



cutting through complexity

Expectations of Risk Management Outpacing Capabilities – It's Time For Action

KPMG INTERNATIONAL

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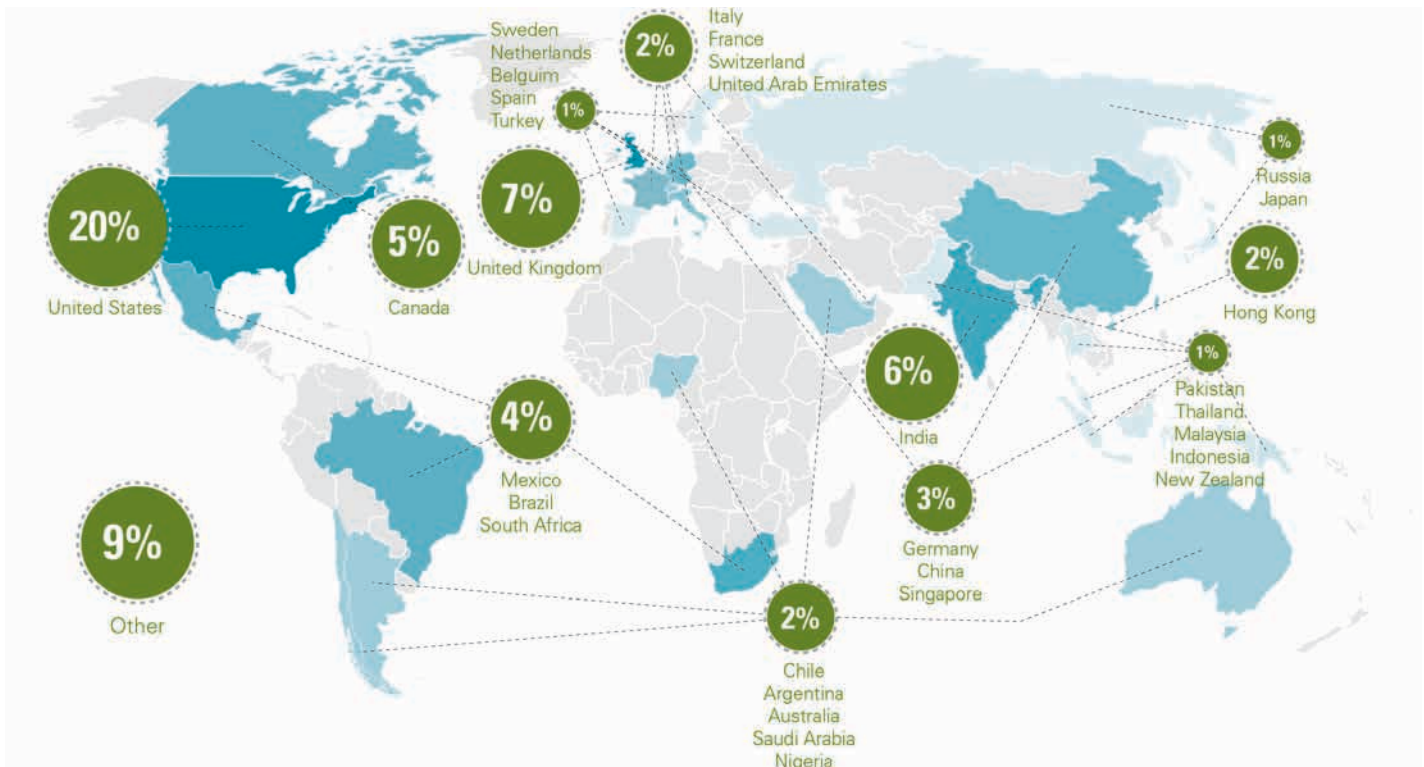
About the survey

In December 2012, the Economist Intelligence Unit carried out a global survey on behalf of KPMG International. This survey gathered data from 1,092 respondents around the world in a closed-ended online questionnaire. All were C-level executives: 28 percent were Chief Executive Officers or equivalent and 18 percent were Chief Financial Officers, the two largest groups. Five percent were Chief Risk Officers. If you combine those in the risk function and departments that work most closely with risk (legal, compliance and audit), the number comes to 131 people, or 12 percent of the total. Responses were evenly spread among companies of different sizes. Forty-six percent came from companies with annual revenues of US\$500 million or less. There were a lot of large companies: 37 percent reported revenues of US\$1 billion or more. Most of the responses came from North America (25 percent), Europe (25 percent) and Asia-Pacific (23 percent). The remainder was from the rest of the world, including Latin America (15 percent), Africa (8 percent) and the Middle East (4 percent).

The survey was answered by people from more than 21 industries. To make it easier to drill down into individual categories, we grouped respondents into sectors; Financial Services (including banking, insurance and so on) comprised 17 percent; Technology, Media & Telecommunications made up 16 percent; Healthcare comprised 15 percent; and Energy and Natural Resources comprised 14 percent. Another large category was Diversified Industrials (including manufacturing, automotive and aerospace) which made up 15 percent of the total. This left 23 percent from other industries such as consumer goods and chemicals.

Executive summary

In which countries are the survey respondents located?*



*Nine percent of countries surveyed globally had less than 1 percent participation.

Risk management is at the top of the global executive agenda as companies face an array of threats that grow more complex by the day. The risks are multitudinous and ever-present, and those companies that fail to manage them well imperil their future. Many risks are posed by the challenge of complying with complicated, new government regulations drafted worldwide in the wake of the financial crisis, affecting all industries. The global economy remains fragile, the Eurozone wracked by a series of crises. Economic growth in the developed world is weak and faster-growing emerging markets are unfamiliar to many corporate executives. At the same time, companies have to contend with increasing competition, rapid technological change and the battle for talent.

These challenges are growing faster than most organizations' abilities to respond: today's complex environment requires an even stronger capability to master and optimize risk management. This is the main finding of a large-scale study

of risk conducted by KPMG International, based on a global survey of 1,092 C-level respondents that was deployed by the Economist Intelligence Unit in December 2012. The aim was to find out about executives' perceptions of the risks facing their companies and their sense of how, and how well, their companies and industries are tackling them. We also interviewed senior executives in five major industries and turned to KPMG's Risk Consulting experts for their insights into risk management.

We found the risk management capability is not advancing fast enough at most companies. Given the difficult challenges faced by companies around the world, the survey shows there are significant gaps and weaknesses in the management of enterprise risk. These problems often arise from an inability to manage risk in an integrated and holistic way. Executives say they take the 'business of risk' very seriously, but the survey shows that many enterprises are not rising to the challenge.

When risk management is a strategic tool, the risk program and profile will constantly evolve. Now that the global economy has shakily recovered from the financial storm, executives have become less risk-averse. But they need to be more risk-savvy. After a risk program has been running for a while, things tend to go stale, says Dan Fitz, Group General Counsel and Company Secretary of BT Group (BT). “Keeping it relevant in an improving economic environment is probably the biggest risk that we face,” he says.

Among the main findings of the research are:

- Risk management is widely seen as a high priority among companies surveyed, but only 66 percent build it into strategic planning decisions often or constantly.
- Most companies surveyed do not have a consistent way of assessing risk across the enterprise. A significant minority of respondents (20 percent) say there is no process at their company to develop and aggregate a risk profile and a further 38 percent rely on a self-assessment by the business units. Almost half profess difficulties in understanding their enterprise-wide risk exposure.
- Less than a fifth of companies surveyed have developed a formal risk appetite statement. But without one, it is hard to calibrate the risks of pursuing a given strategy. Are we taking on too much risk for a given level of return, or are we taking on too little? Many cannot answer this fundamental question.
- The top risk perceived by senior executives is the growing regulatory pressure from governments around the world. C-level executives in almost all industries say this, not just those in Financial Services, where companies are facing arguably the greatest regulatory challenge in their history. A global economic crisis and geopolitical instability are seen as the most threatening risk scenarios across almost all industries.
- Respondents say the business units (the first line of defense) are more adept than the risk and compliance specialists (the second line), as well as internal audit (the third), in assessing and managing risk. To the extent organizations have improved their risk management processes in recent years,

they have not effectively communicated it. Less than half (44 percent) believe the organization is effective at developing stakeholder’s understanding of the risk program. This means organizations often do not translate enhancements into value in the minds of the Board, investors and/or regulators.

- Forty-two percent of respondents say that a lack of skills is the main obstacle to the convergence or integration of risk and control functions in companies.
- Survey respondents admit they need to do more to motivate business managers to make risk-aware decisions by linking their performance in this area to compensation. Forty-three percent said there was a weak link between risk management and compensation.
- Many companies understand some, or all, of these problems and are investing in ways to upgrade their risk management. Yet more than a quarter of respondents have no means of measuring the return for the investment and a similar proportion is simply reviewing past events to assess the effectiveness of their risk controls. Does this inability to measure the return on investment in conventional ways prevent investment altogether?

Companies have their work cut out to improve their risk management commensurate with the challenges they face. By ensuring that risk management is everybody’s business and not just a single department, companies have a chance to rise to the challenge. They have no other option. In the sections that follow, we will describe in more detail the problems laid bare by the survey and offer solutions, as well as pose questions for the reader.

The strategic importance of risk management

Risk management plays a key role in strategy and is widely seen as essential.

Given the complexity of the risks companies face, the management of those risks is seen as a high priority, according to the survey. Forty-seven percent say it's essential. Risk management plays an important role in strategic planning, but only 66 percent said it was factored into these decisions, and of these, 27 percent said it was constantly factored in. A further 20 percent do so at least once a year. The survey does not ask whether risk management has become more important than before, but we can infer this from another question which asks whether the level of investment in risk management has grown as a percentage of total revenues in the past three years. Sixty-five percent say it has risen and, of these, 18 percent say it has grown substantially. What is more, a slightly higher percentage (66 percent) expects the proportion invested in risk management to rise in the next three years, suggesting that companies will not be relaxing their guard any time soon.

We will consider later whether this money has been well spent, but let us note another important finding, that one reason for the increased attention to risk management is the pressure on companies from new government regulations. A full 70 percent of respondents say that regulatory changes have caused either substantial or moderate alterations in their risk management and reporting processes in the past two years.

Attribute of excellence from the survey analysis

In our survey, one of the chief differentiators of companies that excel in risk management compared with those that do not is the importance of risk management in strategic planning. Among those companies that rated themselves as "very advanced" in all five categories of risk management (governance, assessment, quantification, monitoring and control), 77 percent said they constantly factored risk management into their strategic planning decisions versus 27 percent for the survey respondents as a whole.



KPMG perspective and leading insights

Operationalizing risk management

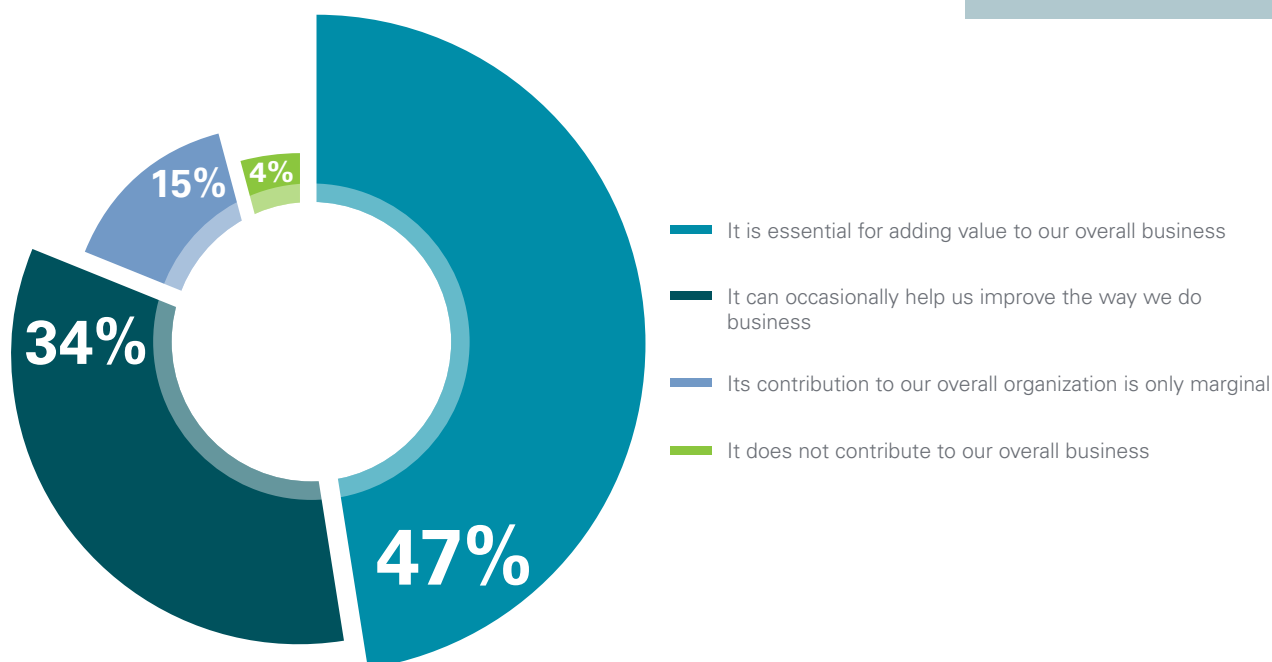
A risk program can only become fully operational when all the C-level executives are using risk management as a tool for collaborative decision-making. This can be done by embedding it into management routines (such as strategic planning, management risk committee meetings, budgeting, and corporate policy-making) and by engaging all C-level executives in a debate and discussion about enterprise risk. Individual members will gain the perspective of their peers and be able to share ideas about emerging risks and how best to manage them.

Expanding the Board horizon

Faced with growing legal and business responsibilities, Board members are becoming fully engaged in understanding the link between risk management and strategy. They expect regular updates from management and are engaging in a dialogue with the designated risk owners and not relying solely on discussions with the Chief Executive and Chief Financial Officers. They should not only evaluate risks to the enterprise now and next year, but also the risks that may emerge several years' out. If there is open communication between the Board and senior management, companies will be able to use risk management as a tool that ties long-term strategy with short-term implementation.

Despite the acknowledged importance of risk management, there is a significant difference of opinion among C-level executives about its contribution to the company. Fifty-four percent of Chief Executives said risk management was “essential,” but only 26 percent of Chief Legal Officers said so, even though they work very closely with the risk function. They were the least positive of all, followed by Chief Information Officers (31 percent said it was essential). In total, 47 percent of C-level executives said risk management is essential for adding value to the overall business, 34 percent said it can occasionally add value and 15 percent said it made a marginal contribution to the business. Clearly, the Chief Executive has a tough job embedding risk management throughout the organization when perceptions of its value vary so much.

Which of the following best reflects your view of risk management’s contribution to your organization?



Key considerations

1. In what ways is risk management integrated into the strategic planning process?
2. How often do members of your senior management team talk to the Board about specific strategic risks that they are accountable for?
3. When the Board looks at enterprise risks, what is the time horizon it uses?
4. Is a risk lens, equivalent to the growth lens, applied to key strategic business decisions?
5. Is stress testing and scenario planning applied with rigor to challenge growth strategy assumptions?

Assessing risk exposures

Executives struggle with assessing risks across the enterprise.

Senior executives consider risk management to be very important and the majority of respondents said it is included in strategic planning at least annually. However, 20 percent of executives said there was no process at their company to aggregate risks, an essential part of any strategic plan. And although most respondents rate the maturity of their risk management programs fairly high relative to peers, risk quantification and aggregation is rated lower than other aspects of risk management.

Nonetheless, most industries have made some improvements to their systems for aggregating risk data since the onset of the financial crisis. Today, nearly half (48 percent) of executives say their risk management function performs a bottom-up risk assessment process at least annually. For organizations with diverse businesses, it is critical to have a robust, bottom-up risk assessment to fully understand business risks. Another 38 percent say the business has a process for self-assessing its risk and control process (respondents could select all the options that apply). Again, this is essential if companies want their employees to “own” the risk, but it would be more effective if it were integrated with a bottom-up assessment by the risk function. The latter can examine objectively whether the businesses are self-assessing effectively.

Having performed a bottom-up assessment and a self-assessment, the next step is to ensure that all the risk assessments are aligned to enable an enterprise-wide risk profile. But only 34 percent of respondents do this. These statistics illustrate some of the gaps between theory and practice. One result is that almost half (47 percent) admit

Attribute of excellence from the survey analysis

Among those companies that rated themselves as “very advanced” in all five categories of risk management (governance, assessment, quantification, monitoring and control), 66 percent have a process for self-assessing risks and controls, compared with 38 percent for survey respondents as a whole.



KPMG perspective and leading insights

When assessing a company’s risk exposure, executives should start with a top-down assessment of the most important strategic risks that are tied to the overall strategy. Then, the company should undertake a “middle-up” risk assessment focused on business and functional units (as opposed to a bottom-up assessment which may sometimes translate to process-level risks). If the company starts with a bottom-up assessment, there is a danger of it becoming mired in too much detail, which may make it difficult to aggregate the risk assessment into an enterprise-wide view. Self-assessments are an effective way to corroborate the prioritization of the risk profile.

When aggregating risks, it is important to identify the inter-relationships of risk and clearly understand the velocity at which risks may occur. It is clear that, say, a downgrade of a company’s credit rating will affect other aspects of its business. Its cost of borrowing is likely to rise and market perceptions of the company might deteriorate. Similarly, a reputational crisis might make it harder for the company to recruit highly skilled people. Executives need to think carefully about the way risks are related to each other.

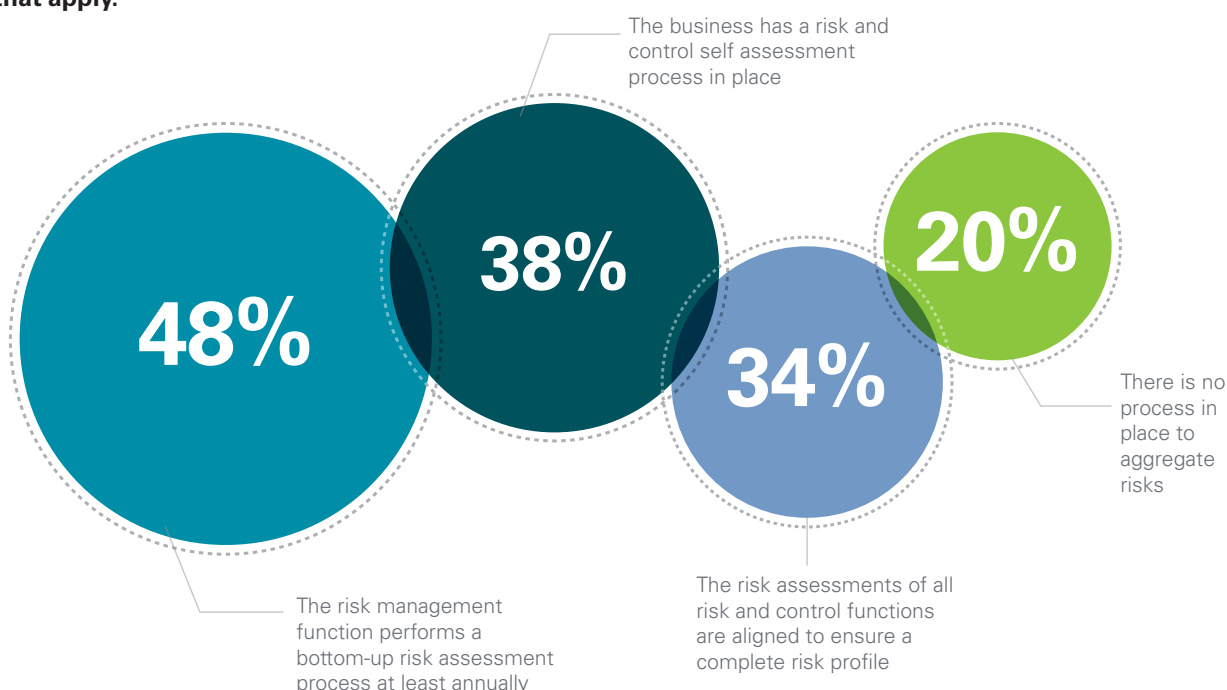
The management risk committee, with members drawn from different functions and business units, can evaluate the risks from multiple vantage points in the company to see how risks are linked. The committee can also often connect the dots when aggregating risks, and common themes will begin to appear. What may seem like random threats may collectively amount to significant strategic risks.

they face difficulties in clearly understanding the enterprise-wide risk exposure across all the regions and businesses in which the company operates. Ideally, companies should be conducting regular bottom-up assessments, business self-assessments and alignment of them to create a comprehensive risk profile of the enterprise.

