Pushing the envelope on competitive advantage

Developing your risk management function for the future

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Risk management has evolved - from compliance monitoring and problem prevention to value enhancement. But to extract the most value from the risk function, organisations need to develop a holistic and commercially minded approach to risk management.

The role of risk management and the risk function has changed dramatically in recent years. Initially risk management was primarily driven by corporate governance and regulatory requirements, with most organisations struggling to extract commercial value from risk management investments. The focus was largely on detection and prevention and on building a framework to manage problems and crises.

Recently, leading organisations have increased the level of maturity and sophistication of their risk management practices to identify key risks and better understand how effective their risk mitigating strategies are in the context of protecting the value drivers and enhancing the overall performance of the business.

Creating real value

So what does it mean to drive greater performance? Ultimately it's about harnessing risk management to help the organisation achieve its strategic goals without taking unacceptable levels of risk that may compromise the future value and performance of the business. And in the current environment, this is more important than ever. The lifespan of an organisation has changed dramatically – disruptive business models appear, employees move around a lot more, capital moves even quicker, networks are more interconnected and expectations from key stakeholders to deliver on strategy are higher.

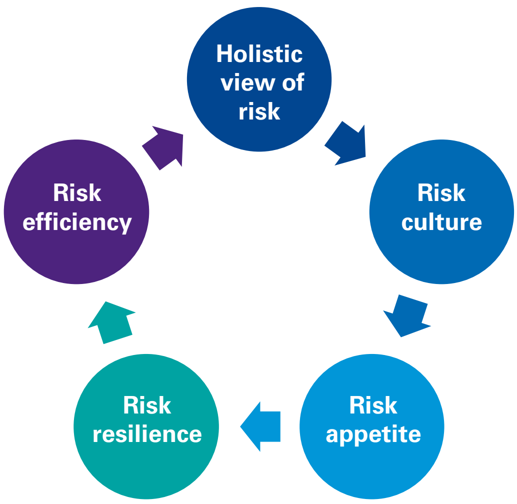
Against this backdrop, the role of risk management has never been more important.

Risk management is central to the performance of a business. Successful organisations that are leading the way and creating real, tangible value out of risk management know this, which is why they have brought the Chief Risk Officer (CRO)/risk function to the heart of the organisation and have positioned it as a key contributor in the strategic decision making process. An enabler of innovation rather than a barrier, the CRO is ideally positioned to create sustainable competitive advantage through effective management of risks as well as harnessing business opportunities.

Risk management is central to the performance of a business.

Leading organisations have strategic risk functions which identify emerging trends, longer-term opportunities and risks to help drive performance and resilience. They ensure that the accountability for continual identification and management of business risks is embedded within the first line of defence (e.g. management) with clear escalation mechanisms. They understand the power of 'conscious risk taking' within the boundaries of the defined risk appetite model of the business.

For organisations that are yet to harness the potential of risk management to deliver their strategic goals, there are five key areas where transformation will help drive organisational performance:



Holistic view of risk

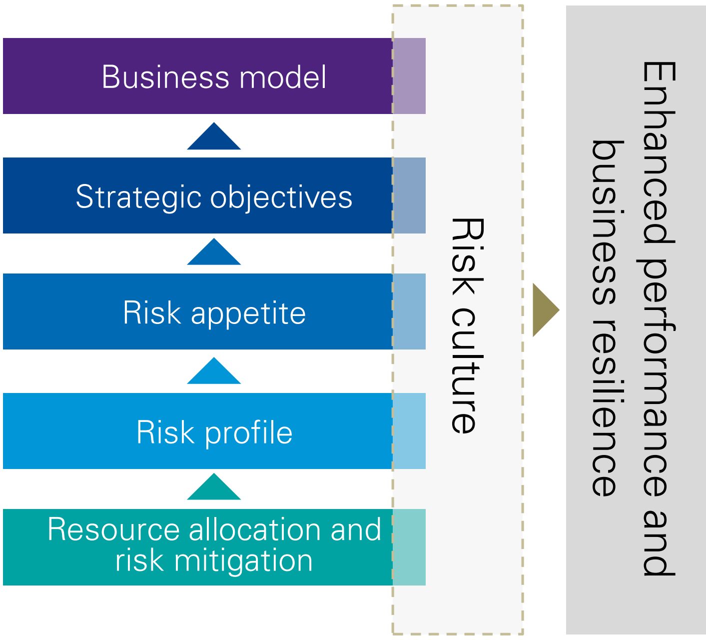
Effective enterprise risk management is fundamental to protecting the value of an organisation and enhancing performance.

