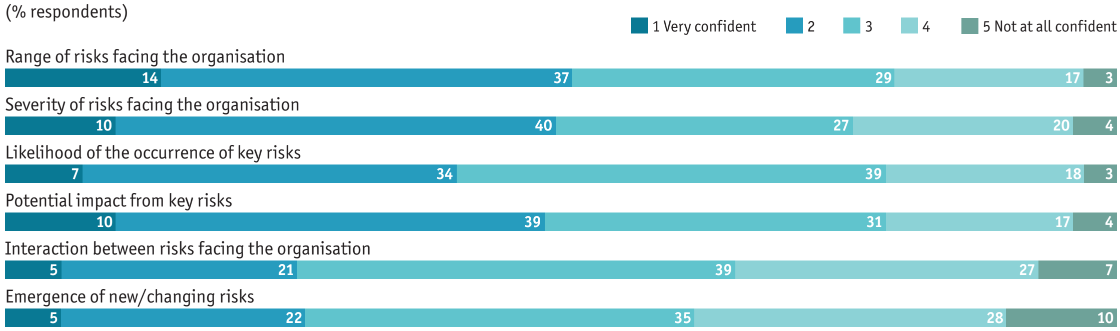
What do you see as the biggest specific risks faced by your organisation in the next 12 months?
Please select up to three.
(% respondents)



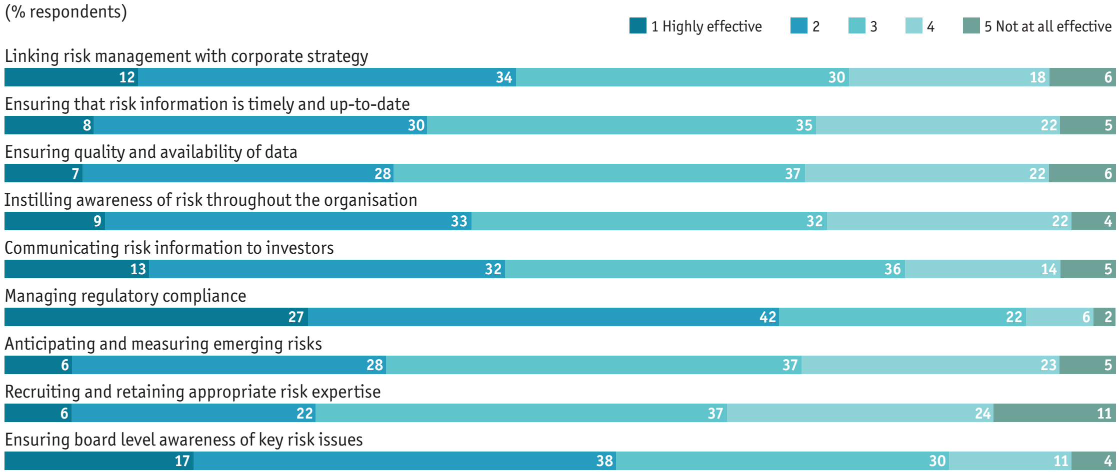
How has your organisation's overall tolerance for risk developed in the last 12 months? How do you expect it to develop in the next 12 months? Please select one only in each row.
(% respondents)

How confident are you in your organisation's ability to mitigate risks over the next 12 months?
(% respondents)