Prioritization is an important way of creating an enterprise-wide view of risk. Richard Fearon, Vice Chairman of Eaton Corporation says that setting priorities is crucial. "We distinguish between those risks that senior management and the Board needs to focus on, so-called enterprise risks, and risks that need to be delegated and dealt with at a lower level," he says. "They need to focus on those risks that could frustrate accomplishment of the Board's objectives for the company."

Setting priorities cannot be done without a systematic approach towards risk. Two of our interviewees—Dan Fitz, Group General Counsel and Company Secretary of BT Group and Richard Fearon—said that their companies were more systematic in their risk management now than before the financial crisis. In the case of BT, business lines regularly self-assess the maturity of their risk management and this is tested by a team at the group level and then checked by internal audit. The same process occurs at the enterprise level. The executive committee then goes through the totality of risks once a year and at subsequent meetings it discusses each particular strategic risk in turn.

**How is the risk profile of your organization developed and aggregated?
Select all that apply.**



Note: Percentages may not add up to 100% as respondents were instructed to select all that apply

Key considerations

1. How well do you synthesize the top-down with the middle-up risk assessments to ensure that you have captured all risk themes that may be aggregating from the business?
2. What guidance is provided to the business units and functional groups to ensure that they have a consistent approach that is focused on business objectives?
3. Is the management risk committee actively engaged in aggregating and evaluating risks at the enterprise level?

Articulate risk appetite

Risk management is important but few companies articulate their risk appetite.

Nearly all C-level executives recognize risk management as an important ingredient in their organization's overall business success. An overwhelming majority (86 percent) of survey respondents said that risk management considerations are to some degree factored into strategic planning decisions. By the same token, companies will have difficulty developing a strategic plan without knowing their appetite for risk, and whether they are taking on too much risk for a given level of return or too little. Companies may find they can afford to increase their risk appetite, assuming the business gains are high enough. But they won't know if they don't develop a framework of their appetite for risk. Indeed, a key question for executives is how to reach a common understanding of the company's risk appetite, as part of the strategic planning process.

Attribute of excellence from the survey analysis

Among those who said they had fully implemented their risk appetite statement, 93 percent said that strategic risk and the actions to manage these risks were always included in risk management reporting to the Board. Of those with no risk appetite statement, only 42 percent do this. When we asked them to rate their ability to identify, assess and manage risks, 49 percent of the former group said they were very effective at it, compared with 6 percent of the latter group.



KPMG perspective and leading insights

Most executives believe they have an intuitive sense of the organization's risk appetite. The challenge is creating a common understanding among the Board and executive team of that appetite. To say simply, 'We are conservative', will not help to drive a strategy or to evaluate a proposed strategy. "Used strategically, risk appetite frameworks can allow companies to balance their strategic ambitions with performance metrics expected by stakeholders," says John Farrell, Global Lead Partner of ERM at KPMG LLP US.

It should be a tool to help executives make decisions about how much risk to take on. It is meant to enable them to determine whether they are comfortable with the company's position on the risk spectrum, from high tolerance to low. If a company operates without a risk appetite statement, it is hard to know whether it is taking excessive risks or too few—the latter can be as injurious as the former.

Risk appetite statements link risk exposures to financial performance in a way that offers insights into risk-taking strategies. There are two parts to the assessment of risk appetite: (1) Companies should stress-test the resilience of their balance sheets by calculating the monetary value at which solvency would be jeopardized. If they don't do this, then they are taking on risk without a financial framework. (2) At an operational level, companies should calculate the monetary value at which a loss or risk event would jeopardize its credit rating, bank covenants, and other key financial ratios, such as interest rate cover.

Business managers should calculate key risks in monetary terms so that corporate executives can monitor whether the aggregated risk exposure comes close to (a) the value at which solvency would be jeopardized and (b) the value at which a risk event might jeopardize its credit rating. If there is a sizeable gap between operational values-at-risk versus financial resilience, then there may be opportunities to take on more strategic risk. If the gap is narrow, then the company may be taking on too much strategic risk.

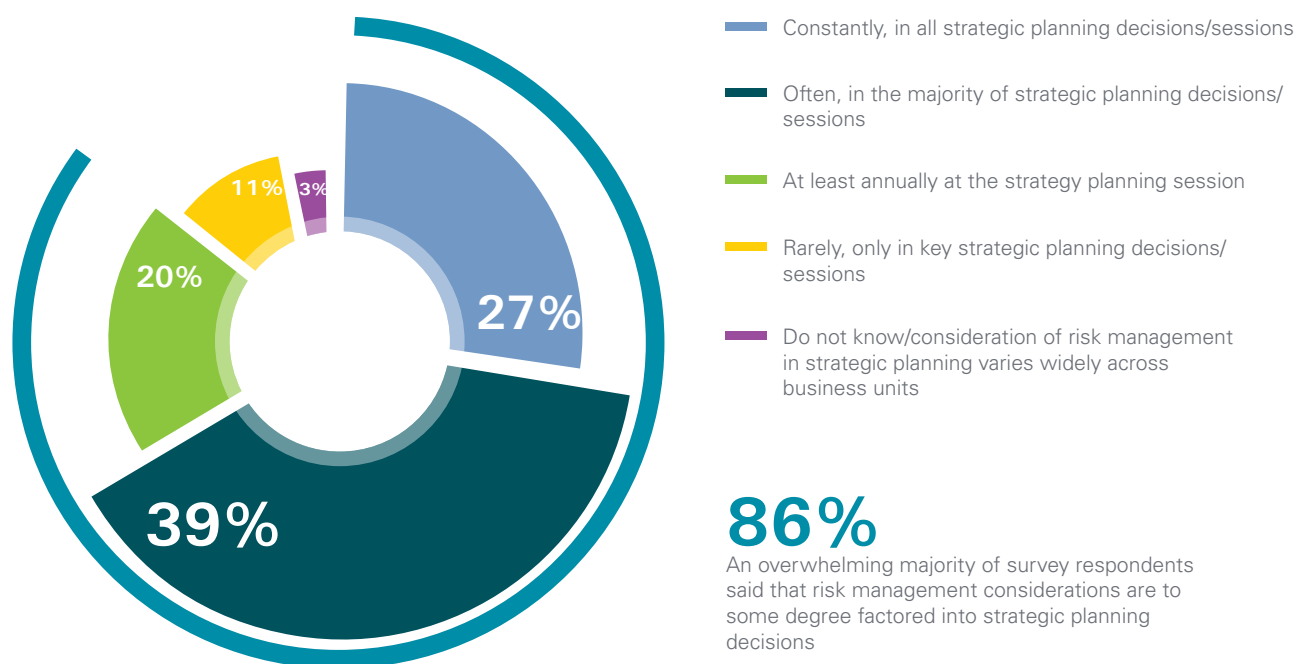
According to the survey results, less than a fifth (19 percent) of companies has developed a formal risk appetite statement. A further 22 percent say an appetite statement is being developed. About 40 percent say that a statement has been created, but not communicated across the organization. And 19 percent say it has not been developed at all. These statistics show that there has been some progress in creating risk appetite statements, but organizations need to try harder to develop these statements for decision-making.

It is difficult to make strategic decisions without developing a risk appetite statement, as executives will attest. "The real risk for my shareholders and everybody else, including our management team and me, is: Are we sensible and are we assessing the market and are we taking on too much risk?" says Andrew Littlefair, Chief Executive Officer of Clean Energy Fuels, a United States supplier of natural-gas fuel for road vehicles that was publicly listed in 2007.

Key considerations

1. How well have you aligned risk appetite with strategy? Have you embedded that risk appetite into the business units and functional areas (e.g. Technology and R&D)?
2. How do you know whether you have taken too much or not enough risk (e.g. is the risk appetite aligned with desired returns)?
3. Are the risk appetite statements translated into a usable tool for the business?

How often are risk management considerations factored into your organization's strategic planning decisions?



Greatest threats

Regulatory pressure is seen as the issue posing the greatest threat to respondents.

In the wake of the deluge comes the reckoning. It was almost inevitable that, after the business excesses in the years leading up to the financial crisis, governments around the world would tighten the regulatory framework of global capitalism. New financial regulation is in the forefront of this trend, but the Financial Services industry is not the only sector feeling the heat. Healthcare, manufacturing, technology, energy and other industries face many new government rules.



KPMG perspective and leading insights

Companies can transform compliance into a source of competitive advantage. This may seem highly improbable at first sight when companies face an expensive and burdensome array of new regulations. But those new regulations are an opportunity to claim industry leadership; all your competitors are in the same boat, but very few are going to take advantage of the regulatory onslaught to become more competitive. The sheer impact of regulation is astounding when you consider respondents rank the regulatory threat higher than reputational, credit/market/liquidity, supply chain, information protection, and disruptive technology risks.

The compliance department may require a complete re-alignment to reflect a more strategic approach to compliance. This will need a deep understanding of how to use the organization's resources more effectively, by embedding compliance into business processes and integrating overall assurance with other risk and control functions. Senior executives have to lay out a new, clear policy towards compliance that will then have to be fully operationalized and integrated into new processes and into the thinking of all employees. Compliance and risk officers must work with the business units to identify key regulatory risks and how to manage them.

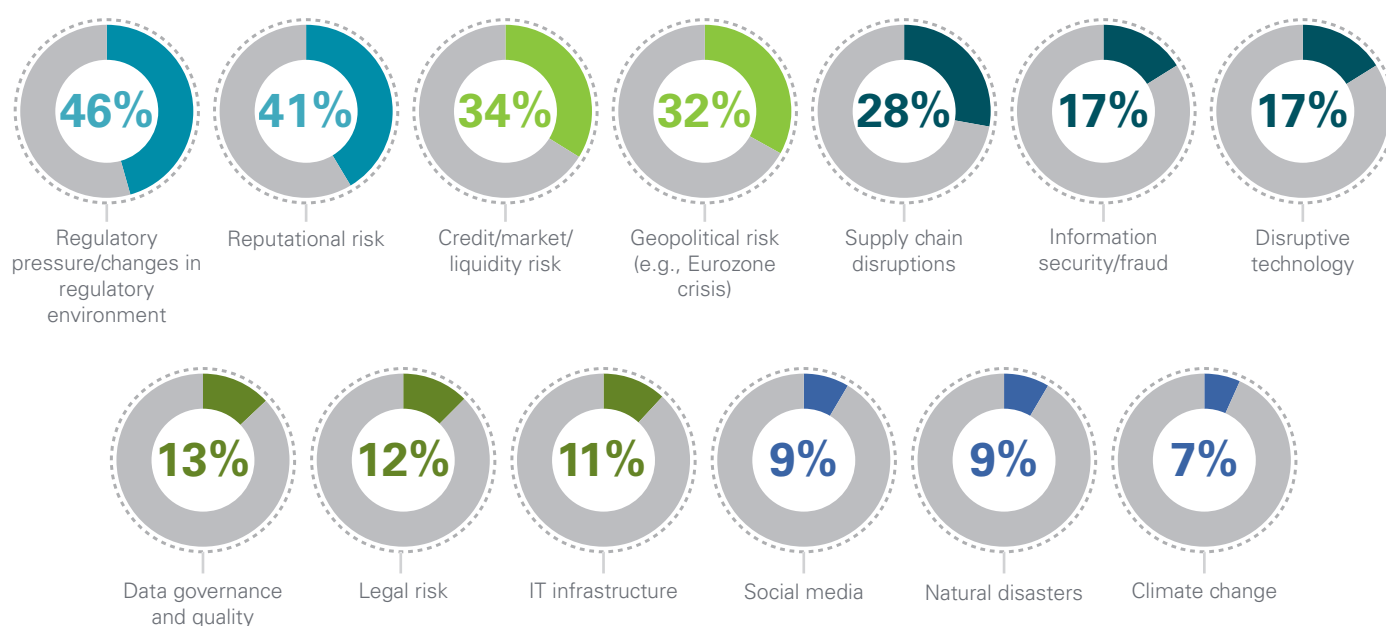
All of this requires great agility (a) to understand the nature of the changes in risks, (b) design the appropriate response to them, and (c) alter the operations to manage the risks more effectively and efficiently. The greater the agility, the higher the likely cost savings.

If the re-alignment of compliance is thorough enough, competitive gains will follow. The cost of compliance will fall; business processes will improve; operations will face less disruption due to the close coordination of risk and control functions. A strong governance framework for risk and compliance will not only seek to meet the requirements of regulators but will improve a company's reputation in the eyes of its customers. It's about turning regulatory risk into advantage.

In the survey, we asked which issue posed the greatest risk to the respondent's industry. Regulatory pressure came top in Financial Services, Energy and Natural Resources, and in the "other industries" category (covering such sectors as Consumer Goods, Construction and Chemicals). "Government pressure to contain spending," a regulatory issue, was the top risk in Healthcare. Nor was there a significant difference among regions. Regulatory pressure was regarded as almost as big a threat for most industries in Asia-Pacific, as it was for those in Europe and North America.

Regulatory pressure in whatever form adds to the complexity of doing business. In the Financial Services industry, banks and other financial institutions face a plethora of new regulations, especially in Europe and the United States, where international banks face at least 40 major sets of new regulations that affect everything from how retail customers are treated to the way derivatives are traded.¹ In addition, new global regulations for bank capital and liquidity (so-called Basel 3) came into effect in January 2013. Banks and insurers now have to focus on two different aspects of their business: the re-engineering of their corporate and risk governance on the one hand, and the restructuring of the business to reduce costs and raise revenues on the other.

Which of the following issues pose the greatest threat to your industry?*



Note: Percentages may not add up to 100% as respondents were instructed to select the top three

*All respondents except Financial Services, Healthcare, Diversified Industrials, Technology, Media & Telecommunications and Energy and Natural Resources

¹ Evolving Banking Regulation: EMA edition February 2013 KPMG

Although the global economy has steadied somewhat since 2011 and investor's risk appetite has grown, there are still plenty of dangers lurking in the shadows. Even a financial crisis in a small EU member state can set off alarms in financial markets around the world, suggesting that the Eurozone's troubles are far from over. For reasons such as these, survey respondents in all industries other than Healthcare say that the most threatening risk scenario is the possibility of a global economic crisis or geopolitical instability. But the biggest concern for Healthcare executives is a spending slowdown, which could of course be caused by an economic crisis.

Key considerations

1. How can you take strategic advantage of regulatory changes?
2. How will you obtain additional assurance with the same or fewer resources?
3. How effectively is the compliance function using the management of the business to develop a risk-aware culture?
4. Do we have a process to conduct a gap assessment when new regulations are issued?
5. Is your company positioned to influence regulatory direction?



Three lines of defense and communication to stakeholders

Business units assess risk better than the risk, compliance and internal audit functions. Communication to stakeholders must be enhanced.

Survey respondents give their organizations high ratings for their ability to identify, assess and manage risks in the context of the “three lines of defense” of enterprise risk management. The first line of defense (business units) is considered strongest, with 79 percent and 75 percent, respectively, saying that their organization is effective in assessing risk and managing risk. The proportions drop off to 74 percent and 73 percent, respectively, for the second line of defense (the standard setters, mostly in the risk management function and compliance, whose job is to monitor risks and controls, look for emerging threats and design new processes to manage them). The third line (internal audit) receives the vote of 67 percent and 66 percent of respondents.

These findings are contrary to conventional wisdom that suggests that the second and third lines should be equally or more adept at identifying, assessing and managing risk than the first. Ideally all three lines should be aligned and integrated effectively with one another, but there are sizeable gaps. The challenge for companies is to coordinate the three lines of defense to ensure there are no gaps in managing priority risks or duplication of effort. This requires clear definitions of the roles and responsibilities of the different functions as well as cross-functional training in risk management for all three lines of defense together to enhance collaboration. The three lines of defense will work cohesively if they are in frequent communication, so that they develop a common understanding of the diverse array of risks. In BT’s case, communication is helped by adopting “a single vocabulary for talking about risk” throughout the company, says BT Group’s Dan Fitz.

Attribute of excellence from the survey analysis

Those who said they performed a bottom-up assessment were much more positive about the effectiveness of their three lines of defense than those who did not. For those with a bottom-up assessment, this positive rating did decline from first line to third (from 86 percent to 75 percent, a fall of 11 percentage points), but less than half the decline perceived by those with no bottom-up assessment (from 57 percent to 32 percent, a drop of 25 percentage points).

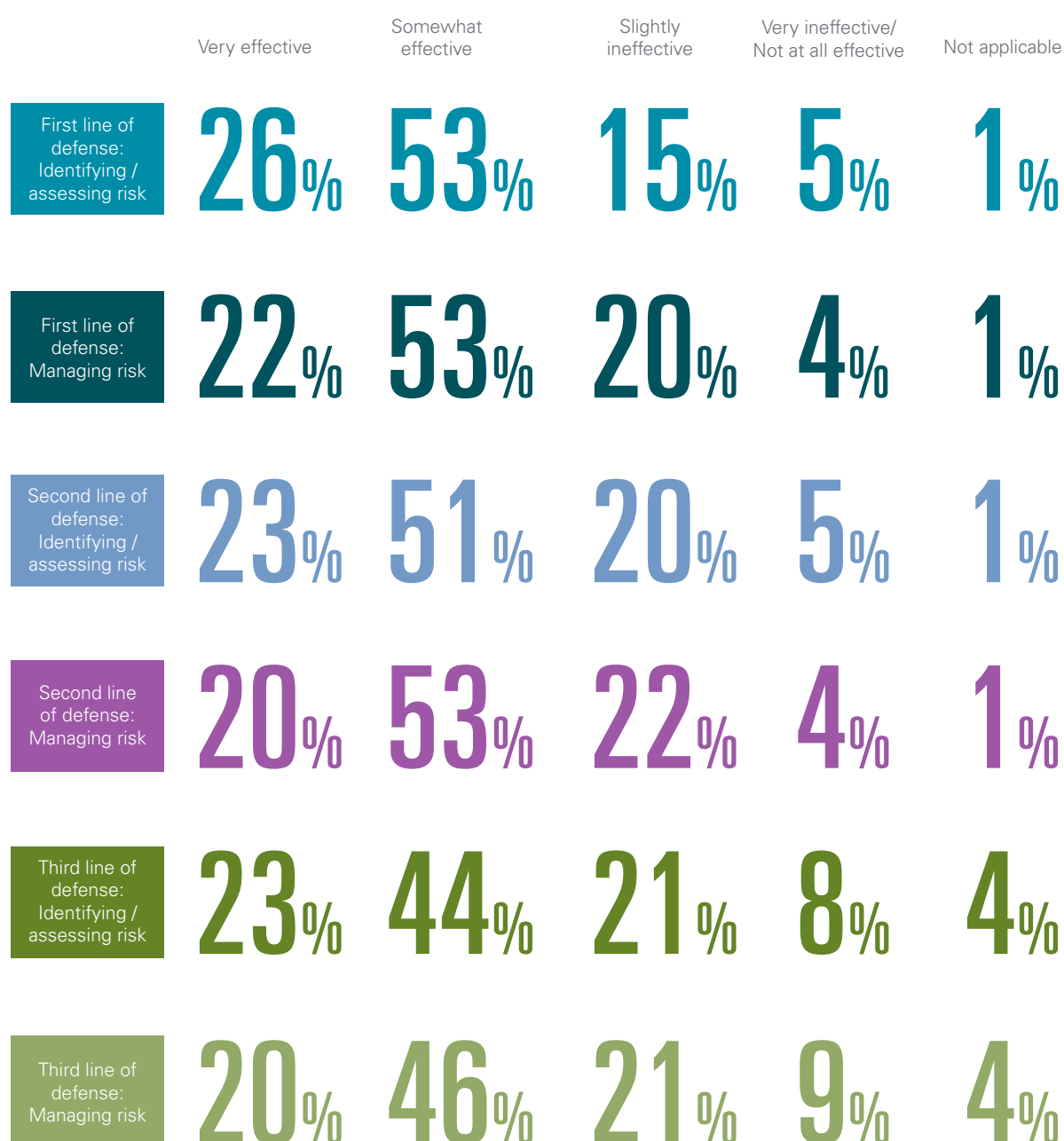


KPMG perspective and leading practices

There are two points to bear in mind. First, if the three lines of defense are out of alignment, executives should ask themselves whether the company’s capabilities in risk management are keeping up with the demands placed on them by the rapidly changing business environment. Second, executives must improve the visibility of risk information between the first line of defense and the rest of the company. Often, the second and third lines of defense are dependent on information provided by the first line of defense in order to discharge their responsibilities. Improving the culture of sharing information or providing enhanced tools to enable a seamless flow of risk information will benefit all three lines of defense and provide the senior leadership with better risk information for decision-making.