This means that Audit and Risk Committees have a renewed focus on establishing effective mechanisms that support management by identifying potential risks and helping manage that risk cost effectively.

Many organisations understand that achieving their strategic objectives is inextricably linked to their ability to manage risk and harness opportunity. But many still struggle to identify those risks and opportunities that truly matter to their company's strategic framework. However, it is encouraging to see that directors and executives are highly engaged in better understanding how effective their risk management activities are, and whether there is an opportunity to optimise the risk management investment and generate more value out of that investment.

Successful organisations use clear indicators to understand their risk management effectiveness and proactively allocate resources to those areas that may compromise the achievement of their strategic objectives.

By articulating risk profiles holistically, and establishing mechanisms to assess the effectiveness of their risk management activities, we help our clients make better-informed decisions that can optimise their risk management investments in the context of an agreed risk appetite.



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Risk culture

Risk culture is the most important control an organisation has.

A robust risk culture empowers all risk management and business activities. So what's driving this focus on risk culture?

- A recognition that organisations need to be risk taking.
- The mechanics of a risk management framework and process will only get you so far.
- People are at the heart of all organisations – they make the decisions.
- Stakeholder expectations around risk culture are changing – especially regulators.

Risk culture has historically been an abstract concept. Questions that organisations keep avoiding include "How risky is your business?" From preventable, strategic to external risks, KPMG has developed a structured approach to tackling this abstract concept based around five key elements:

- Strategy and direction: What are we setting out to do, and how does our behaviour support this?
- Relationships and organisation: Are we structured in a way that allows us to achieve the culture we are seeking?
- Motivation: How do we motivate our people and do we create conflicts?
- Responsiveness: How do we respond to challenges?
- Competency: Do we know what we're doing and do we believe it?

Our approach splits into five activities:

1. Creating the vision: Supporting our clients in articulating what they want their culture to be.
2. Diagnostic: Using a wide range of tools, we can provide high level or detailed diagnostics on where an organisation is currently. By observing both the mechanics and behaviours of an organisation, we can identify the gaps to address to lead clients to the desired outcome.
3. Building the road map: Working with our clients to build a bespoke road map to help them achieve their risk culture vision.
4. Implementation: Working with our clients to meet their target state using our subject matter experts across the firm.
5. Health check and update: Periodically reviewing and updating an organisation's risk culture to ensure that it's aligned with their vision.

What's the benefit of this approach?
Ultimately, organisations that have developed a workforce that consciously thinks about risk when making decisions knows what to do when 'moment of truth' decisions need to be made. When companies have built a clearly defined set of risk behaviours that are understood and embedded, and have developed a risk culture that supports the achievement of their objectives, they get the most out of their risk investments.

Risk culture has historically been an abstract concept.

Risk appetite

Risk appetite sits at the core of the organisation, placing limits on the level and nature of risk that the organisation is willing to accept in pursuit of its strategic objectives.

Defining these risk limits takes the form of a board-approved document – a risk appetite statement. The challenge is that many organisations find this difficult to conceptualise and construct appropriately.

KPMG's structured approach to developing and updating a risk appetite statement includes:

- Running a risk appetite survey: A tried-and-tested set of structured questions for people across the first and second lines of defence.
- Facilitating risk appetite focus groups: Discussion and challenge of the survey responses, to agree key risk dimensions, including the organisation's view of the risks and the possible metrics for measurement of how effectively the risks are being managed.
- Drafting the risk appetite statement: Use the outputs from the survey and focus groups to draft a risk appetite statement for board comment and approval.
- Performing an independent review: Benchmarking the risk appetite statement against those of peers, as well as emerging regulatory expectations.