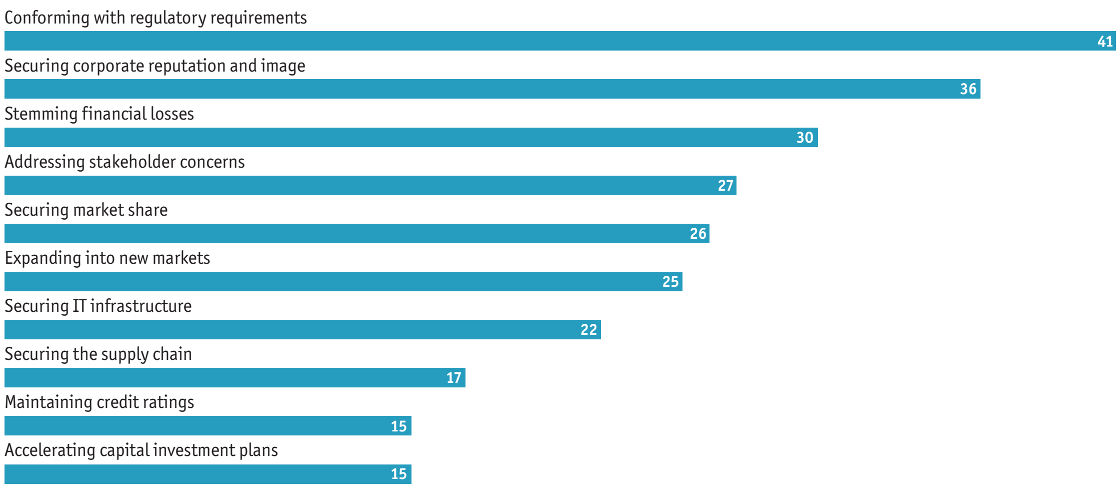
How confident are you that there is broad understanding throughout your organisation of the following?
Please rate on a scale of 1 to 5, where 1=Very confident and 5=Not at all confident.
(% respondents)



How would you rate the effectiveness of your organisation at the following activities?
Please rate on a scale of 1 to 5, where 1=Highly effective and 5=Not at all effective.
(% respondents)

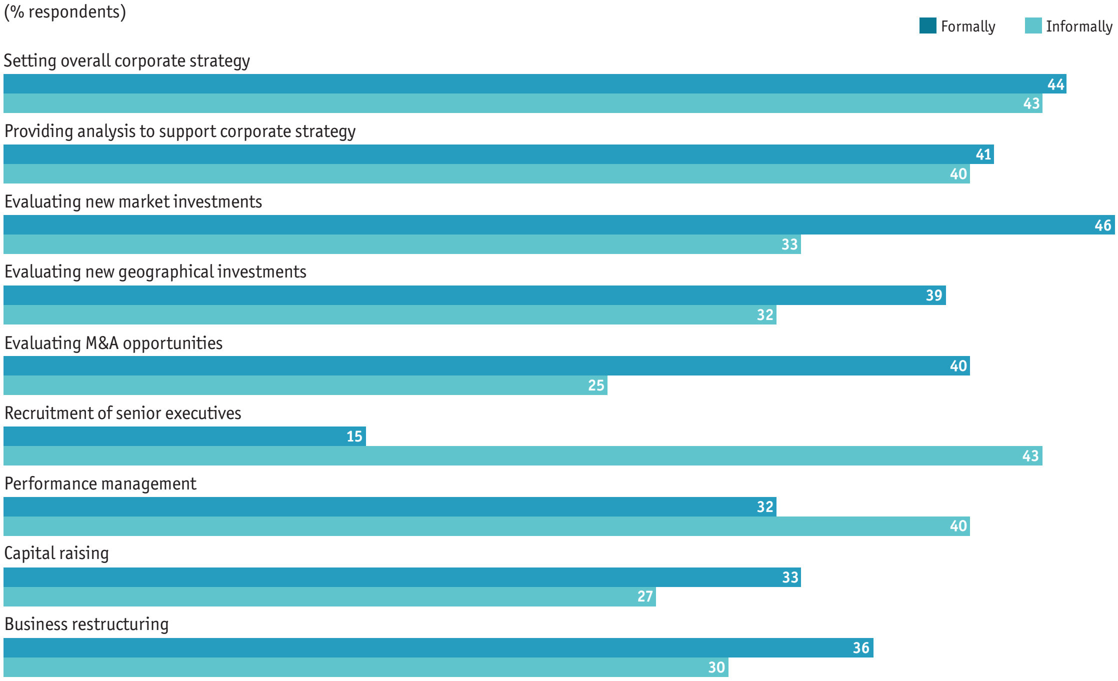


Where do you expect risk management to make the most meaningful contributions to your organisation in the next 12 months?
Please select up to three.
(% respondents)