Effective communication can assist in capturing the value of your risk program in the minds of stakeholders.

**How would you rate your organization's ability to identify, assess and manage both current and emerging risks?
Please answer on a scale from Very effective to Very ineffective.**



Good communication is also important in developing stakeholders' understanding of the risk program (such as roles and responsibilities, policies and procedures, and processes). Forty-four percent say they are good at it and 16 percent of respondents say their companies are poor at it. These numbers are significant in terms of both internal and external stakeholders. Internally, there needs to be a clear understanding among stakeholders such as the Board, senior management and employees about the way in which the risk and control functions are to work together as part of the risk program.

The communication to stakeholders should not be limited to internal stakeholders. Externally, executives must manage the expectations of shareholders and regulators about the risks companies face and to get them comfortable that good risk management and governance is present. Banks are in a particularly acute dilemma in communicating risks to stakeholders, a point noted by Russell Picot, Group Chief Accountant at HSBC. Picot is critical of the quality of the risk analysis that companies in general publish. "It's weak right now: you get a long description and a lot of numbers, but I think there are not many good examples of disclosures showing how a company has responded to changing risks and its use of relevant metrics," he says. This is especially important for financial institutions. "We need to create a forum where it is safe for banks to talk to investors and find out what they are worried about and respond rapidly to provide them with information," he says.²

Another banker who stresses the importance of good communications is Matías Rodríguez Inciarte, a Vice Chairman of Banco Santander. "We want to be as transparent as possible to the outside stakeholders and then internally," he says. "If you don't open up your information or mention anything that is negative, you are misleading yourself at the end of the day because you are not addressing properly the issues and you are wasting a very great opportunity to improve your culture."

Effective communication often enables stakeholders to understand risk program capabilities and enhancements that can positively impact value in the minds of the Board, investors and regulators.

Key considerations

1. Have risk management capabilities across all three lines of defense kept pace with the changing needs of the enterprise and expectations of stakeholders?
2. What is your corporate risk culture?
3. Is risk management embedded in business processes in a way that enhances transparency?
4. Do your Board, shareholders and regulators understand your risk program?
5. Is there consistent risk training across your three lines of defense?
6. Are processes and technologies in place to monitor and measure risk in a way that get the three lines of defense closer in alignment?

² The future of corporate reporting: towards a common vision KPMG February 2013



Barriers to convergence

Lack of human resources impedes the convergence of risk and control functions.

There's no doubt that systems and software play a crucial role in gathering and analyzing data to enable risk executives to make well-informed decisions. The growing ability to analyze terabytes of data and continuously update executives on internal and external trends makes it possible, in theory, to gain an enterprise-wide view of risk. So it is not surprising that 74 percent of those surveyed say that technology is a crucial or very important tool for embedding risk management into the business. Technology is particularly important in helping to integrate risk information across the risk and control oversight functions. This enhances convergence between them and enables them to operate more efficiently and effectively.

But before we go overboard and buy a new technology tool, let's look at the skeptics. Twenty-six percent of the overall survey sample said it's either marginally important or not significant at all. Their lack of enthusiasm is shared by nearly a third (31 percent) of Chief Executive Officers. What these numbers tell us is that technology is important,

Attribute of excellence from the survey analysis

Companies that said they were very advanced in all areas of risk management were almost as likely as all the survey respondents to say that a lack of skills is a barrier to convergence (39 percent to 42 percent, respectively). It seems that all respondents struggle with this aspect of convergence; it was the most significant barrier for the majority of respondents.



KPMG perspective and leading insights

The aim of converging risk and control functions is to arrive at a single version of risk in order to make more effective business decisions and to do so more efficiently. When executives from different parts of a company come to a common perspective of key risks and their impact on the business, this is likely to improve effectiveness.

Converging risk and control functions to arrive at a single view of risk enables effective business decisions. Financial reporting provides a good comparison in that the objective, the financial statements, is clearly defined as a single view of the financial results. Understanding and clarifying processes and controls can be based on the end-state, thus eliminating redundancy.

In the risk environment, the goal is less clear and changes on a regular basis. Reporting usually entails collecting and analyzing huge amounts of data. But due to changing goals and less clarity of risk data, there is an increased risk of duplication and redundancy. Due to risk and control siloes being established in companies over time, risk information does not flow freely between the risk and control functions. The goal of convergence is to break down the siloes and to reconsider the governance structure for these functions to reflect the agility of the organization.

The setting of common goals for risk and compliance and the analysis of the relevant risk data can only be done with sufficient numbers of people with the right skills. Human judgment is critical in developing a single view of risk. Although the issue of convergence tends to arise in industries that have long been regulated, other, newly regulated industries can learn from the former about how to break down the barriers between risk, compliance, internal audit and other risk and control oversight functions including using relevant technology in order to make more effective business decisions.



but it is not a panacea. Technology is an enabler of the convergence of risk and control functions, but human skills are essential if companies are to manage the complexity of this kind of convergence. This is why we stress the importance of corporate culture: everybody needs to be aware of the risks they run whenever they make a business decision (see UCLA Health System box on page 26).

Given the importance of human talent, it is a matter of concern that 42 percent of survey respondents said that a lack of skills is the main obstacle to the convergence of risk and control functions in their organization. This was seen as the biggest barrier, well ahead of process complexity, with 36 percent of respondents. This perceived weakness may make companies unwilling to launch a convergence program. Given the pressure to become more efficient while managing risk more effectively, companies may have no choice, but to hire the right talent or bring in external resources.

As is so often the case in risk management, the technology and processes are only as good as the people who run them. Given the complexity of the risks and of the systems and processes to manage them, the people in the risk function must have the highest level of skills to combat every possible risk scenario. They must have the ability to communicate with the rest of the business and understand the needs of their business counterparts. And they will play a crucial role in creating the right corporate culture. If the business leaders regard the risk function as somehow estranged from their daily concerns, it will be impossible to create a risk-aware environment.

Key considerations

1. Do your risk and control oversight functions operate in siloes?
2. Is there executive support to integrate/converge risk information across risk and control oversight functions?
3. As your organization transforms, are the governance structures and operational procedures of your risk and control oversight functions being re-evaluated in a similar fashion?
4. Do you have the risk competencies to support a risk program focused on optimizing risk and meeting stakeholder expectations?

Weak incentive structures

Risk-based decision-making is impeded when there is a weak link between incentives and risk.

Most survey respondents admit they are not very good at motivating business-line managers to adopt risk-based methods of making decisions. One likely reason is that 65 percent of respondents admitted that the link between risk management and compensation among business-line employees was weak or non-existent. Even so, there have been a large number of examples of executives, particularly in the United States and Europe, whose compensation has been negatively affected by risk events. Much-publicized cases of such failures can often drive companies to align their incentive structure with their corporate culture and risk profile.

A way to improve alignment is to provide employees from top to bottom with incentives that will motivate them to weigh skillfully the risk and opportunity in every business decision they make. Of course, financial compensation tied to evaluations of risk management is not the only form of incentive. Career development and public praise are two of the many other ways of motivating employees to improve their business judgment.

Note here that we are talking about business-line employees. Providing them with the right incentives is one thing; full accountability is another. What BT did in this regard was to clearly make the business managers the owners of the risks. "There had always been ambiguity about whether the group risk team was there to manage risk for the businesses or to facilitate their management of the risks," says Dan Fitz of BT Group. "The Rubicon moment was acceptance by all [those running the businesses] that the risks were theirs to manage and that the head office was there to facilitate good methodologies and to help keep people focused."

Attribute of excellence from the survey analysis

Seventy-four percent of companies with a strong link between incentives and risk management rated highly their risk and compliance culture. Only 42 percent of those companies with a weak link rated it highly.



KPMG perspective and leading insights

Successful companies set key attributes that they wish to see in their leaders and develop future leaders with these attributes in mind. These could include abilities to manage people, motivate and develop employees, manage budgets etc. Companies that are successful at risk management tend to include it as an important attribute for leadership, with competency of risk management included in job descriptions and goals. This sends a clear message to all employees regarding the importance of risk management and the fact that they need to continue to enhance their risk management skills. Future leaders are trained to handle risk from an early stage in their career at the company, and then once they have attained management positions they will set goals for their teams, among which will be the ability to manage risks. The ability to manage risk should be included in performance reviews, while recognizing that the evaluation often tends to be more qualitative than quantitative.

By the same token, employees should be rewarded for prudent decision making, not just for aggressively hitting financial targets. There needs to be a careful balance struck between exceeding business targets and carefully navigating risks to achieve them. Too often, managers are rewarded for the former and not the latter. It's not just what you accomplish, but how you did it.



To what degree is the compensation incentive structures of business line employees (e.g., marketing, sales, etc) at your organization linked to effective risk management?



Key considerations

1. Does your company consider skillful risk management as an important competency for leadership and is it included in performance reviews?
2. Are all the company's incentives aligned to encourage good risk management, or are there some incentives that may motivate the wrong behavior?
3. How is risk management included in performance management as a core competency?
4. Are risk metrics gathered in a way that can effectively contribute to performance management?

Return on investment

Organizations need to improve how they measure the benefits of risk management.

One clear trend in the survey is that companies are spending more to strengthen risk management. Two thirds of respondents said they will invest more in risk management as a proportion of corporate revenue in the next three years than they did in the previous three. Yet even here, there are concerns about whether companies are getting their money's worth. More than a quarter of respondents (28 percent) say they have no means of knowing whether they are getting value for the investment and 30 percent are simply reviewing past results to assess the effectiveness of their risk controls.

Measuring the return on preventing a negative event from happening is not easy. Conversely, losses in market value as a result of a hit to a company's reputation can run into billions of dollars. Mike Bergines, Director of Enterprise Risk Management at eBay Inc., takes a quantitative approach, as far as possible. "We quantify all aspects of a risk and avoid nebulous designations like 'reputational risk'. There must be some anticipated real world, tangible effects to a reputational risk or other effects that seem qualitative on the surface: we go the next step and identify what those effects are," he says.

Few would doubt that sizeable investments in risk management are valuable if they reduce the uncertainty of achieving corporate objectives. But the imprecision is a perennial challenge, particularly for the Chief Financial Officer, 31 percent of whom said they have no way of measuring the return on investment in risk management. Despite these difficulties, organizations must always carefully evaluate the business case of additional investment in risk management. Given the nature of

Attribute of excellence from the survey analysis

Fifty-two percent of those whose risk management was very advanced said they used quantifiable measures to value the contribution of risk management. This is much greater than the 20 percent of the entire survey sample who said this.



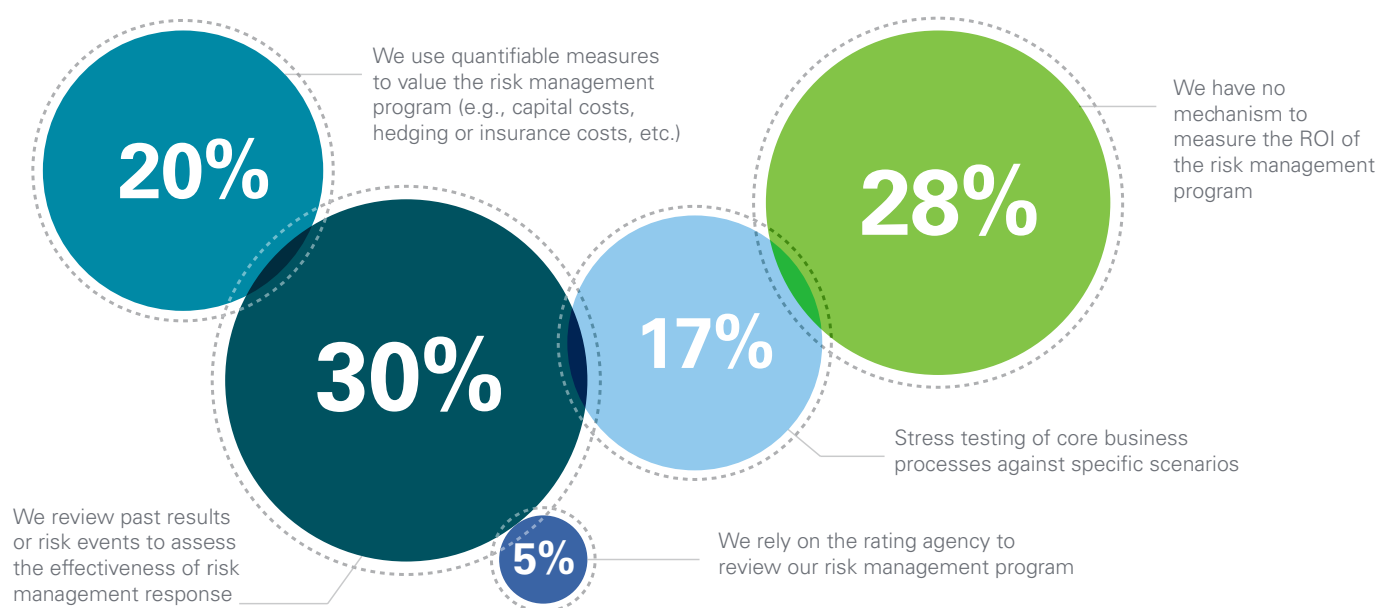
KPMG perspective and leading insights

Many companies struggle to estimate an ROI for risk management, primarily due to the limitations in defining the 'return' component of the equation as well as determining the scope of risk management activities across the three lines of defense. We therefore do not suggest over-engineering the actual calculation, but to start by understanding the linkage between risk management and corporate strategy. By understanding how identified risks threaten the achievement of strategic business objectives (e.g., business transformation), executives can move risk management from a theoretical exercise to a business tool. Depending on the culture of your organization, this will automatically allow risk management to move into the same ROI measurement mechanism as deployed by the rest of the organization.

As an organization's risk management capabilities are enhanced, certain trends should become more apparent – effective use of hedges, insurance instruments and offloading risks to third parties; improved cost of capital and debt rating; increased resiliency regarding emerging risks; successful acquisition decision making (both deals executed and terminated); clear examples of risk/loss avoidance; and more alignment between risk appetite and desired returns (deploying effective stress testing and scenario planning for strategic growth assumptions) reducing the volatility in estimated earnings.



How do you measure the return on investment (ROI) in your risk management program?



risk management, the business case may focus on qualitative value drivers together with a limited number of quantitative drivers. After all, when risk management is fully embedded in an organization's processes and culture, risk management is everyone's responsibility – so isolated measures become nebulous.

Key considerations

1. How well do you understand the way that enterprise risks threaten business value?
2. How can / should you define the success of your enterprise risk management program?
3. Are you evaluating the investments in risk management to determine efficient integration?
4. Which combination of quantitative and qualitative measures best articulate your risk management value proposition for stakeholders?

Creating a risk-resilient culture: A call to action

Companies cannot afford to ignore warning signs if their risk capabilities do not match stakeholder expectations.

This report demonstrates that companies are trying to rise to the challenge of the times by emphasizing the importance of risk management. To help companies navigate a more complex global economy and an ever-growing list of government regulations, risk management has never been more essential. Yet, despite its importance, the skills to manage risks appear to be lacking in some crucial respects. Companies struggle to build an enterprise-wide view of threats and this makes it difficult to plan strategically. Many companies do not perform bottom-up risk assessments or develop risk appetite statements. Self-assessments by the business units are lacking. Companies are increasing their investment in risk management and believe that technology can help, especially in breaking down the barriers between the risk and control oversight functions. But measuring the value of those investments remains a perennial challenge.

A 1,092-respondent survey of C-level executives from around the world enables us to highlight the weak points in companies' defenses. It also helps us to understand the strong points. By focusing on the companies that say they do well in various categories, we have been able to compile some of the attributes of a "risk-resilient culture." These include the following criteria of excellence that are grouped into three themes to describe the best practices for risk management. (See chart on next page).

There are very few companies that excel in every aspect of risk management. But the best ones focus on many of these criteria and are constantly trying to do better because their expectations for risk management are always high. These organizations realize that the risks threatening their future are constantly evolving and that their capabilities must develop as rapidly.

For the companies that excel in only one or none of these criteria of success, their task is to decide quickly which ones they are weakest in and raise the bar. Failure to improve their risk management may have severe repercussions. By then, it may be too late to realize the true value of strong risk management. **IT'S TIME FOR ACTION.**

How UCLA Health System inculcates risk awareness

David Feinberg is the president of the non-profit UCLA Health System in Los Angeles, which treats 80,000 patients a year and sees 1.5 million in its clinics. He says there are two ways UCLA has tried to inculcate a culture of risk awareness. One is a tight focus on patient-centric care. The other is to personalize the risks. There is, for example, a ban on the re-use of syringes. "You write policies that say 'Don't reuse syringes.' You can even get mad at people. You could fire people. It doesn't work," Feinberg says. "What works is personalizing it. If telling the story about when we screwed up—and better than us telling the story is to have it come from the patient or the patient's family directly."

At the health system's annual clinical retreat, Feinberg invites such people to tell their story about when they or their relative was a patient. One example was a husband and wife whose very ill 12-year-old son was treated at the hospital. "We brought them in for two hours and they literally told us everything that we do wrong in the nicest, sweetest way. It was amazing to see it through their eyes," he said. Amid all the technology, Feinberg tries to focus on the human side of things. Personalizing the risk is something that companies in other industries can learn from if they aim to create an awareness of the dangers of doing the wrong thing.

- Risk management is fully integrated into strategic decision making.
- Risk is aggregated to form an enterprise-wide view by means of a top-down and a middle-up assessment.
- Companies analyze and gain business insights from the way in which risks are interrelated.
- Understand and develop the company's risk appetite to determine whether it is taking on too much risk, or too little.



