Enterprise Risk Management

Building greater business resilience

Helping organizations to understand and profit from the risks they face

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The challenges and the rewards of risk

Every organization seeks to protect its people, property and profitability. Yet, taking risks is a necessary part of growing a successful business. If an organization acts too cautiously or is adverse to risk, then it may fail to grow. The challenge is to find the best balance between risk and reward and to be consistent in the approach to managing risk, so opportunities are not missed and potential threats are mitigated.

Having a robust and flexible framework in place for managing risk enables organizations to achieve their desired balance of risk and reward. Enterprise Risk Management (ERM) is one such framework. Corporate directors and officers use ERM to link strategic planning and capital allocation processes with the risks that could stop their businesses from meeting strategic and operational goals. An ERM framework allows organizations not only to manage disruptive risks but also to leverage the right risk as an opportunity for creating value.

This white paper outlines the risks businesses face and explains why the ERM framework is a useful tool to help tackle them. It provides details about the way ERM can be applied in an organization and the benefits of ERM, as well as an explanation of Zurich Total Risk Profiling™, a well-established ERM diagnostic tool that can help to identify gaps in risk management and align priorities to drive a successful ERM transformation.

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What is Enterprise Risk Management?

ERM is an approach to business management that considers the risks an organization faces across all its functions, and including all types of risk. By taking such an holistic view, management can prioritize the risks and ensure the effort is aligned to the most material risks. This approach supports strategic and operational decision-making.

There are a number of standards that are designed to support an ERM framework. The standards include ISO 31000 and Committee of Sponsoring Organizations of the Treadway Commission (COSO). These are generic standards that provide principles that may be applied to all businesses. The challenge is to find an appropriate application to each specific business that supports the business in achieving sustainable value creation.

The risks that businesses face

Businesses of all sizes face a wide range of risks that can change regularly. There are risks related to an industry sector, issues arising from the economic or market environment, risks specific to an organization's activities, and challenges linked to meeting regulatory and legal requirements.

Some risks can be anticipated, but many are harder to predict or happen unexpectedly. What is certain, however, is that organizations often fail to recognize the risks they may face, and many not have an effective way of managing those risks.

A lack of risk awareness

More than two-thirds of business executives interviewed for a report by Harvard Business School* in 2011, sponsored by Zurich, said risk management had increased in importance since the recession. But most executives felt their companies still had a long way to go to build an effective, risk-aware culture. Only one in 10 thought that their executive management was 'highly effective' at creating a 'stronger risk-aware culture'.

In today's complex commercial world, risks to businesses include:

- complex global supply chains
- dependence on technology
- complicated financial models and relationships
- the need to bring products to market as quickly as possible
- compliance and regulatory changes
- social media
- corporate and social responsibility.

Understanding risk across your business

Threat to capitalization

Poor risk management can pose a serious threat to a company's shareholder value and capitalization. A study by the Corporate Executive Board** in 2005 found that strategic risk was cited as a contributing factor behind a 63% decline in the market capitalization among Fortune 200 companies.

There is a complex interaction between the positive and negative aspects of risks. Understanding this connectivity and having the tools to manage risk can be best achieved with an enterprise-wide risk management framework in place to map and to manage risk exposure.

The impact of risk on business performance

Failure to anticipate and address risks or events that could have a negative impact on an organization can have serious consequences. If risks are not managed, customers – and reputations – can be lost due to a broad variety of issues such as:

- You could lose market share if you are unable to provide products or services due to a supply disruption.
- Key assets can be put in jeopardy from poor maintenance, a strike or a natural catastrophe.
- An organization may not survive if it cannot operate an important asset for a prolonged period or if it does not have a backup continuity plan in place.
- There may be more difficulty meeting national and global environmental standards, which can lead to fines or loss of trade if products have to be withdrawn, for example, factory emissions, transportation or packing materials.

Companies should think about risk as often as they think about value, because the two are intimately related. The long-term impacts of risk on businesses can be felt financially in terms of lost profit or a fall in share price if they are not managed or mitigated. Once a business has suffered losses through poor risk management, it can take a long time to recover, which may damage its future performance.

The benefits of Enterprise Risk Management

Organizations that use ERM are better able to consider the potential impact of all types of risk that affect:

- processes
- products
- services
- activities
- stakeholders.

ERM sets out a structured framework for an organization to identify, rank and control the risks it faces. By doing so, it can be more resilient and better prepared to adapt to changing conditions. Businesses use ERM to take advantage of opportunities, anticipate events and recover more quickly when disruption occurs. In addition to helping a firm to understand common and known risks, ERM allows organizations to get ahead of unexpected and emerging risks.