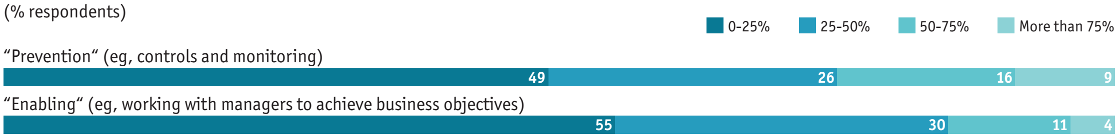


How would you describe the contribution of risk management to meeting your organisational priorities in the coming year, versus the past year?
(% respondents)

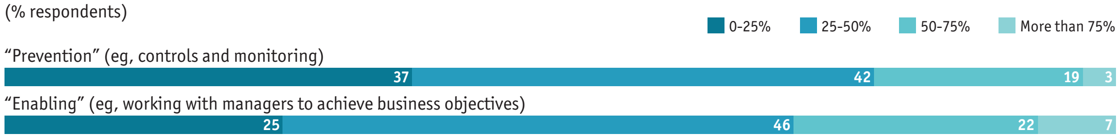
In which of the following activities does your organisation's risk function play a role, either formally or informally? Please select all that apply.
(% respondents)



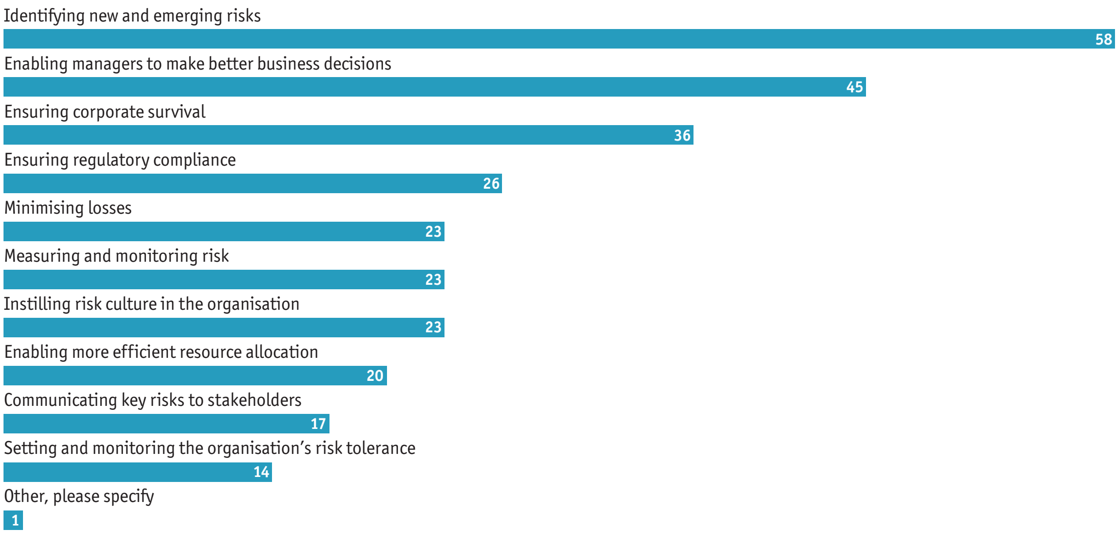
Very approximately, what proportion of your time does your risk function *currently* spend on the following activities?
(% respondents)