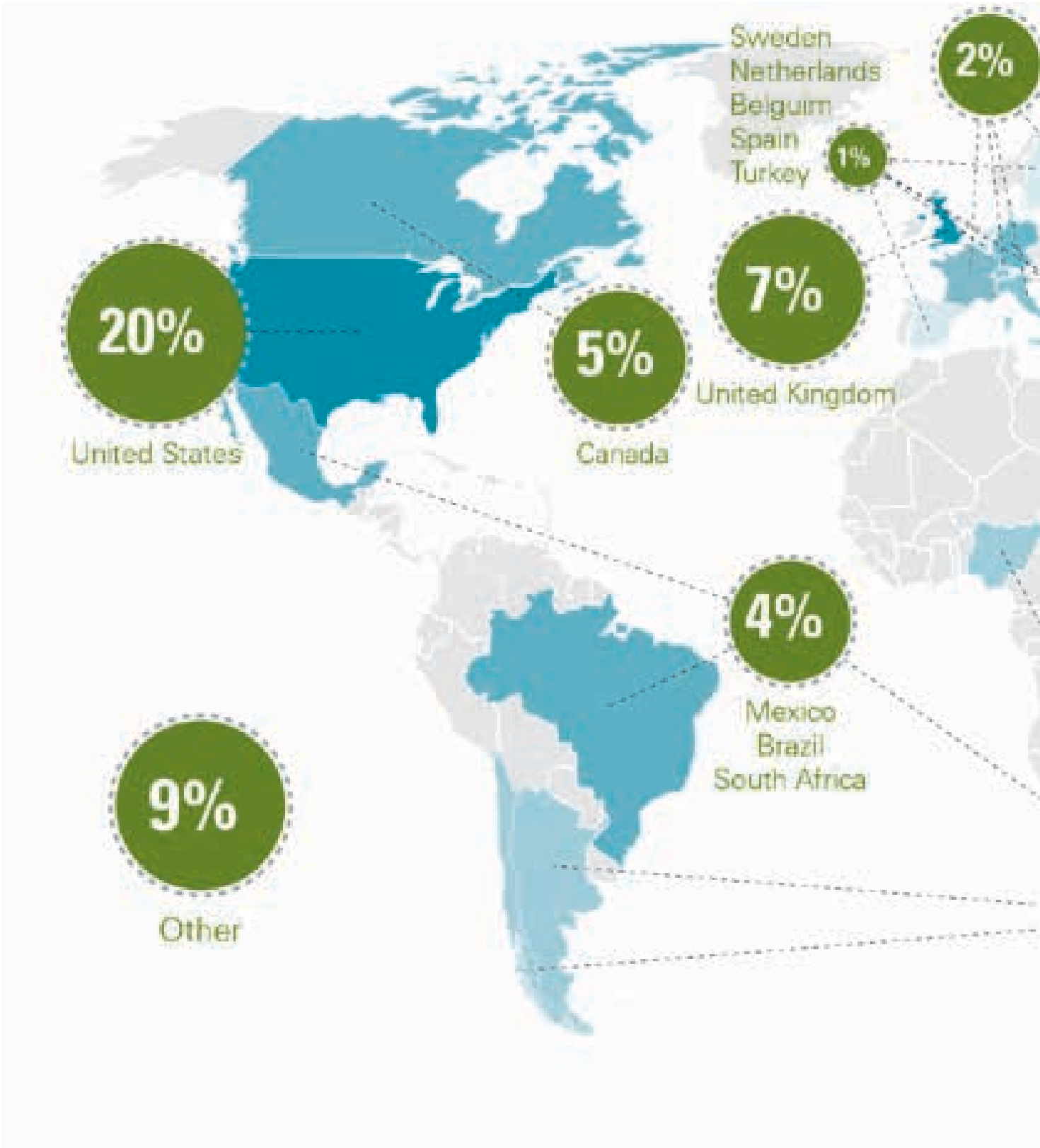
- The company's leadership sets the tone in terms of integrating risk management into top-level decisions.
- The company that manages risk effectively has three lines of defense that are well integrated and coordinated.
- The company communicates well about risk issues with its stakeholders, both internal and external.
- Compliance should be seen as a competitive advantage.

- Companies focus on developing a single view of risk, by converging risk and control competencies and by integrating the single view with strategy.
- Companies clearly identify the benefits of successful risk management and communicate such.
- Companies provide employees with incentives that will motivate them to behave in line with the corporate objectives and culture.

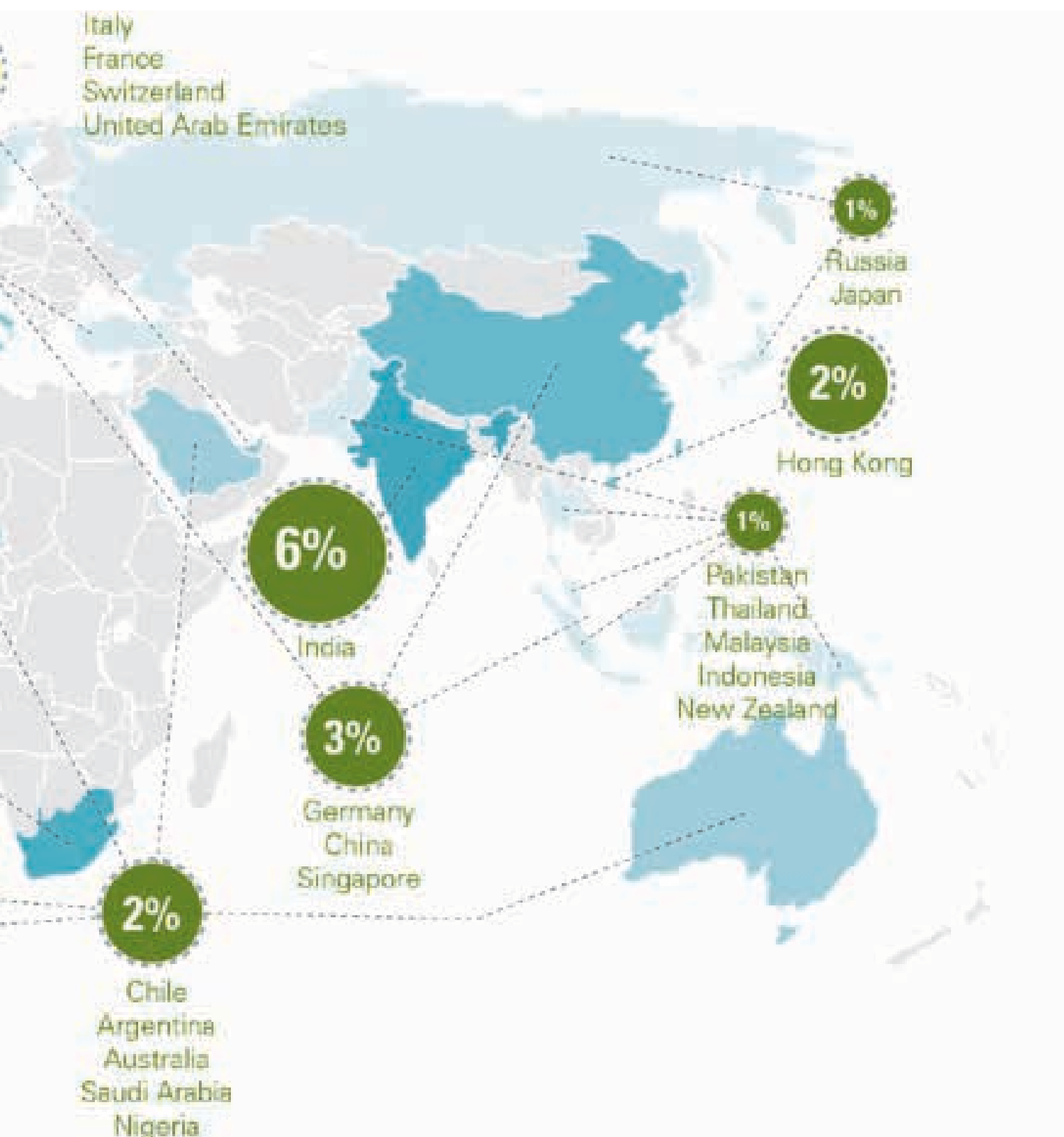


Appendix

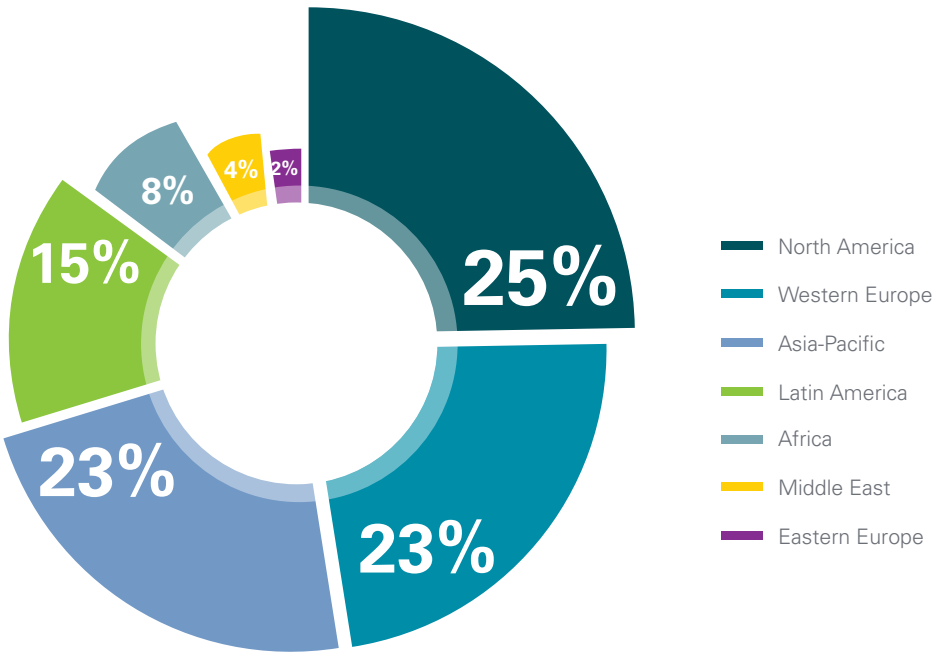
In which countries are the survey respondents located?*



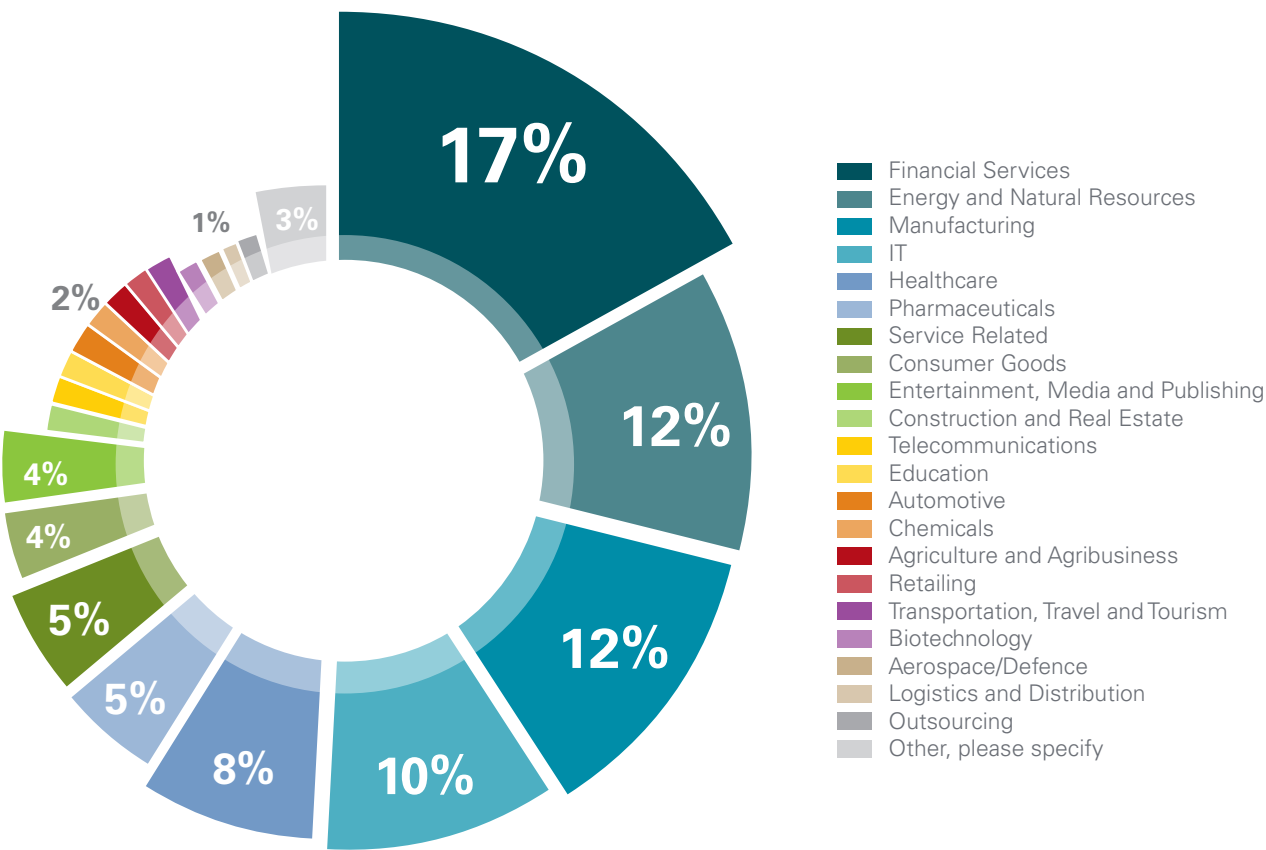
*Nine percent of countries surveyed globally had less than 1 percent participation.



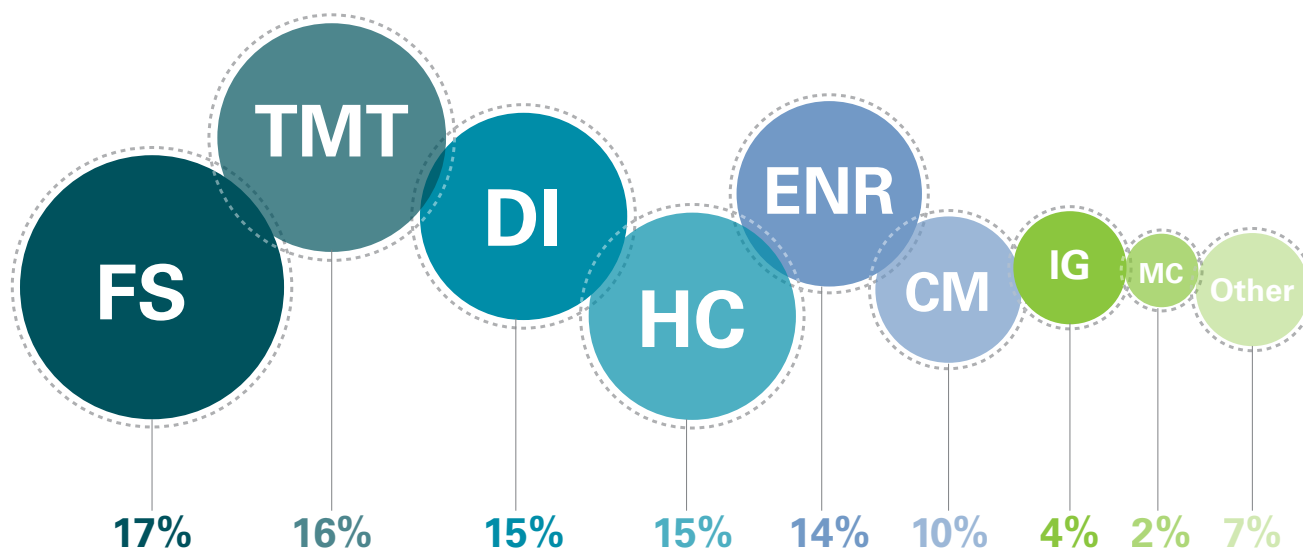
In which regions are the survey respondents located?



What is your organization's primary industry/sector?



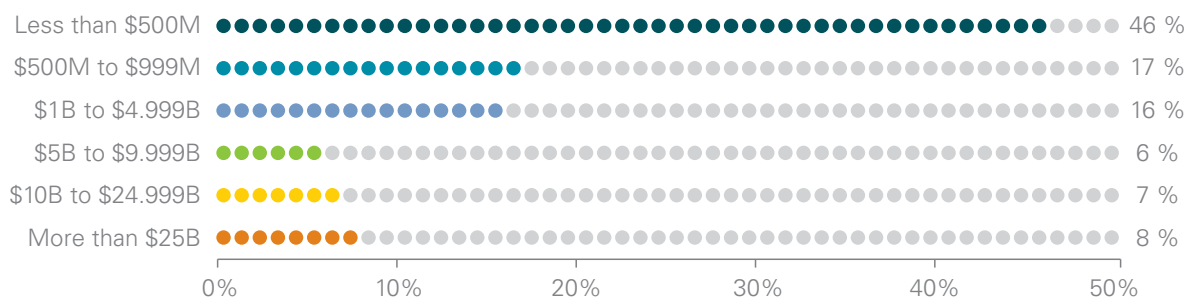
What is your organization's primary industry?



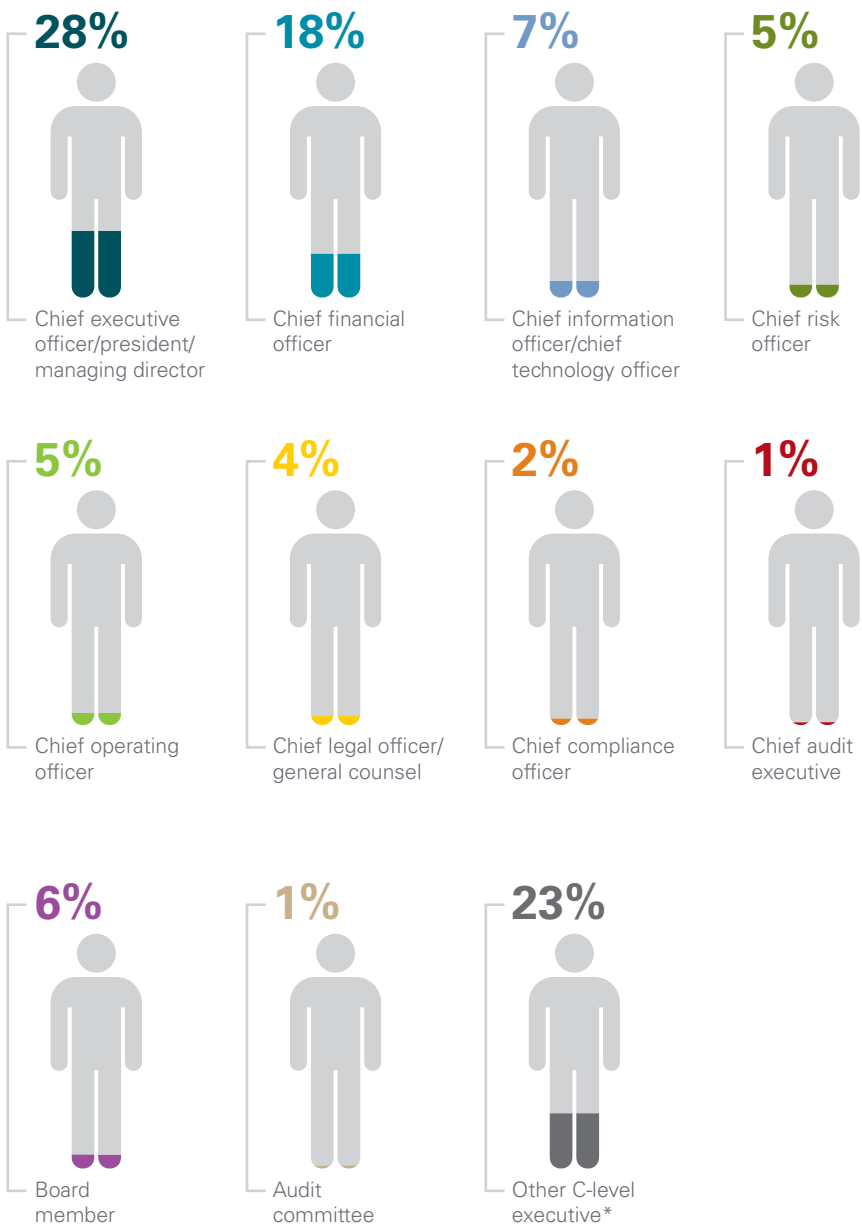
FS - Financial Services (Banking, Insurance, Investment Management, Private Equity)
TMT - Technology, Media & Telecommunications
DI - Diversified Industrials
HC - Healthcare

ENR - Energy and Natural Resources
CM - Consumer Markets
IG - Infrastructure, Government
MC - Management Consulting

What are your organization's global annual revenues in US dollars?

