A Changing Risk Landscape

A Study of Corporate ERM in the U.S.
The manner in which companies view and address risk is changing rapidly. To begin with, risk and risk management are playing an increasingly strategic role as companies struggle to optimize the risk/return relationship and to enhance corporate decision making. Governmental regulations such as Sarbanes-Oxley, while initially focused on compliance issues, have heightened awareness of broader risks. Additionally, companies are looking at traditional risk categories — operational, financial/capital markets, insurance-based, etc. — in new ways with the development of more advanced risk management tools and increasing popularity of enterprise risk management (ERM).

INTRODUCTION
With this changing risk landscape in mind, Towers Perrin periodically surveys leading corporations to identify the crucial issues that shape their views of risk management, to understand the drivers of risk and risk management, and to further the development of solutions to meet existing and emerging client needs.*

In this 2006 survey, conducted with the assistance of Monitor Group, more than 75 senior finance and risk management executives completed comprehensive online surveys or in-depth interviews. The research sample included U.S.-based, publicly traded companies with revenues greater than $1 billion with representation across a suite of nonfinancial industries. This report highlights the key findings of that research.

AN INCREASING FOCUS ON RISK MANAGEMENT
While respondents almost unanimously acknowledge the importance of risk management to their business strategy and operations, 85% believe that their firms’ emphasis on risk management will increase over the next five years, driven by significant changes to the risk management landscape and the changing expectations of investors, regulators and other stakeholders.

Among the key drivers of risk, as highlighted by survey respondents, are corporate governance issues, natural disasters and pandemics, and increased liability risks (Exhibit 1, page 3). Corporate governance and other governmental regulations have pushed companies to identify and catalog risks across their organizations. Natural disasters like Hurricane Katrina and the threat of global pandemics such as the avian flu have caught many firms off guard and uncovered gaps in their current approach...
to risk management. Increased shareholder attention and the breadth of related lawsuits have also pushed companies to be more vigilant about their risk profiles. In addition, increased investments in complex and specialized facilities and infrastructure have increased firms’ risk exposures. Meanwhile, the number of cross-functional stakeholders that must be engaged and coordinated has also increased.

Amid this risk environment, it is not surprising that 63% of firms are concerned with how they manage risk today. Most companies believe there is significant room to better understand, quantify and manage their risks. As a major U.S. retailer explained, “Katrina took us by surprise, and our losses were enormous. The firm’s leadership realized that we were lacking some basic risk management capabilities…. There is a tremendous amount of work to do.”

**KEY RISK DOMAINS IN TODAY’S ENVIRONMENT**

Senior executives are faced with identifying, assessing and managing a wide range of risks. While the importance and impact of a specific risk domain may vary by company or industry, a number of risk domains were consistently mentioned as top of mind (Exhibit 2, page 4). These key risk domains — operational, property/casualty, financial and capital market, compliance, pension and human resource — are highlighted in the following.

### Operational Risk

Operational risk was identified as the most important risk that executives face today. While the specific nature of a firm’s operational risk varies (but is often linked by industry), supply chain risk emerged as a particularly important issue across industries. Companies point to increased exposure to supply chain risk given the globalization of the marketplace (increasing number and geographic spread of a firm’s suppliers and customers), increased participation across the value chain and a variety of potential external shocks (e.g., natural disasters, political disruptions). Demand is growing for methodologies and solutions to quantify and mitigate supply chain risk.

#### Exhibit 1

Drivers of Increase in Emphasis on Risk Management

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<tr>
<td>Corporate governance issues</td>
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<td>Natural disasters/pandemics</td>
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<td>Increased liability risk</td>
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<tr>
<td>Physical infrastructure/facility risks</td>
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<td>Government regulation</td>
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<td>Customer requirements</td>
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<td>Accounting rule changes</td>
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<td>Foreign trade/investment</td>
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The survey defined operational risk to include process failure, fraud and safety risks. A leading food retailer noted, “Unfortunately, the operational risks that can damage our brand — such as supply chain, avian flu, sanitation concerns, etc. — are not practically insurable, requiring more sophisticated and proactive risk management.”