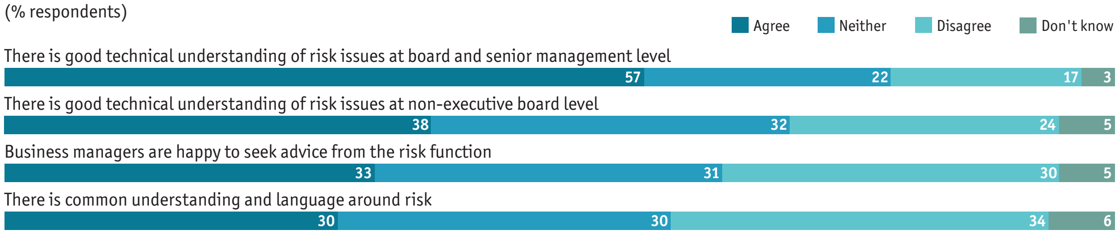
Very approximately, what proportion of your time do you believe your risk function *should* spend on the following activities?
(% respondents)



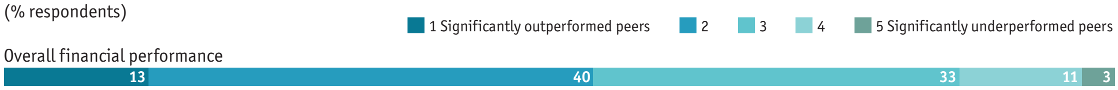
What, in your opinion, are the most important objectives of the risk management function?
Please select no more than three objectives.
(% respondents)



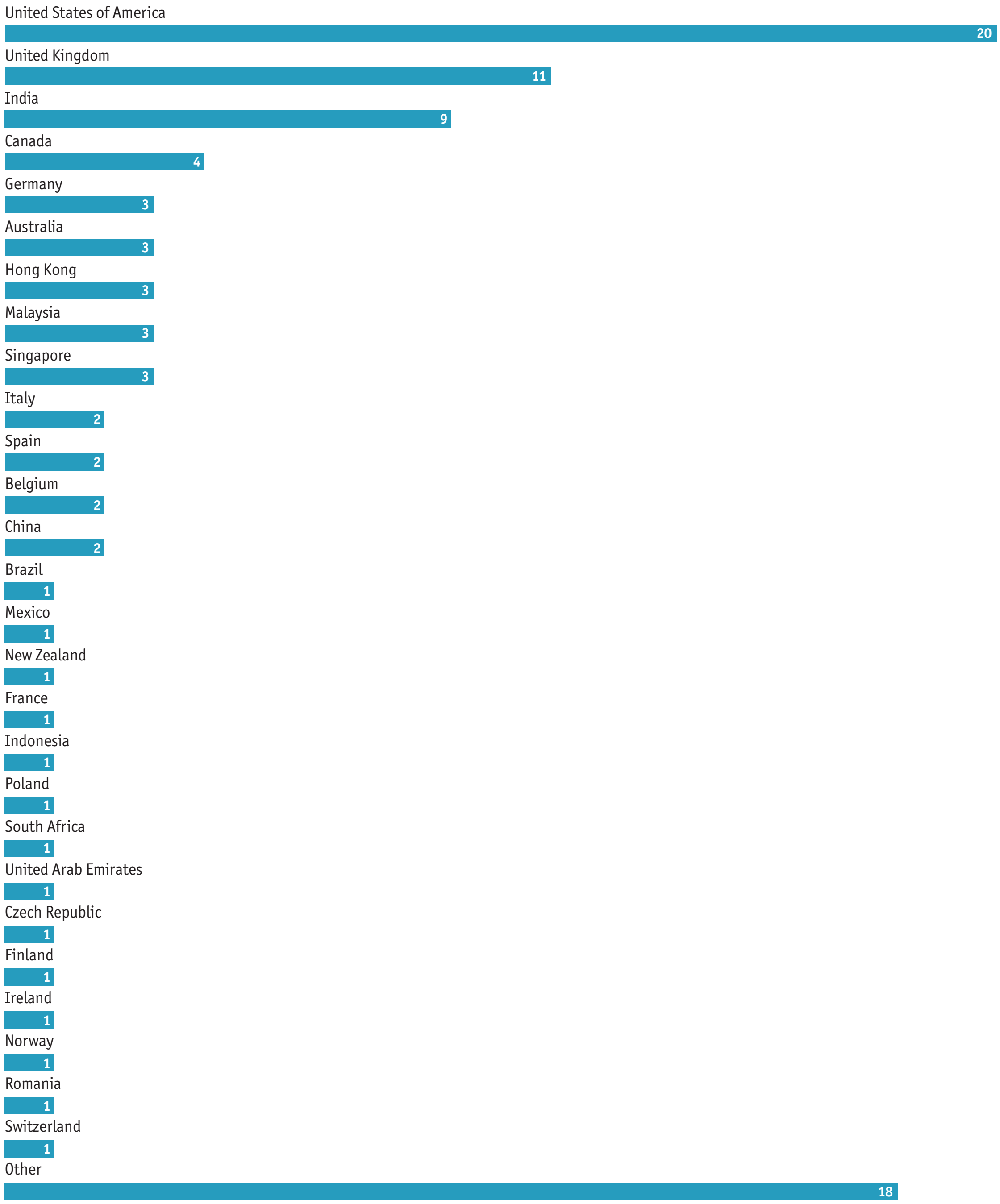
Please indicate whether you agree or disagree with the following statements, as applied to your organisation:
(% respondents)