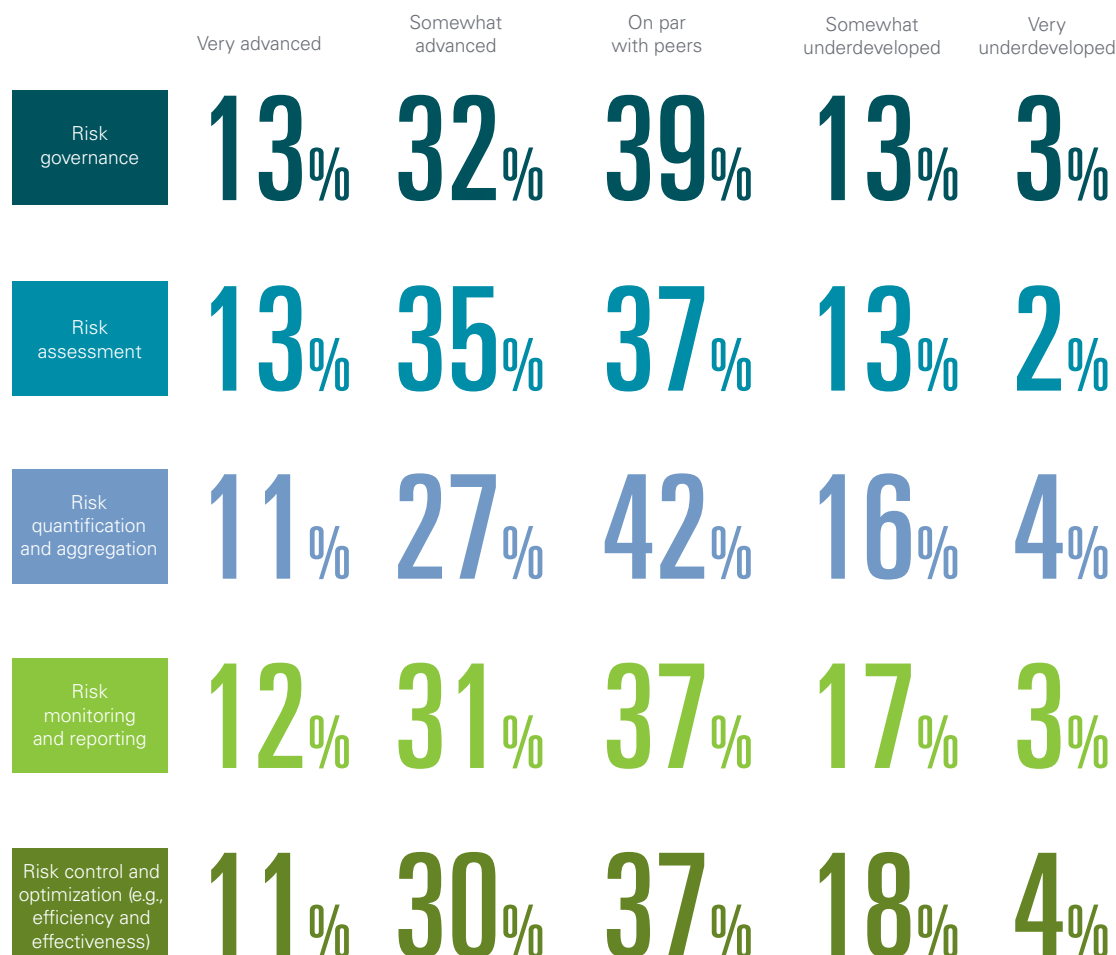


Which of the following best describes your title?

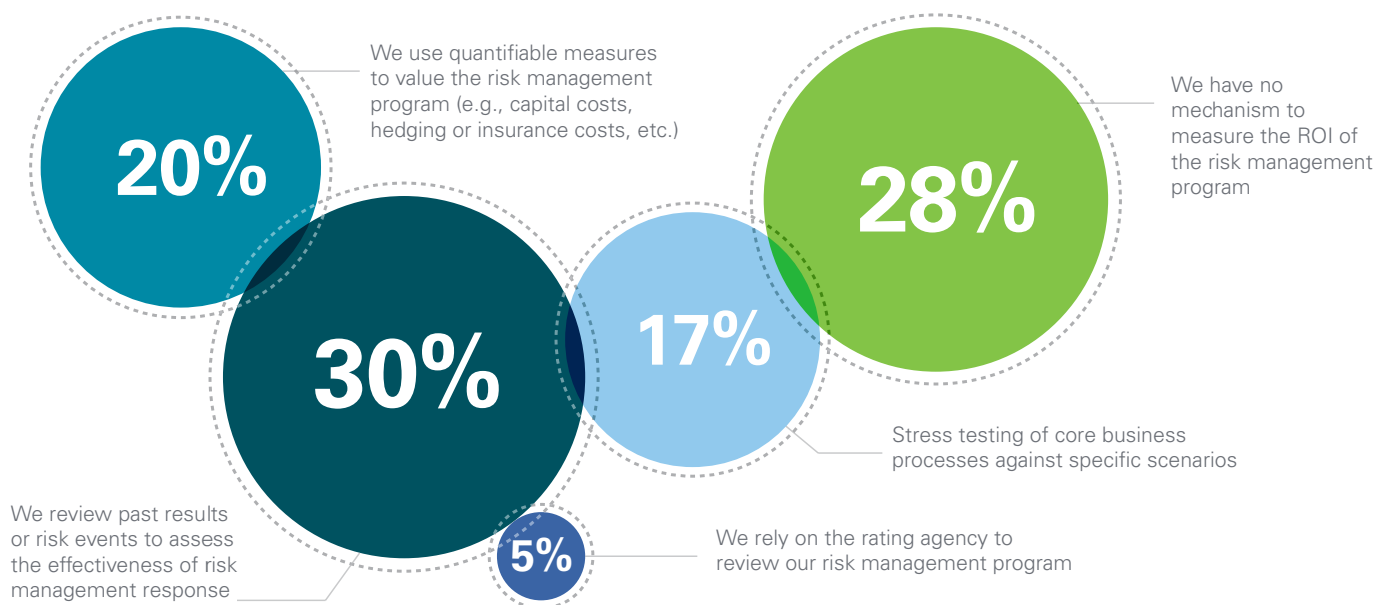


*Individuals were able to self select this option without providing further clarification as to their title.

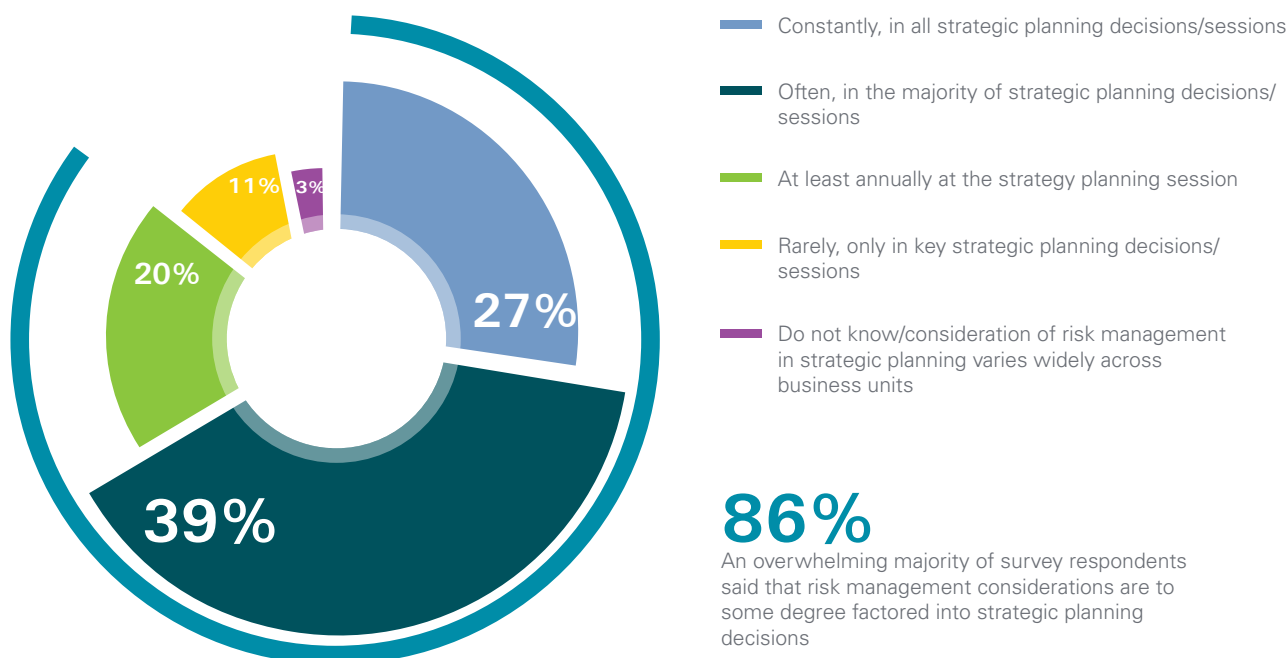
Compared to your peers, how would you rate the maturity of your risk management program based on the following factors?



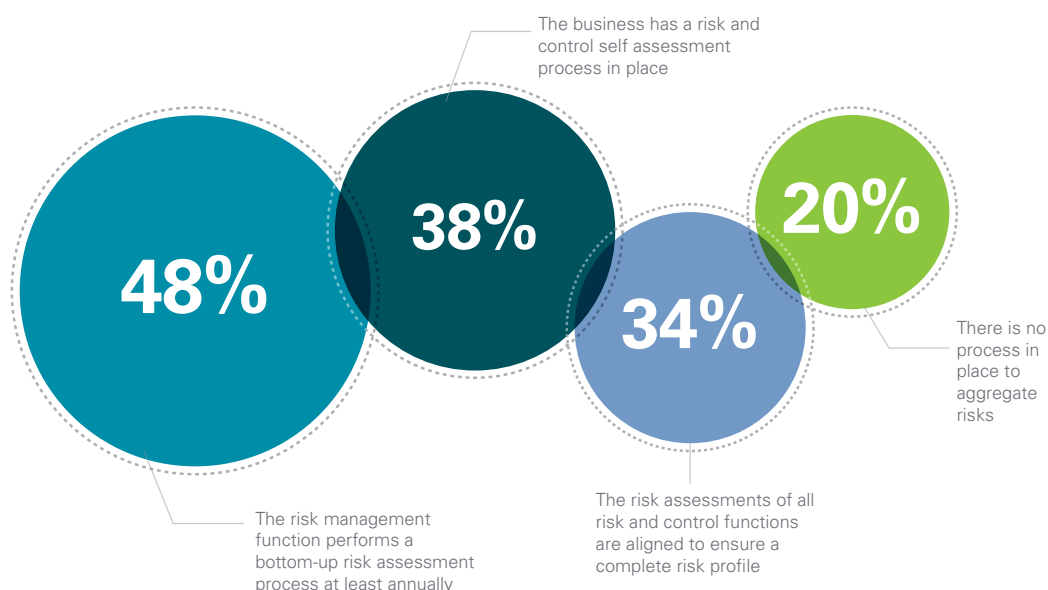
How do you measure the return on investment (ROI) in your risk management program?



How often are risk management considerations factored into your organization's strategic planning decisions?

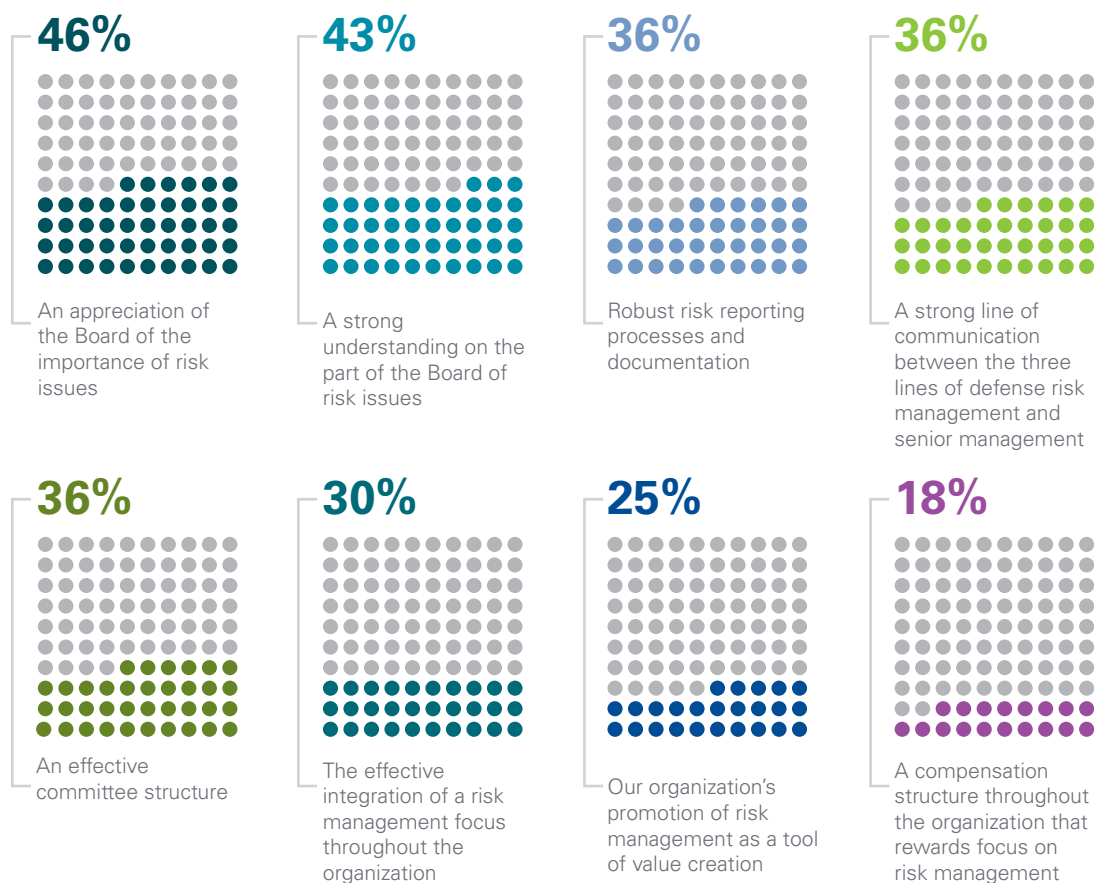


How is the risk profile of your organization developed and aggregated? Select all that apply.



Note: Percentages may not add up to 100% as respondents were instructed to select all that apply

To what do you attribute your organization's success in effectively communicating risk issues to the Board level? Select all that apply.



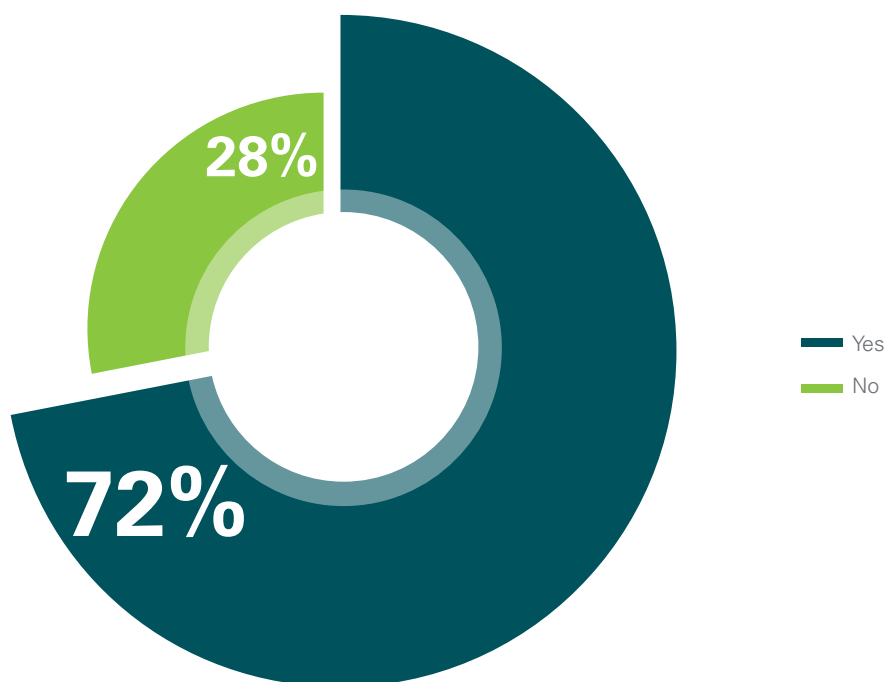
Note: Percentages may not add up to 100% as respondents were instructed to select all that apply

To what do you attribute your organization's weaknesses in effectively communicating risk issues to the Board level?

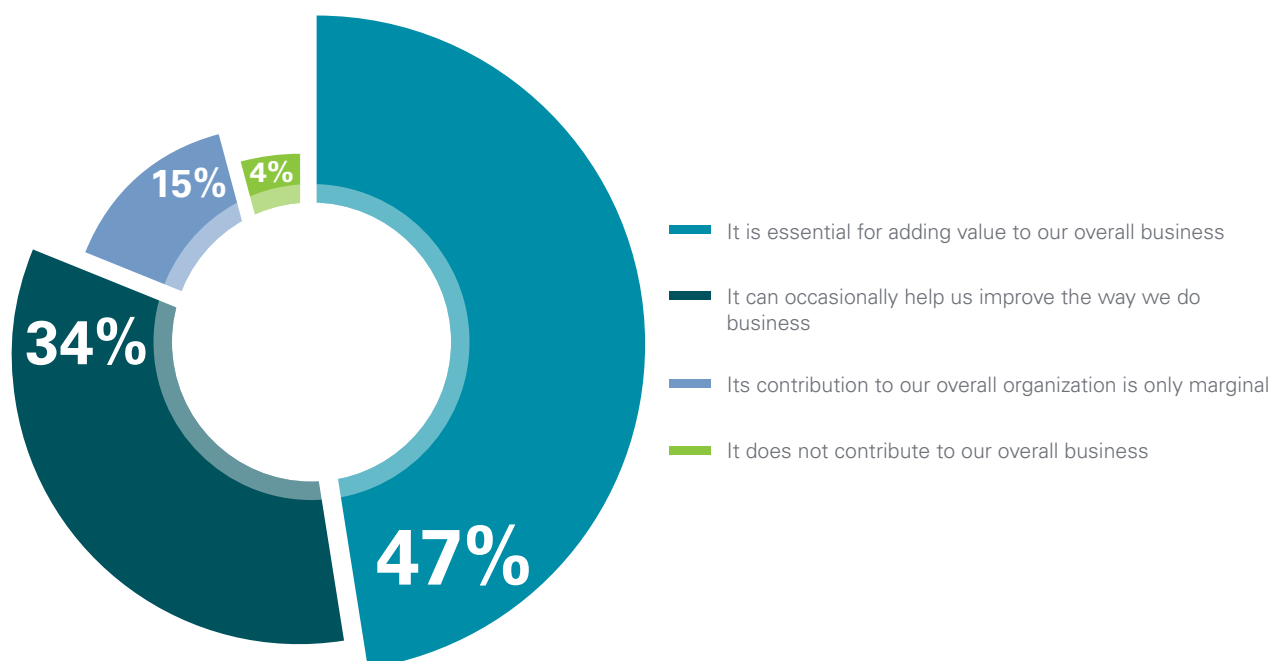


Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Is strategic risk and the actions in place to manage strategic risk included in the risk management reporting to the Board?



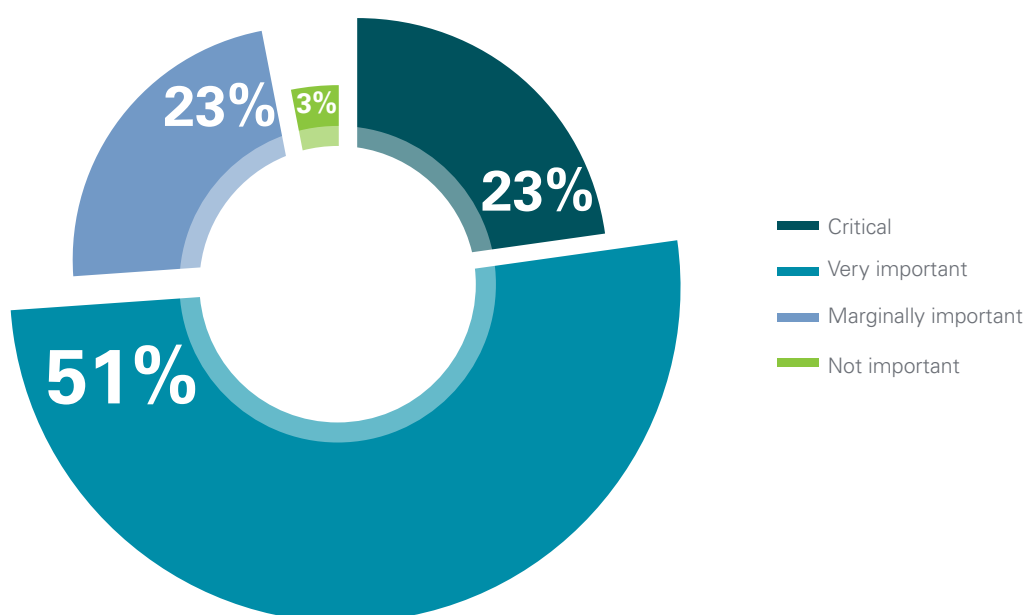
Which of the following best reflects your view of risk management's contribution to your organization?