It's important to ensure that the risk appetite statement demonstrates five key attributes. It must:

1. Set clear boundaries within which executives must manage the business.
2. Be owned and approved by the board, with updates at least annually in line with the business plan and risk management strategy.
3. Focus on key dimensions that drive the risks and opportunities faced by the organisation as it seeks to protect long-term performance and value.
4. Include measurable quantitative or absolute qualitative statements to drive clear and consistent risk and business decisions.
5. Be supported by monitoring, reporting and escalation mechanisms that identify and address unacceptable trends or instances of risk exposures.

A well-constructed and agreed risk appetite statement has a wide range of benefits:

- Enables management and the board to be on the same page when it comes to the level of risk they are prepared to take on.
- Empowers management to make decisions and maximize opportunities within the boundaries established by the board.
- Supports the optimisation of risk management investment and resource allocation.
- Provides data points to assess the effectiveness of treatment plans and the acceptability of risk exposures.

Risk appetite sits at the core of the organisation.

Risk resilience

Risk resilience is the ability and capacity of an organisation to protect competitive advantage from external stresses and shocks.

It's a measure of how much disturbance an organisation can handle without losing functionality. External stresses and shocks are risks that threaten widespread disruption or the collapse of physical or social systems within the operation of an organisation. Examples of stresses include the consumption, availability and affordability of energy and fuel, while shocks include natural disasters such as cyclones. By addressing both stresses and shocks, organisations become more able to respond to adverse events, and will therefore have better ways to deliver basic functions on an ongoing basis.

Key drivers for greater risk resilience include increasing economic losses from global shocks which, in turn, are decreasing affordability of insurance premiums due to increased costs and reduced cover. Coupled with this is a growing economic imperative to proactively invest in risk resilience to avoid disruption to market dynamics, and increase investor expectations for disclosure of such resilience planning and preparedness.

As such, organisations need to understand how external stresses and shocks are creating vulnerabilities within their systems and then determine how they can be adapted to improve their resilience.

Our approach considers how relevant external forces are connected and overlap to influence each other. By clustering related risks together, it's possible to address the interconnectivity of the risk drivers that are most central and have the greatest impact on the ability of organisations to withstand, recover and adapt. Identifying the most highly connected risks helps to inform organisations in the prioritisation of resilience effort and investment.

How much disturbance can your organisation handle without losing functionality?

Risk efficiency and optimisation

While most companies today have a risk function, there is significant pressure from boards and the executive to ensure that the risk function's operations are lean and making the best use of limited resources.

KPMG has developed a framework where we analyse, assess and measure the current value of a company's risk function. Working with directors and management, we construct a risk approach which assesses the target operating state of the risk function and together we develop an action plan to reach optimal size and breadth of operations for the risk function.

KPMG has developed a five-step approach to deliver an efficient and optimised risk function:

1. Conduct a risk management maturity assessment on the current state of the risk management function.
2. Compile a risk analytics survey to determine what is the target state of the company and the risk function.
3. Develop a risk diagnostic report outlining gaps between the current state and target state.
4. Create a strategic risk efficiency report outlining options to reach the target state.
5. Realign the company's risk appetite and tolerances following decisions taken in the strategic risk efficiency report.

There are a myriad of benefits to this approach. If a business improves risk efficiencies, less capital is required to support it and therefore a more positive, productive future will inevitably lie ahead. Other benefits include using the risk target operating model for comprehensive coverage and thresholds for all key financial and non-financial risks, and a more confident view and approach to risk- taking with an integration of risk data from all operational business units.

Ultimately, the future of risk management lies in maintaining the prevention mind set, but extending the function towards value creation through a more holistic approach. Creating a conscious risk taking environment where everyone understands what risks to embrace and how to fully leverage the risk management investment will deliver a far better outcome than a simple focus on prevention

Creating a conscious risk taking environment will deliver a better outcome.

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