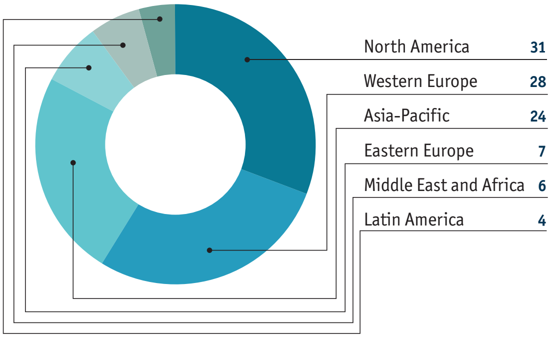
Over the past year, how would you rate the overall financial performance of your organisation compared with your peers?
Please rate on a scale of 1 to 5, where 1=Significantly outperformed peers and 5=Significantly underperformed peers.
(% respondents)



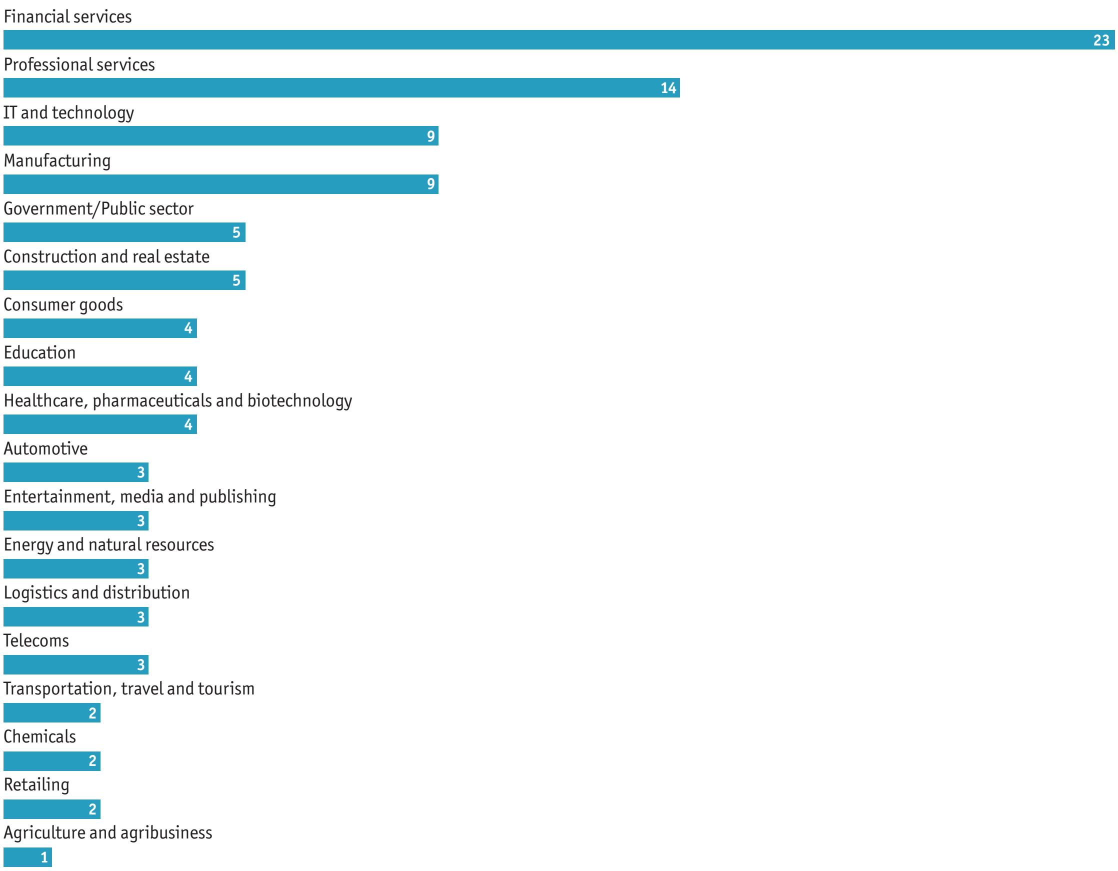
In which country are you personally located?
(% respondents)



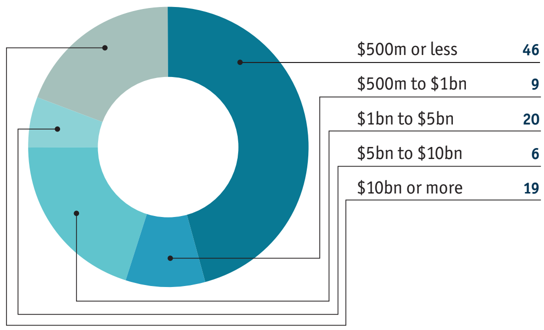
In which region are you personally based?
(% respondents)



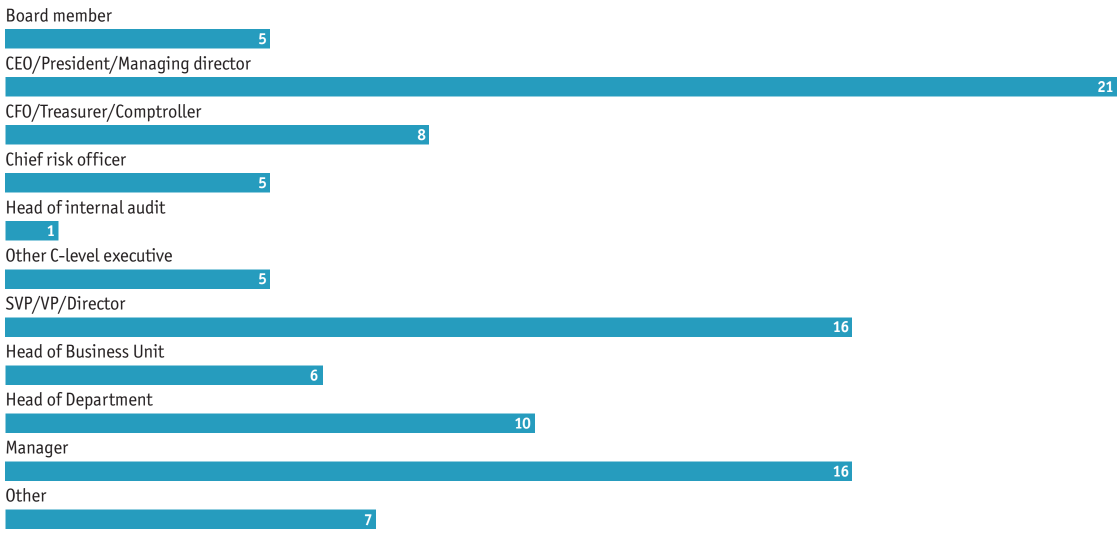
What is your primary industry?
(% respondents)