**Property/Casualty Risk**
Addressing property/casualty (P/C) risk has long been a core part of a company’s risk management activities. Typically including general and product liability, fire, workers compensation and natural disasters, these risks are usually addressed with insurance and other traditional risk management techniques. However, shortage of insurance capital to cover certain P/C risks is prompting many companies to turn to the capital markets and other solutions. The research also indicated increased interest in integrating P/C risks into a firm’s broader risk profile.

**Business/Strategic Risk**
These risks were defined in the survey to include political risk and reputational risk, as well as risk (e.g., avian flu) that threatens business continuity. The comparatively high ranking of this category reflects, in part, the difficulty many companies face in identifying, quantifying and managing these risks.

**Financial and Capital Market Risk**
Financial/capital market risk encompasses interest-rate, foreign exchange, commodity and credit risks. In today’s global marketplace, more and more companies are exposed to these risks through their foreign operations, debt obligations, commodity inputs, etc. While hedging and the use of other financial instruments remain popular tools to manage these risks, there is emerging interest in innovative and more sophisticated solutions to better identify, quantify and off-load risk in a cost-effective manner. Firms are looking to external advisors to provide both general expertise with the capital markets as well as to anticipate industry-specific needs (Exhibit 3, page 5).

**Compliance Risk**
Though most companies tend to focus on Sarbanes-Oxley regulations, in theory, compliance risk includes accounting, labor, safety and securities concerns. In the past two years, a majority of companies surveyed hired consulting firms to help implement compliance-based solutions. However, companies appear to have progressed to see themselves as having compliance concerns “under control” so that compliance risk looks to be more of a process than a
challenge in the future. A gas distributor explains, “We already have a software solution for Sarbanes-Oxley that internal audit is satisfied with. What we need is an advisor to get into the ‘nooks and crannies’ of our other risk challenges.”

Pension and Human Resource Risks
Two areas of risk that are growing in importance and in their relationship with other risk domains are pension and human resource (HR) risks. While traditionally viewed separately from other risk areas, integrated management of pension and HR risks is increasingly seen as an important component of a solid risk management strategy. Over time, more proactive management of pension risk (if relevant) is expected as pension obligations are firmly linked to a company’s overall financial health. Additionally, there are strong correlations between a firm’s financial and capital market risk and its pension risk. Similarly, managing HR risk (e.g., employee turnover, labor supply, labor cost) is fundamentally linked to a firm’s operational risk. Communication between the pension, HR and risk manager functional roles is expected to increase, and expertise that spans across risk domains will become increasingly valued.

Enterprise Risk Management
Beyond these traditional risk domains, respondents also addressed ERM. Survey results indicated that ERM has made the most headway in regulated industries, such as energy, but is increasingly a focus of other nonfinancial corporations. However, much ambiguity remains as to what ERM really is and how it should be implemented. A major objective of this research is to better understand how companies define ERM, who is adopting it and how it is being implemented.

Many companies expressed concern about the “siloed” nature of risk management within their organizations. As risk management needs grow and their organizations become increasingly complex, many executives are concerned by the lack of risk-related communication across divisions. Fewer than half of the surveyed companies have cross-functional risk committees, and many executives find such committees are inadequate to address the need for greater risk integration. The turn to ERM is seen as a more promising way to develop and act upon an integrated risk profile. As one major retailer noted, “ERM would enable us to have a better idea of how our various risks interact.
It would make my job easier, and a broader view would enable us to see shifts in risks to other areas. More generally, it would raise the awareness of risk management in the organization.”