Respondents to the Corporate Executive Board study** identified the top five impacts that an ERM programme can have on business resilience:

59%	Increased profitability
62%	Reduced earnings volatility
86%	Better risk-based decisions, based on learning from risk information and from previous mistakes
80%	Increased management accountability and shareholder confidence
79%	Smoother governance practices

The Harvard Business School report* reinforces this view, highlighting the broader business benefits of having ERM framework as improving strategic decision-making, governance and management accountability.

Other benefits of having an ERM framework include identifying growth opportunities by identifying and measuring positive risk, meeting regulatory and legal requirements and being able to make better-informed business decisions.

A good ERM approach looks at risk from all angles. This type of '360 degree' process helps organizations to meet their strategic objectives and build greater resilience to risk.

Practical examples of how ERM benefits businesses

A number of specific operational and strategic activities can be enhanced using ERM and Zurich's Total Risk Profiling™ tool (see below), including:

Freeing up working capital

Over the past ten years, Zurich has strengthened its own risk management capabilities by introducing an operational risk management framework into its ERM programme. This improved ERM process provides us with risk management tools to specifically identify, assess, manage and quantify operational risks.

As a result, Zurich's operational risk capital efficiency has improved. One Zurich business unit experienced a reduction of 21.7% in operational risk-based capital consumption. The operational risk capital not consumed was then available to fund other profitable growth initiatives for Zurich.

Mergers and acquisitions

ERM can help businesses to identify and understand the risks associated with merger and acquisition strategies. This can increase the likelihood of success by highlighting vulnerabilities and risk triggers that could cause difficulties after the merger or acquisition.

Warning signal for Key Performance Indicators

Key Performance Indicators (KPI)s help organizations see how well they are performing in relation to their strategic objectives or project goals. Yet, KPIs are lagging indicators of performance. Analyzing Key Risk Indicators (KRI) at the same time can provide early warning of potential risks that may have an impact on KPIs. These Key Risk Indicators are leading indicators that can support a company in getting ahead of risks.

Managing new projects and product development

ERM can be used to evaluate various risk scenarios so organizations are able to deliver projects or develop products on time and on budget. This is particularly useful when considering outsourcing activities or using third-party partners.

ERM helps businesses meet regulations

In many countries, ERM is recognised as a key indicator of the stability and reliability of a business. In the US, for example, the New York Stock Exchange requires the disclosure of information that describes the impact of compensation policies on risk taking and expects corporation audit committees to take account of risk management.

The Security and Exchange Commission (SEC) requirements for Boards

Sarbanes-Oxley accounting requirements expect US publicly listed corporations to have a control framework for internal controls. Many include risk assessment in this framework. In addition, ratings agencies such as Standard & Poors and analysts regularly assess ERM processes as part of their evaluation of an organization's credit rating.

The International Standard for Risk Management (ISO 31000), published in 2009, provides useful principles, a framework and a process for managing risk for organizations of all sizes.

The International Organization for Standardization (ISO) points out

"Risks affecting organizations can have consequences in terms of economic performance and professional reputation, as well as environmental, safety and societal outcomes. Therefore, managing risk effectively helps organizations to perform well in an environment full of uncertainty."

Who should be responsible for risk management?

Risk management should not be the responsibility of a single person, nor should it be restricted to a single department or business unit. To be most effective, risk management has to involve people across an organization, who share critical information so better informed decisions can be made about accepting or mitigating risk. Individuals who can contribute to building up a clear picture of risk range from senior executives to people operating equipment or managing processes, as they will be most familiar with 'front line' risks.

According to the Harvard Business School report*, the barriers that many organizations face in creating to a proactive, risk-aware culture, include:

- excessive focus on compliance rather than fundamental processes
- a lack of strong management support
- a reluctance to share information about risk across departments and divisions.

The output of ERM ought to be communicated clearly and regularly by those responsible for risk management. An organization benefits from being transparent about the risks it faces and the actions required to mitigate the risks.

A high level of transparency, internally and externally, helps employees, stakeholders and regulatory bodies feel more comfortable about the approach to risk management.

It is also important to monitor progress in both the functioning of the ERM framework and the effectiveness of risk treatments. Zurich, for example, uses various reports to communicate its risk profile to senior management and the board. Zurich has also developed a 'grading' of its risk process maturity, which can be helpful to find areas for improvement and benchmark internally and against standards such as ISO 31000 and COSO.