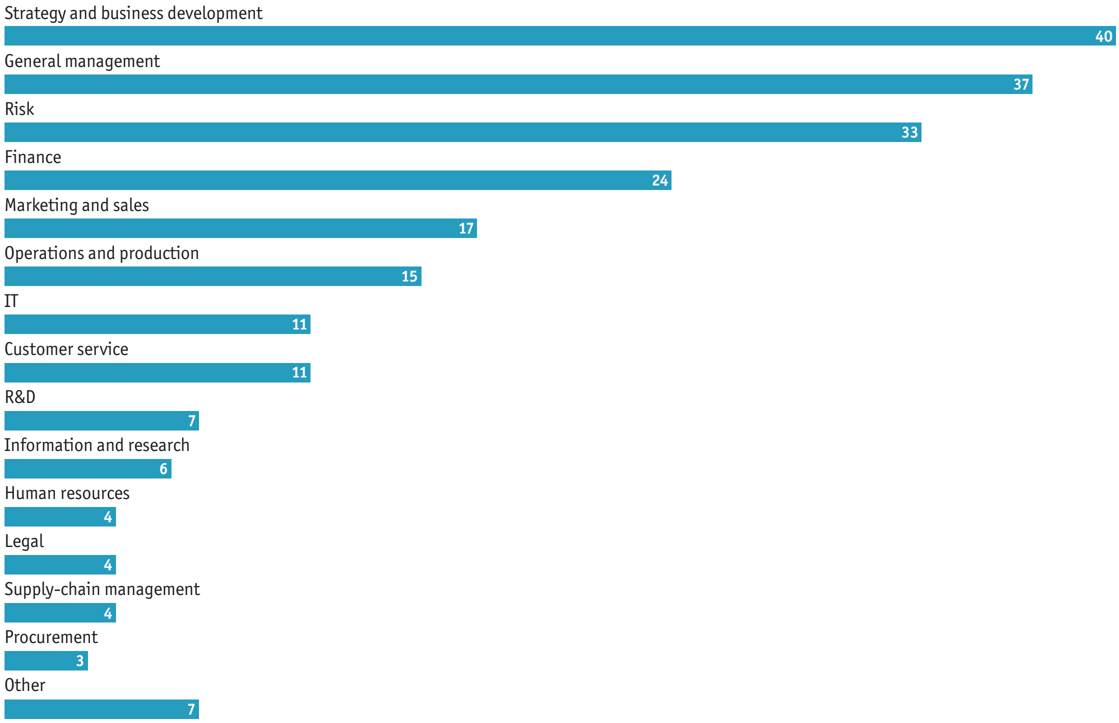
What are your company's annual global revenues in US dollars?
(% respondents)



What is your title?
(% respondents)



What are your main functional roles? Choose up to three.
(% respondents)



LONDON
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

NEW YORK
750 Third Avenue
5th Floor
New York, NY 10017
United States
Tel: (1.212) 554 0600
Fax: (1.212) 586 1181/2
E-mail: newyork@eiu.com

HONG KONG
6001, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

GENEVA
Boulevard des Tranchées 16
1206 Geneva
Switzerland
Tel: (41) 22 566 2470
Fax: (41) 22 346 93 47
E-mail: geneva@eiu.com