**How would you rate your organization's ability to identify, assess and manage both current and emerging risks?
Please answer on a scale from Very effective to Very ineffective.**

	Very effective	Somewhat effective	Slightly ineffective	Very ineffective/ Not at all effective	Not applicable
First line of defense: Identifying / assessing risk	26%	53%	15%	5%	1%
First line of defense: Managing risk	22%	53%	20%	4%	1%
Second line of defense: Identifying / assessing risk	23%	51%	20%	5%	1%
Second line of defense: Managing risk	20%	53%	22%	4%	1%
Third line of defense: Identifying / assessing risk	23%	44%	21%	8%	4%
Third line of defense: Managing risk	20%	46%	21%	9%	4%

How important do you consider a technology enabler/tool to be to successfully integrate risk management across the organization?

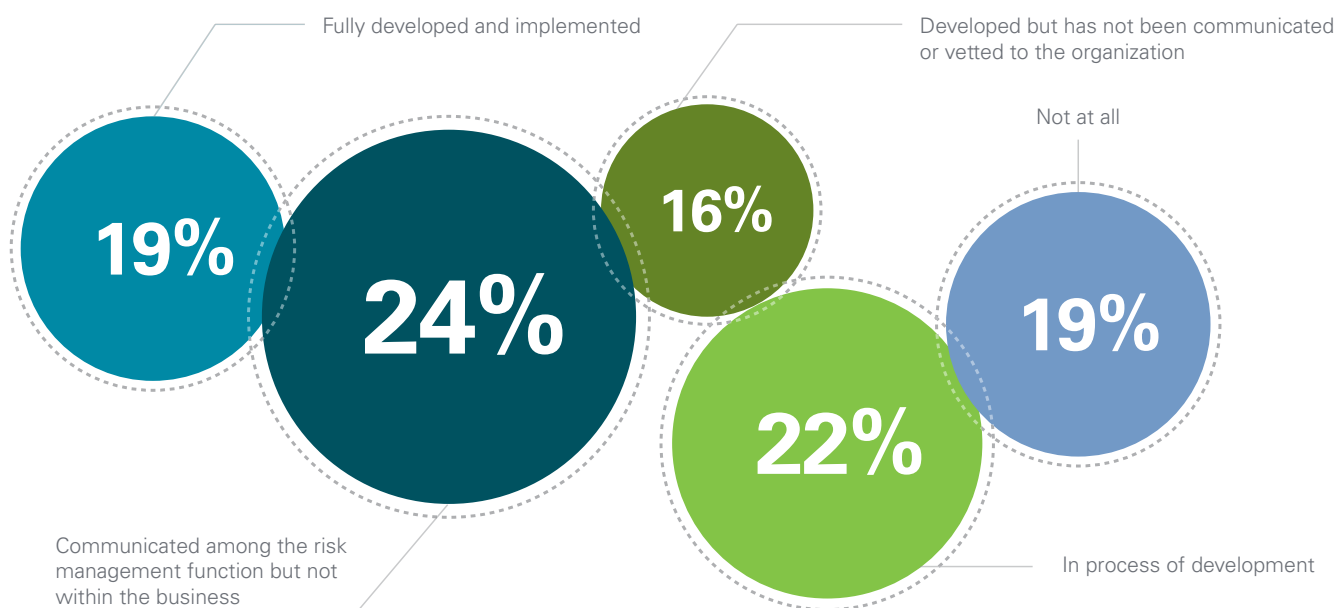


What do you view as the biggest challenges to effective data collection and analysis for risk management purposes within your organization?

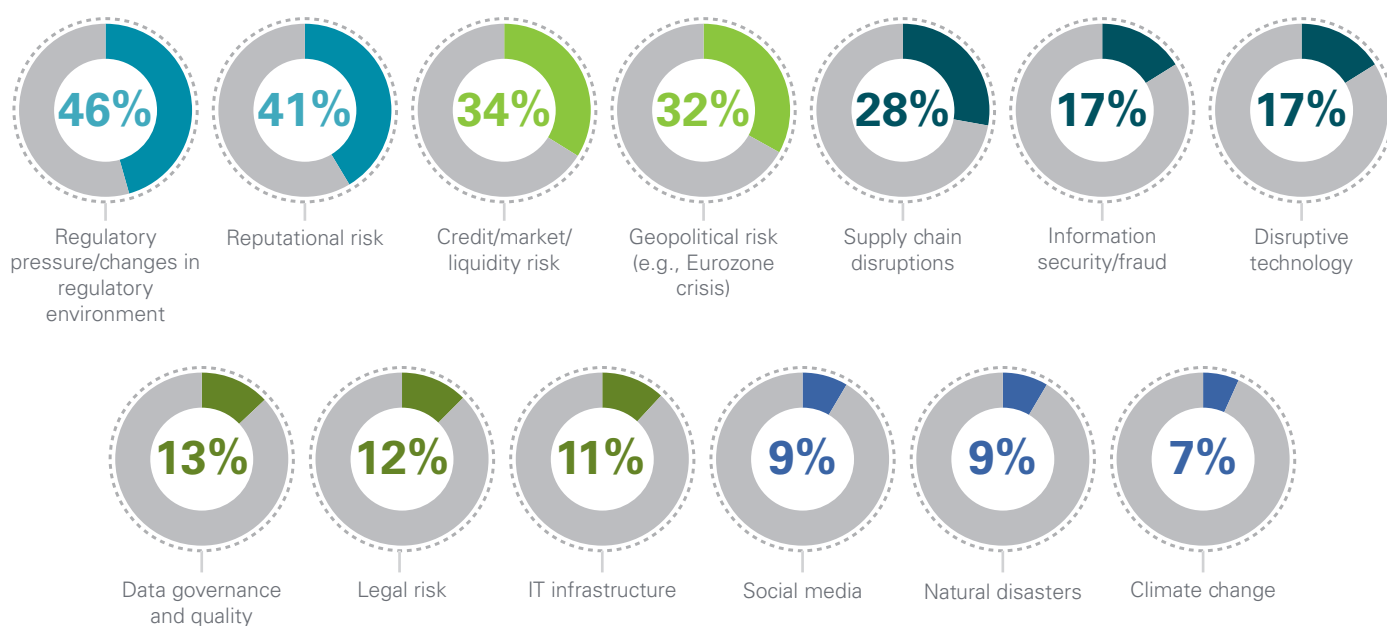


Note: Percentages may not add up to 100% as respondents were instructed to select the top three

To what extent has your organization developed a formal risk appetite statement?



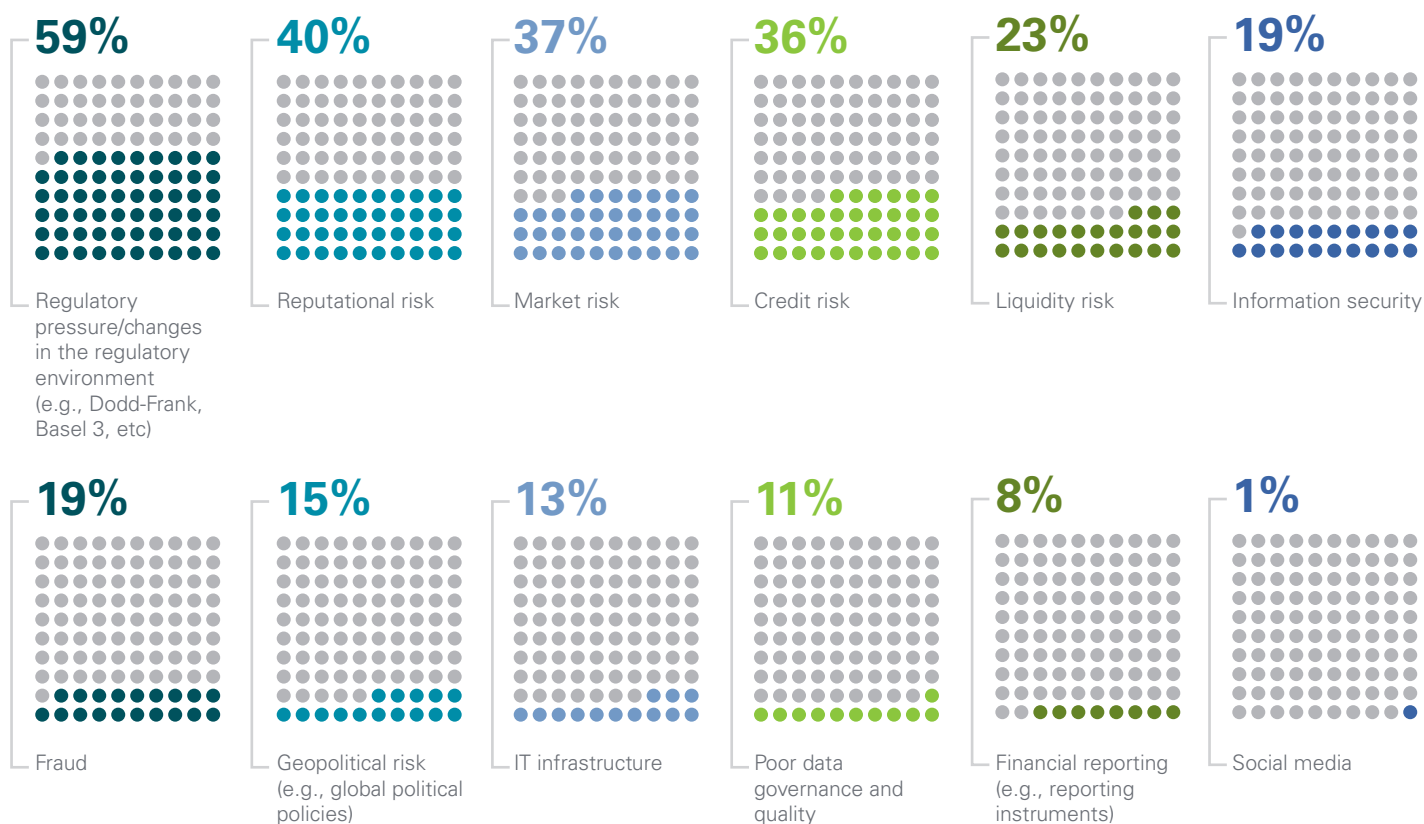
Which of the following issues pose the greatest threat to your industry?*



Note: Percentages may not add up to 100% as respondents were instructed to select the top three

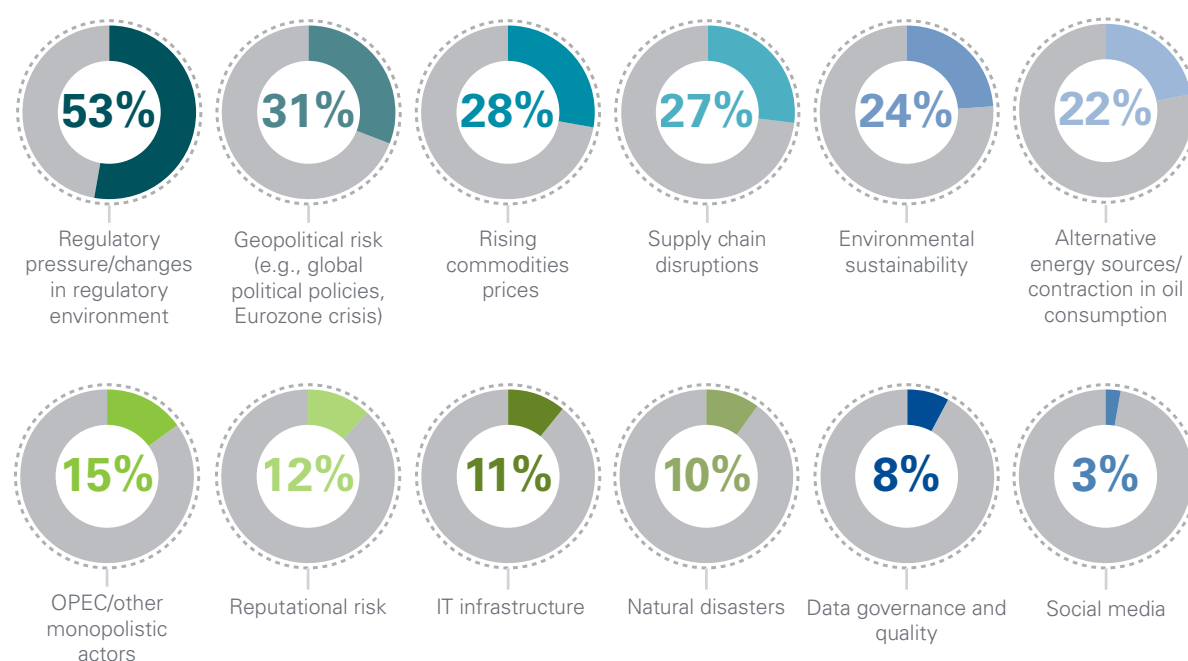
*All respondents except Financial Services, Healthcare, Diversified Industrials, Technology, Media & Telecommunications and Energy and Natural Resources

Which of the following issues pose the greatest risk to the Financial Services industry?



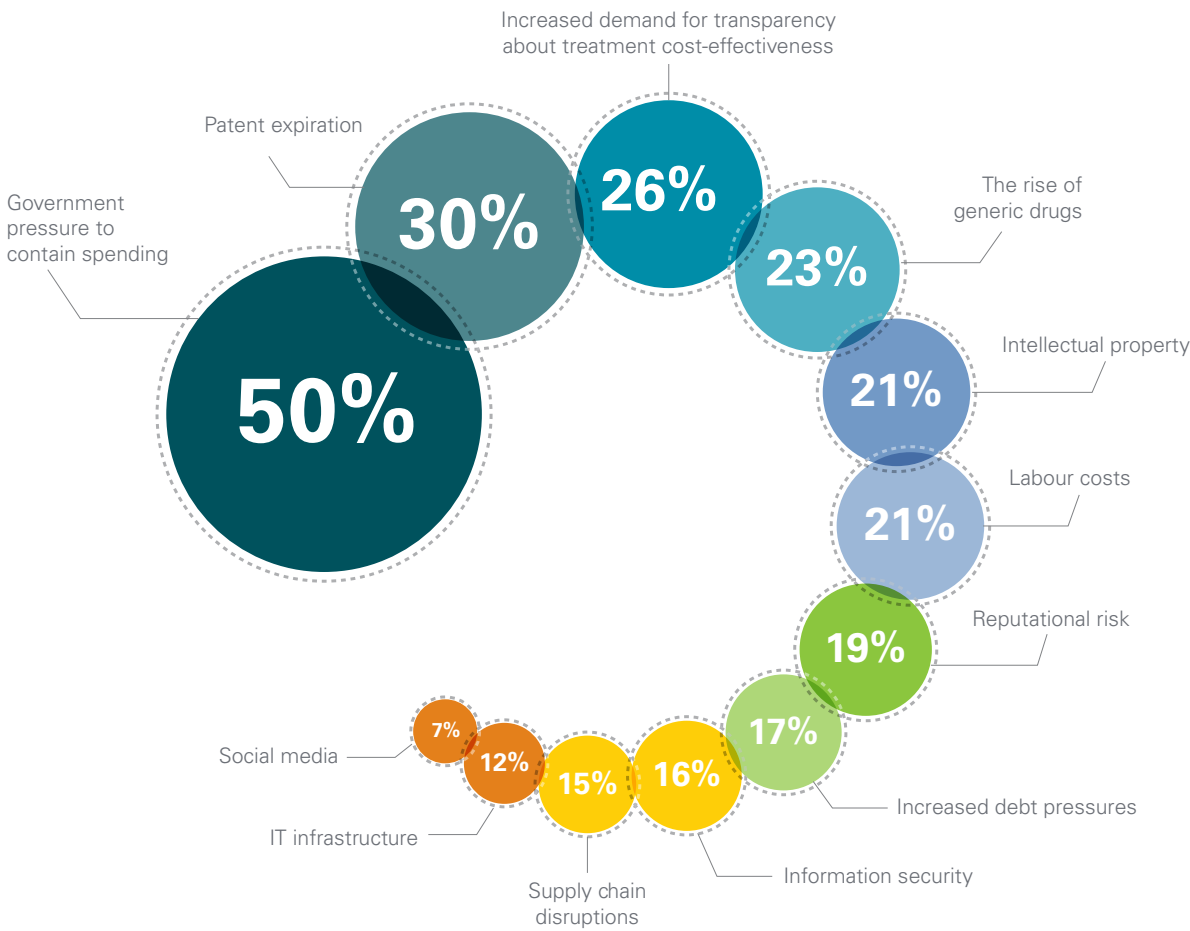
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following issues pose the greatest threat to the Energy and Natural Resources industry?



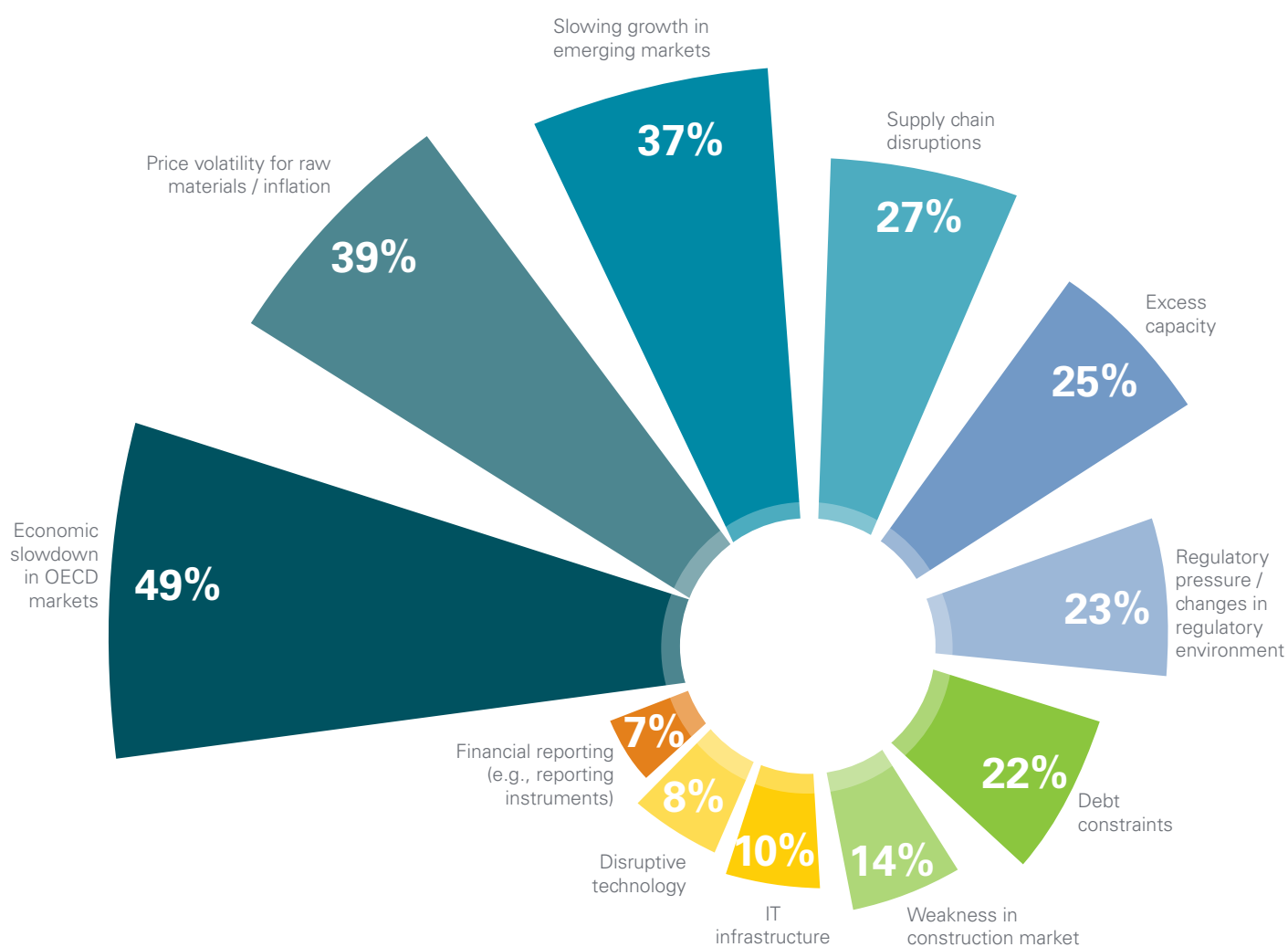
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following issues pose the greatest threat to the Healthcare industry?