Zurich ERM Diagnostic Healthcheck benchmark to ISO 31000 and COSO

Structure based on ISO 31000 standard

Key indicators	Points available	Points earned	Percent	Letter earned	Number scored by section: A	B	C	D	E
A. Internal environment	112	105	94%	A	A				
B. Objective setting	42	37	88%	B		B			
C. Event identification	36	36	100%	A	A				
D. Risk assessment	72	70	97%	A	A				
E. Risk response	42	32	76%	C			C		
F. Information and communication	36	30	83%	B		B			
G. Monitoring and control activities	42	40	95%	A	A				
Overall total	**340**	**310**	**91%**	**A**	**3**	**2**	**1**	**0**	**0**

Total Risk Profiling™ – Zurich's ERM tool to enhance risk capability

Total Risk Profiling™, or TRP, is Zurich's ERM methodology that helps strategic risk managers to embed repeatable risk assessment processes into their business. TRP is used to build a more risk-aware culture and improve business decision-making by identifying and quantifying risk exposures early and encouraging the best mitigation strategies in order to reduce or eliminate risks.

TRP can enable organizations to answer these important risk-related questions:

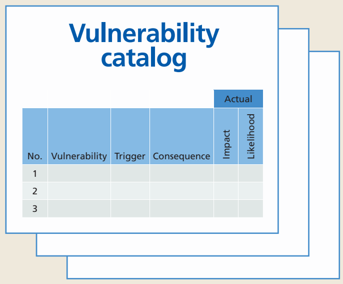
- How can we deal with risks that we may not yet know about?
- How can we prioritize and budget resources to help us reduce risk?
- What is our risk appetite – the amount of risk we are prepared to take in order to achieve our business goals?

The Total Risk Profiling™ process

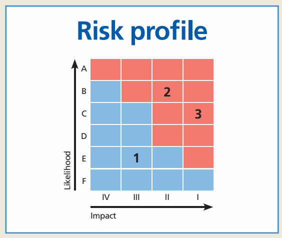
TRP begins with a customer workshop that develops risk scenarios and a profile for an organization and establishes how it rates various risks. A 'tolerance boundary' is established that shows the limit of the organization's risk appetite. Risks can then be prioritized and action plans developed to reduce the highest risks and bring them down within the organization's tolerance boundary.

TRP helps organizations to take a holistic approach to managing risk:

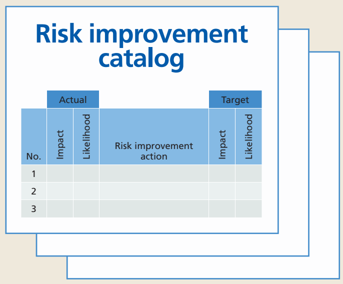
Vulnerability identification and assessment



Risk mapping/ Risk tolerance boundary



Risk reduction/ Risk improvement advice



Conclusion – risk is a threat and an opportunity

By using an Enterprise Risk Management framework, organizations can better identify gaps in managing critical risks that may harm operations, and also identify positive risks that are opportunities for success.

Research shows that, while many organizations recognize the importance of risk management, not all are confident they are doing to enough to avoid the damage of risk or seize the advantages from taking risks. Studies also identify a number of clear business benefits from using ERM.

Organizations that have embedded a robust ERM framework are typically characterized by:

- integrating risk management in the strategic planning process and as part of KPI reporting
- measuring, quantifying and monitoring risk to encourage more transparent risk reporting
- detecting risk earlier to support more effective mitigation
- experiencing fewer risk-related incidents
- minimizing barriers to achieving their business objectives
- reducing the cost of capital to improve shareholder value and improve their credit ratings.

According to the 2012 study by Federation of European Risk Management Associations

Key questions about your organization's resilience to risk

- What direction will your company be heading in during the next three to five years?
- What are your company's strategic objectives and what challenges are preventing you from achieving them?
- What risks related to your business strategy and operations concern you the most?
- How do you think risk management helps you to increase the likelihood of achieving objectives?
- How do you intend to meet the challenge of emerging risks and resilience issues that might affect your business plans?

For more information visit www.zurich.com

Sources

* Harvard Business School report, sponsored by Zurich, Risk Management in a Time of Global Uncertainty, available to download from www.zurch.com

** 2005 Corporate Executive Board study

Other sources:

Enterprise risk management: A critical tool for decision-making, Zurich and SGS

Enterprise Risk Management Tools Create Shareholder Value, By Linda Conrad, Zurich Director of Strategic Business Risk, Kristina Narvaez, President of ERM Strategies, LLC, and David Shluger, Zurich Strategic Risk Consultant

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