Even companies that are not ready for a full ERM framework indicated interest in risk solutions that allow them to look across all risk domains and to identify and prioritize specific risk areas accordingly. A communications company just beginning the ERM adoption process explained, “While we acknowledge we are not yet ready for a sophisticated ERM analysis, we certainly are working toward that goal. Right now, we are focused on implementing a cross-functional risk assessment to help us better understand our own business, understand what risk domains to focus on and to begin to really take control of our risk management practice.”

The value proposition of ERM was very clearly agreed upon among executives. Above all, the key drivers of ERM adoption include the economic value it generates and the improvement in a firm’s risk-return relationships. In addition, the enhanced coordination and communication that an ERM framework enables, as well as the visibility into risk management that firm leadership can now capture, is seen as highly valuable.

From our survey, approximately 70% of respondents believe that ERM would improve coordination and communication across an organization, reveal systemic risks and their interrelations and correlations, and generate economic value by reducing the cost of capital and by increasing profits. As one manufacturer noted, “I think that understanding our overall risk in the business is a huge benefit.… ERM is about awakening people in that there is more risk than they think, and this will drive better decisions in the future.”

Nonetheless, despite agreement on the benefits and value of ERM, the definition of ERM at the implementation level remains varied, leading to some confusion within the marketplace. A pharmaceutical company noted, “We realize ERM is out there, but we are still trying to understand what it means, how is it constructed, who drives it and how it is implemented.” This confusion is cited by some executives as a factor in their use of ERM consultants to help derive economic value and gain competitive advantage.

Some companies fail to capture ERM value because they see it as more of a standardized process for collecting information about risks. On the other hand, companies that take a more robust and quantitative ERM approach also claim to extract the greatest value. A robust ERM approach typically includes:

- integrated analyses of risks to reveal interrelationships and correlations
- optimization of the company-wide risk/return profile instead of purely risk avoidance or mitigation
- processes to increase communication and coordination across functional units
- related solution execution capabilities.

One-third of the companies surveyed either have an ERM program in place or have made a clear commitment to implementing one (Exhibit 4, page 7). Another third of companies are in serious discussions about ERM as they attempt to become more proactive in the management of risk. As the ERM market continues to develop, and in light of regulations and other drivers, more companies expect to adopt ERM programs and reap the resulting benefits.
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EXHIBIT 4
Commitment to an Enterprise Risk Management Program

% of respondents

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<th>% of respondents</th>
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<th>20%</th>
<th>30%</th>
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<tr>
<td>Committed to implementing an ERM program</td>
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<td>Seriously discussed ERM</td>
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EXPECTATIONS
Clearly, major shifts in the risk management environment are taking place. In the more regulated industries — banking, insurance, energy and health care, for example — drivers will continue to include regulatory and rating agency pressure for effective risk management approaches. For many companies, the motive is competitive: ERM is seen as providing competitive advantage as they deploy more sophisticated, strategic risk management solutions and take a more integrated approach to risk management. So the issue appears not to be whether ERM will succeed but how it can be embraced with minimal disruption and rapid payback, and flexible enough to accommodate the changing risk and financial needs of today’s corporations.

For additional information or assistance in evaluating risk management solutions, please contact Prakash Shimpi or Linda Chase-Jenkins at Towers Perrin.

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Towers Perrin is a global professional services firm that helps organizations around the world optimize performance through effective people, risk and financial management. The firm provides innovative solutions to client issues in the areas of human resource strategy, design and management; actuarial and management consulting to the financial services industry; and reinsurance intermediary services.

The firm has served large organizations in both the private and public sectors for over 70 years. Our clients include three-quarters of the world’s 500 largest companies and three-quarters of the Fortune 1000 U.S. companies.

Our businesses include HR Services, Reinsurance and Tillinghast.

Towers Perrin’s Enterprise Risk Management practice offers clients the ability to understand the full spectrum of risks faced by their organizations and to create additional value by actively managing their key risks. Clients can deploy ERM to upgrade business planning through better articulation, quantification and oversight of the risks that drive value, and improve their ability to assess and implement risk solutions — both operational and transactional — to achieve their business objectives.

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