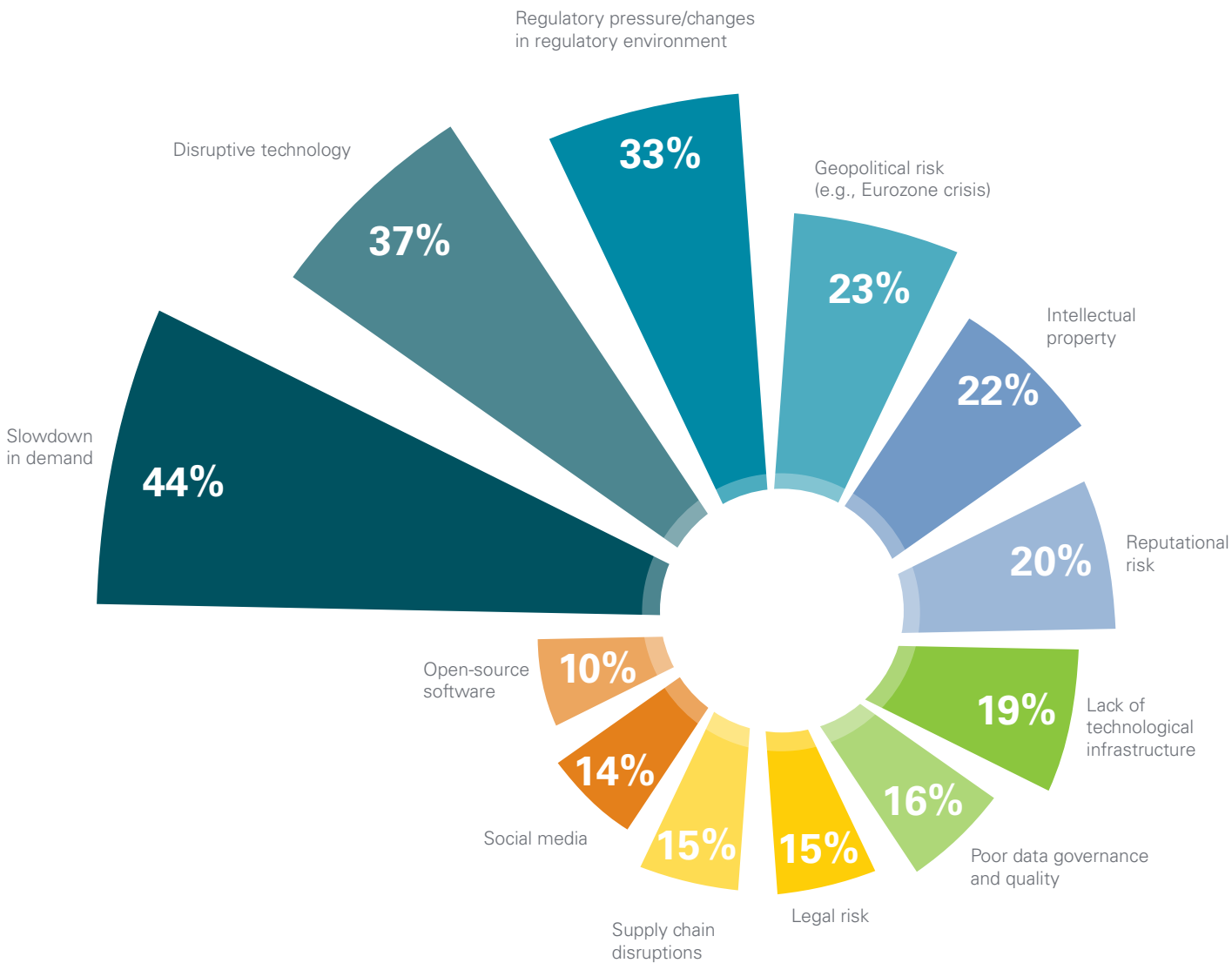
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following issues pose the greatest threat to the Diversified Industrials industry?



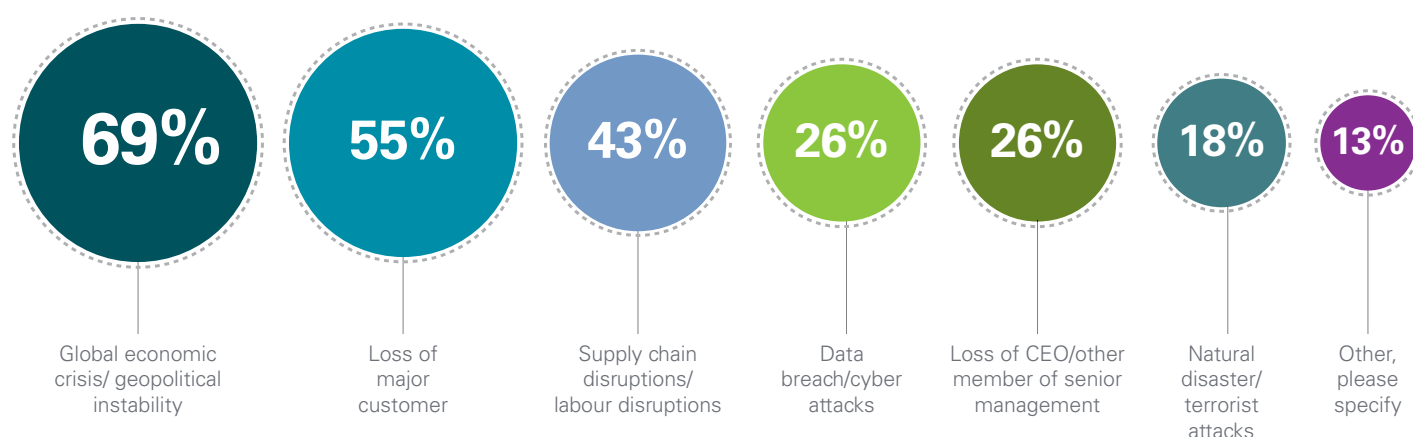
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following issues pose the greatest threat to the Technology, Media & Telecommunications industry?



Note: Percentages may not add up to 100% as respondents were instructed to select the top three

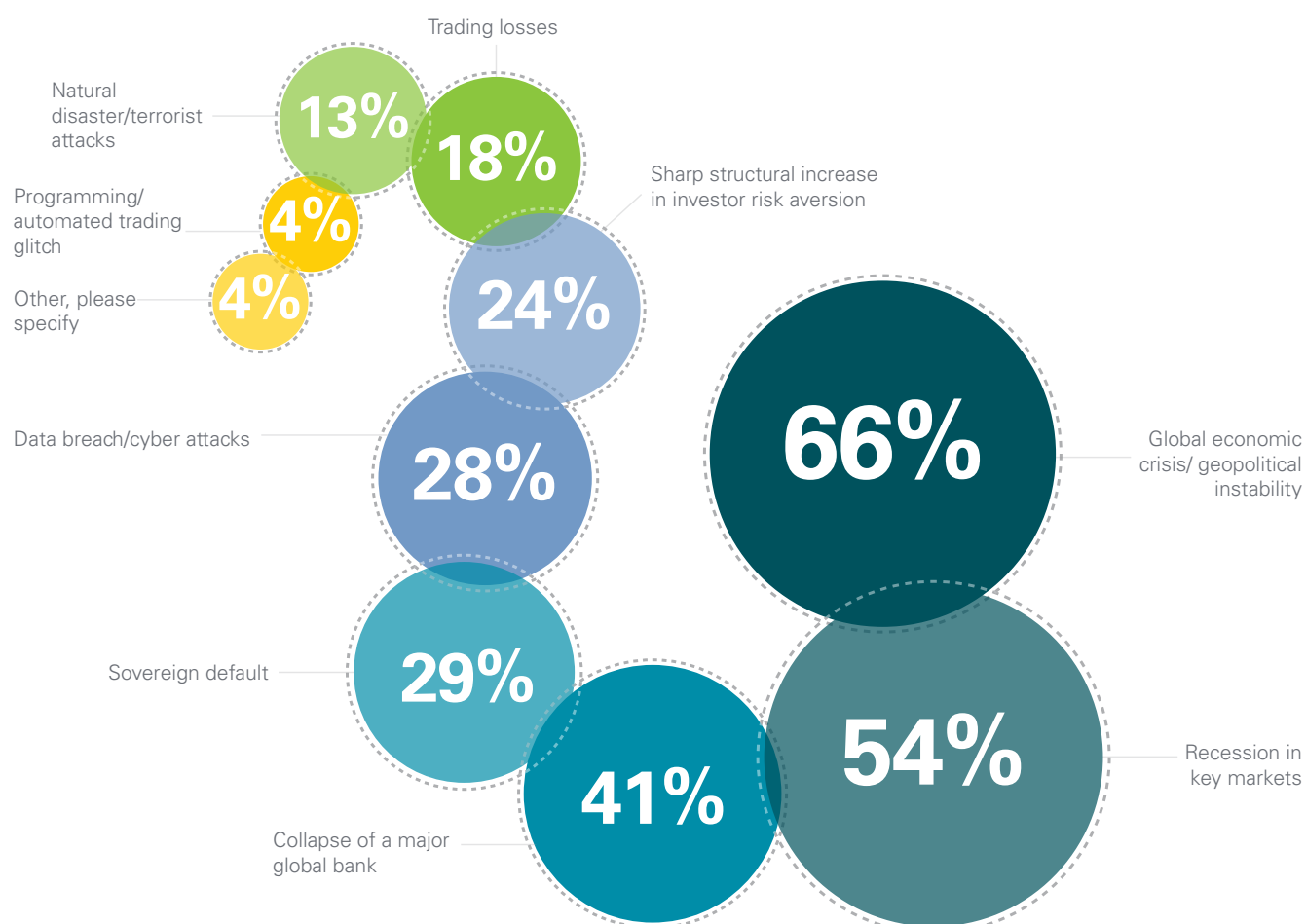
Which of the following risk scenarios pose the greatest threat to your industry?*



Note: Percentages may not add up to 100% as respondents were instructed to select the top three

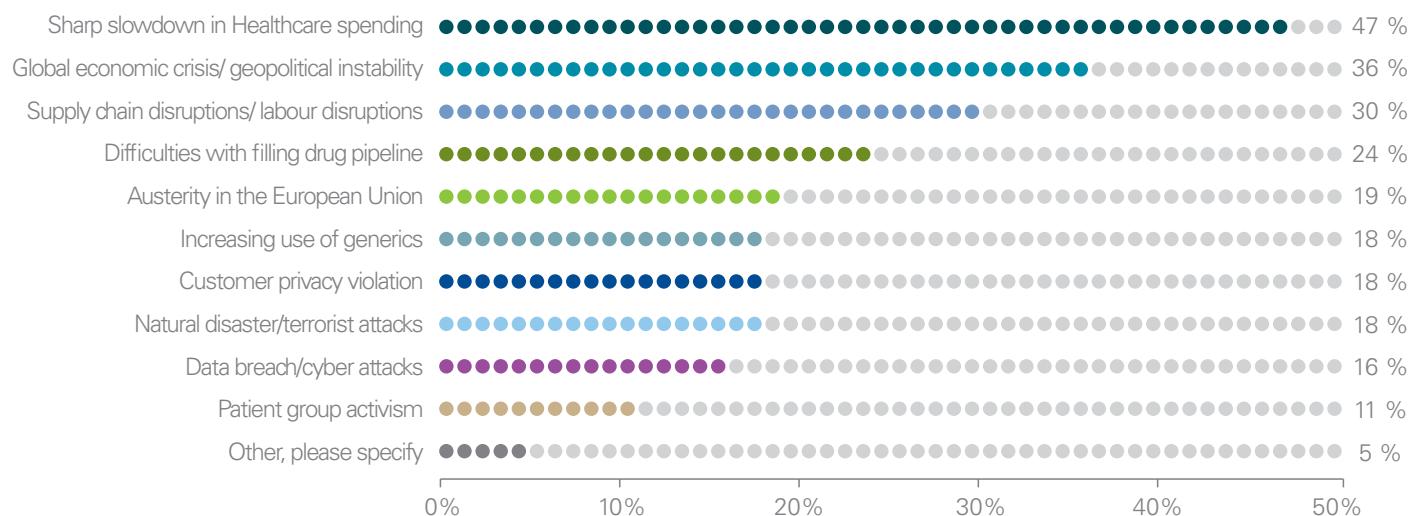
*All respondents except Financial Services, Healthcare, Diversified Industrials, Technology, Media & Telecommunications and Energy and Natural Resources

Which of the following risk scenarios pose the greatest threat to the Financial Services industry?



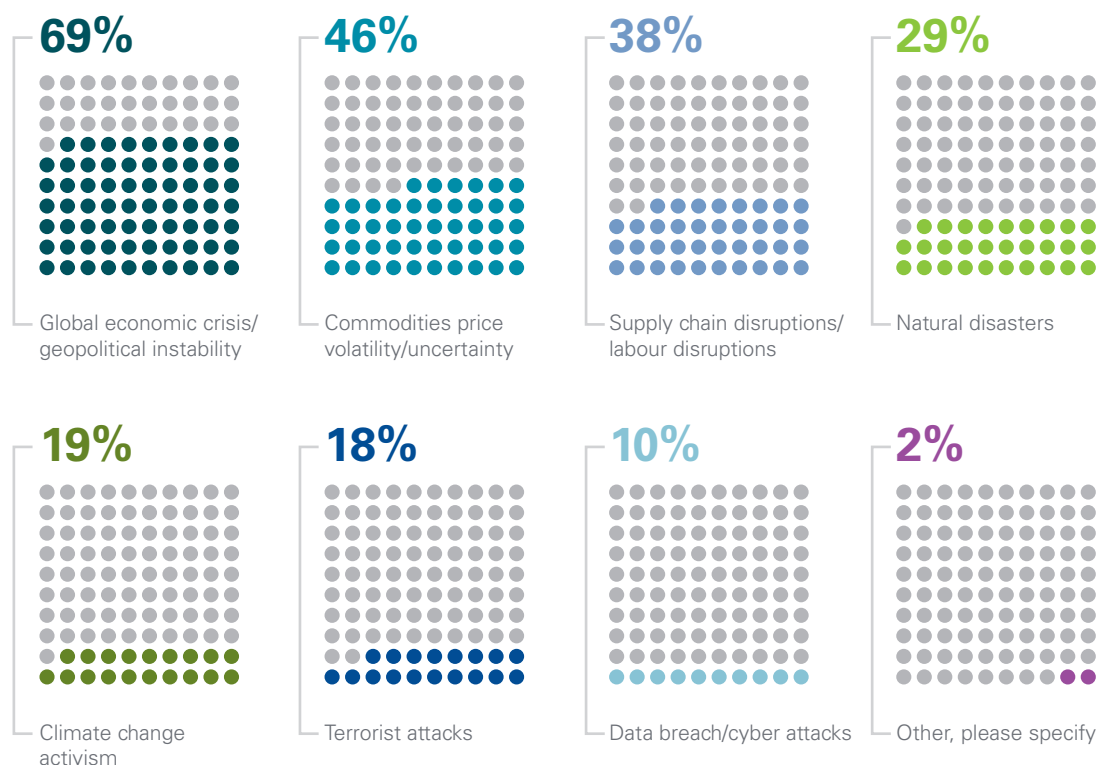
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following risk scenarios pose the greatest threat to the Healthcare industry?



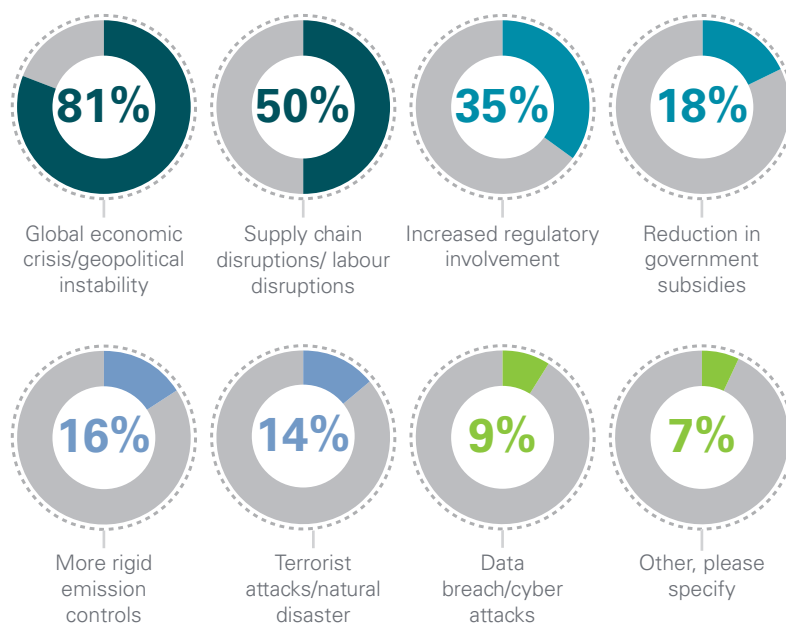
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following risk scenarios pose the greatest threat to the Energy and Natural Resources industry?



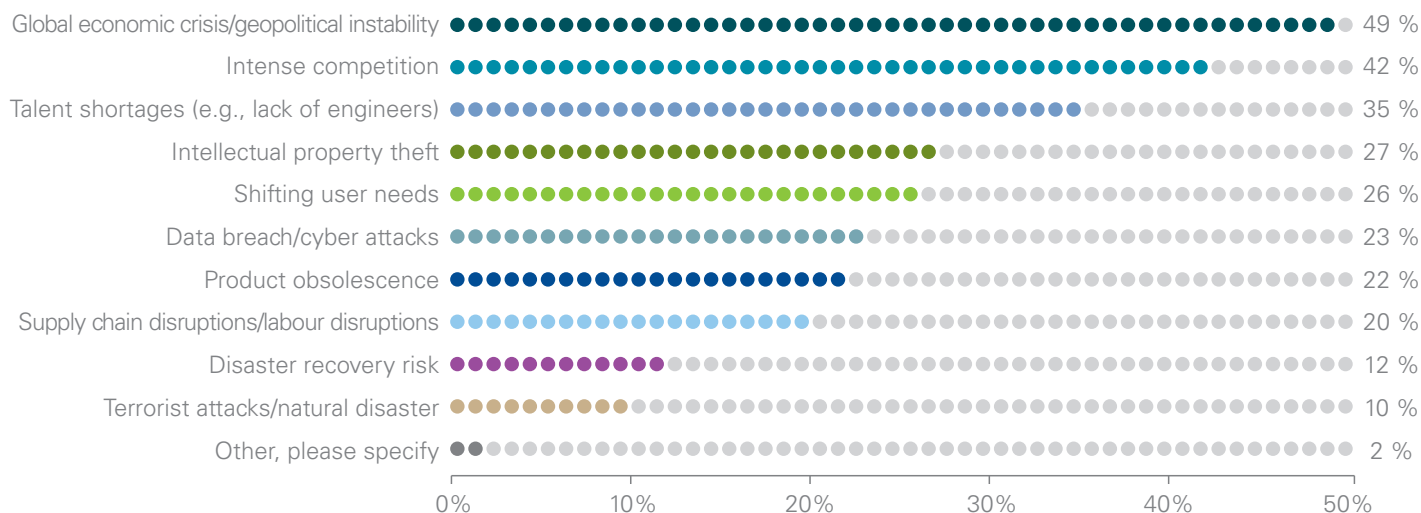
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following risk scenarios pose the greatest threat to the Diversified Industrials industry?



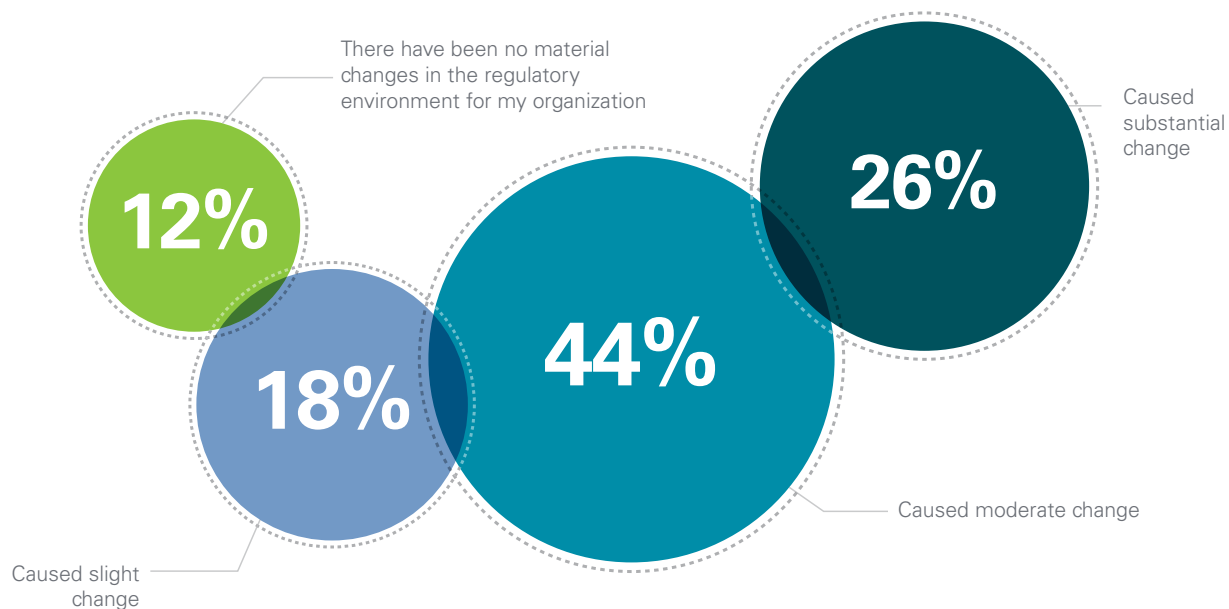
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following risk scenarios pose the greatest threat to the Technology, Media & Telecommunications industry?

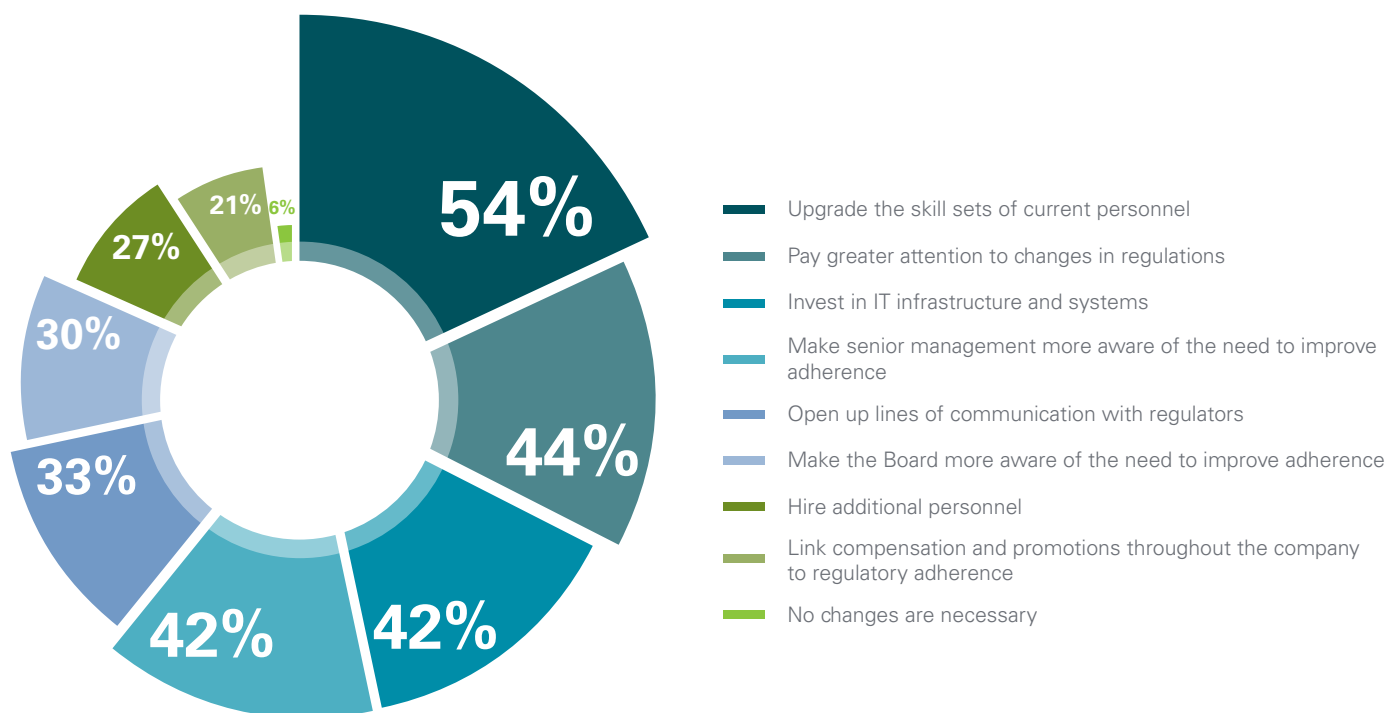


Note: Percentages may not add up to 100% as respondents were instructed to select the top three

To what degree have regulatory changes caused change in your organization’s risk management and reporting processes over the past two years?

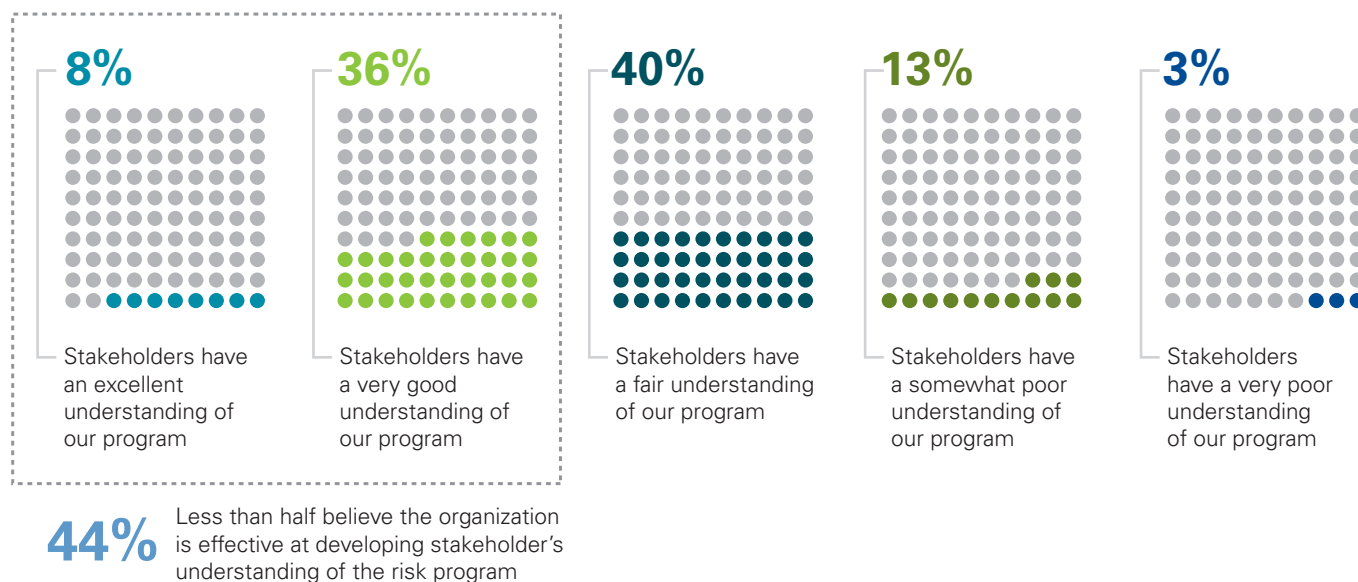


What does your organization need to do to improve adherence to regulations? Select all that apply.

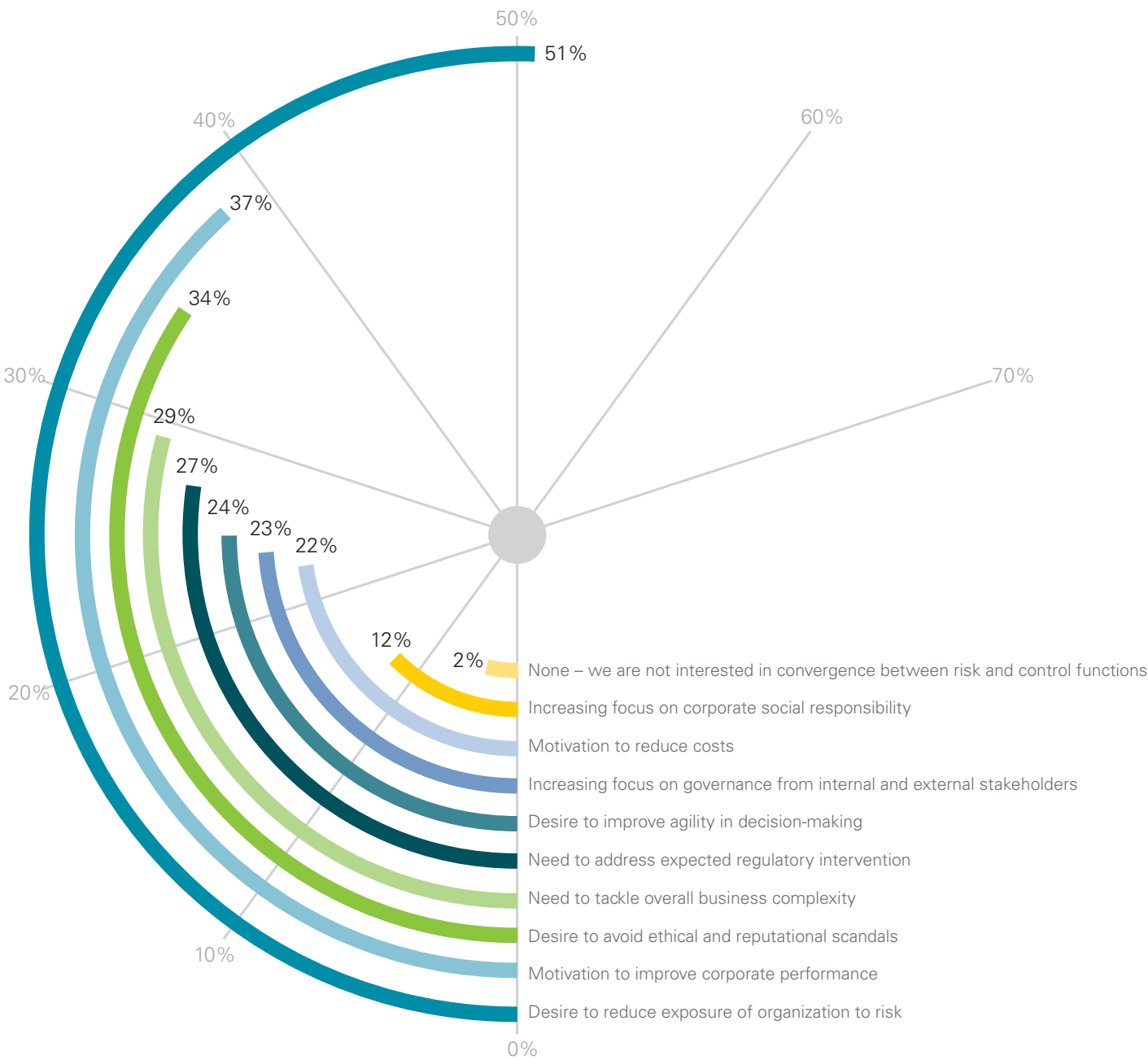


Note: Percentages may not add up to 100% as respondents were instructed to select all that apply

How effectively is your organization able to develop stakeholders' understanding of your risk program (e.g., communicating roles/responsibilities, policies/procedures, risk exposures, tolerance levels, etc)?



Which of the following factors has the strongest influence over your organization's interest in converging its risk and control functions (e.g., risk management responsibilities across all lines of defense)?



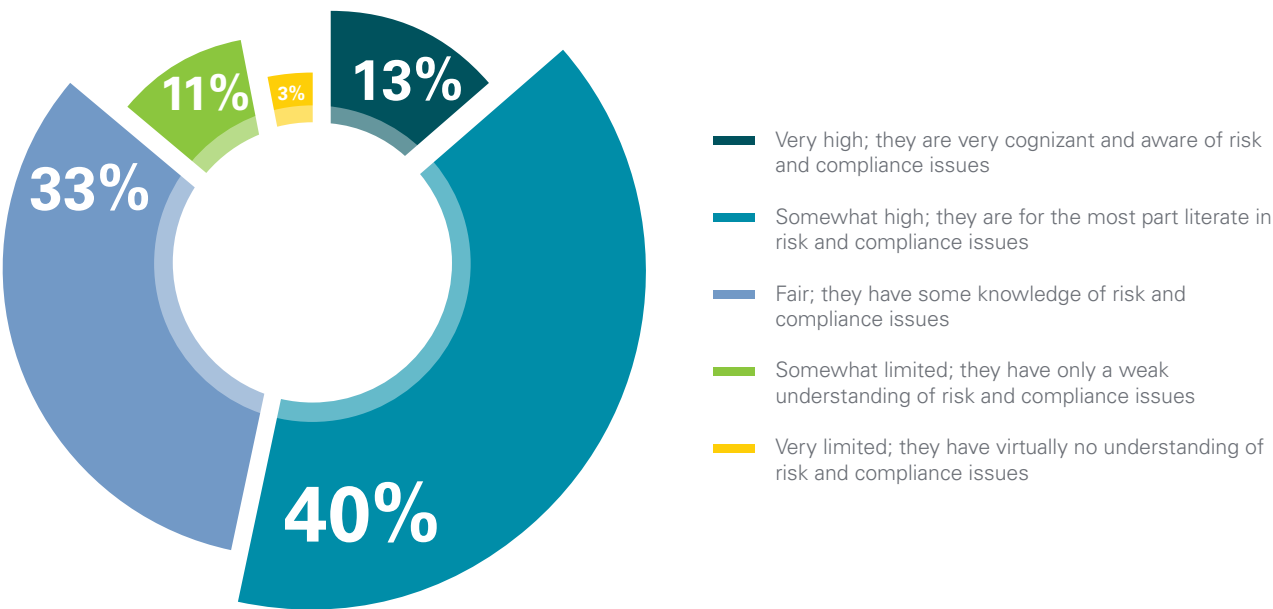
Note: Percentages may not add up to 100% as respondents were instructed to select the top three

Which of the following do you consider to be the most significant barriers to greater convergence of risk and control functions at your organization?



Note: Percentages may not add up to 100% as respondents were instructed to select the top three

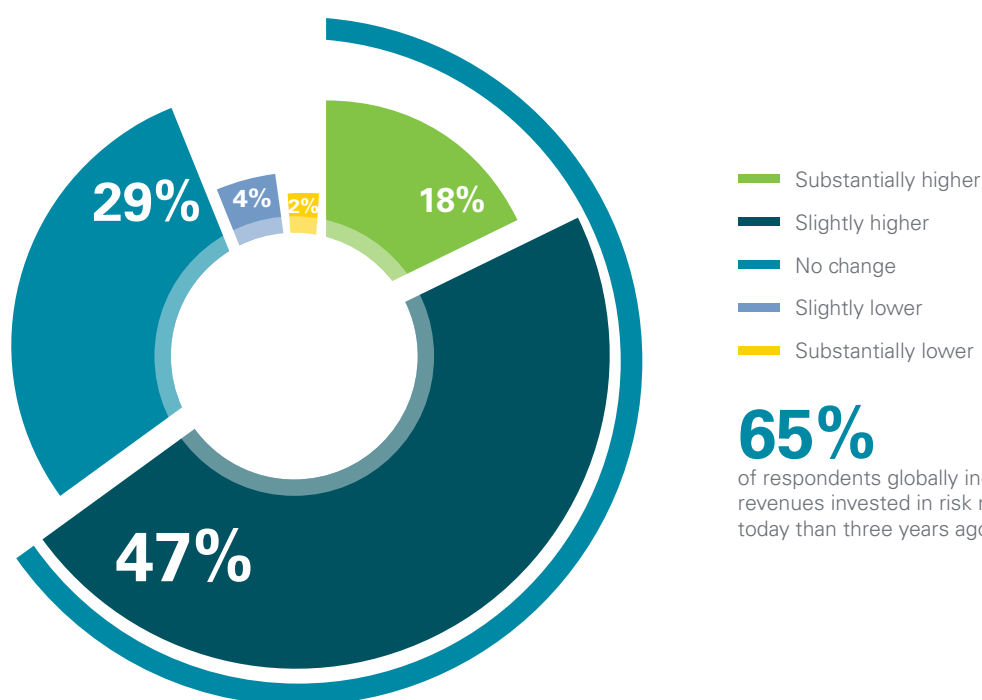
How would you rate the risk and compliance culture at your organization to ensure that employees in all functions are aware of risk when making business decisions?



To what degree is the compensation incentive structures of business line employees (e.g., marketing, sales, etc) at your organization linked to effective risk management?



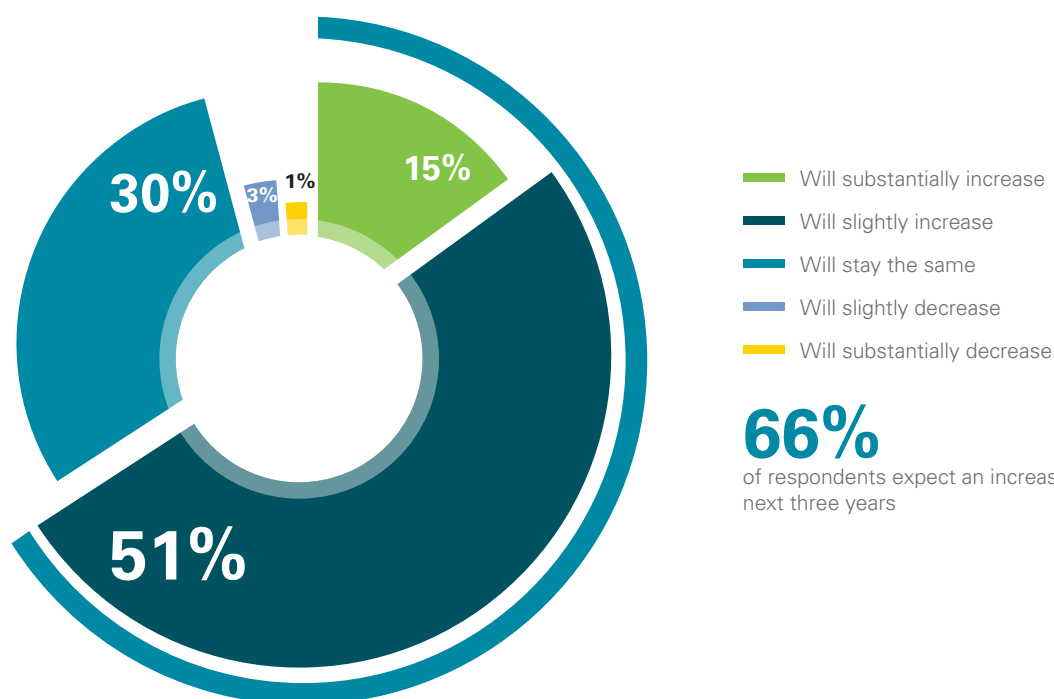
How does the level of investment in risk management (as a percentage of revenues) at your organization today compare to three years ago?



65%

of respondents globally indicate that the share of revenues invested in risk management is higher today than three years ago

How do you anticipate the level of investment in risk management (as a percentage of revenues) will change at your organization over the next three years?



66%

of respondents expect an increase over the next three years





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