Five ways to avoid Armageddon

WITH THE FREQUENCY AND IMPACT OF CATASTROPHIC RISK EVENTS RISING, ORGANISATIONS NEED TO ENHANCE THEIR RISK RESILIENCE. **RICHARD SYKES** EXPLAINS HOW.

In an increasingly global business world, organisations need to enhance their risk management frameworks to improve resilience to unexpected shocks. The risk landscape is changing, and the business world has become increasingly complex and interconnected, creating new risk management challenges.

Board members identify three main shifts in the risk landscape. First, they feel that the risk frameworks and processes they have in place no longer give the level of protection needed.

Second, they see increases both in the speed with which risk events take place, and the extent to which their impacts on the business become contagious – spreading across different risk categories. The speed and contagion of catastrophic risks that can threaten an organisation's existence are a particular concern.

Third, boards sense they are spending too much time and money on running their current risk management processes, rather than being able to identify and tackle new risks quickly and flexibly. Some have doubts about whether their spending on enterprise risk management (ERM) frameworks is fully justified by the level of protection gained.

Underlying these concerns is an awareness of the increasing frequency and impact of "black swan" events, which can hit businesses without warning with potentially devastating effects.

Given these concerns, this article offers five steps to take to boost the organisation's risk resilience and move towards an "ERM-plus" approach.

1. CONSIDER RISK ACROSS THE THREE CORE CATEGORIES
Remember that alongside financial and operational risks, organisations are exposed to strategic risk. This is the area that businesses traditionally have paid less attention to. Strategic risk may spring from a failure to respond to shifts in the external economic, political or regulatory environment, and includes legal and compliance risks. It could also result from changes or flawed risk assumptions in the organisation's strategy.

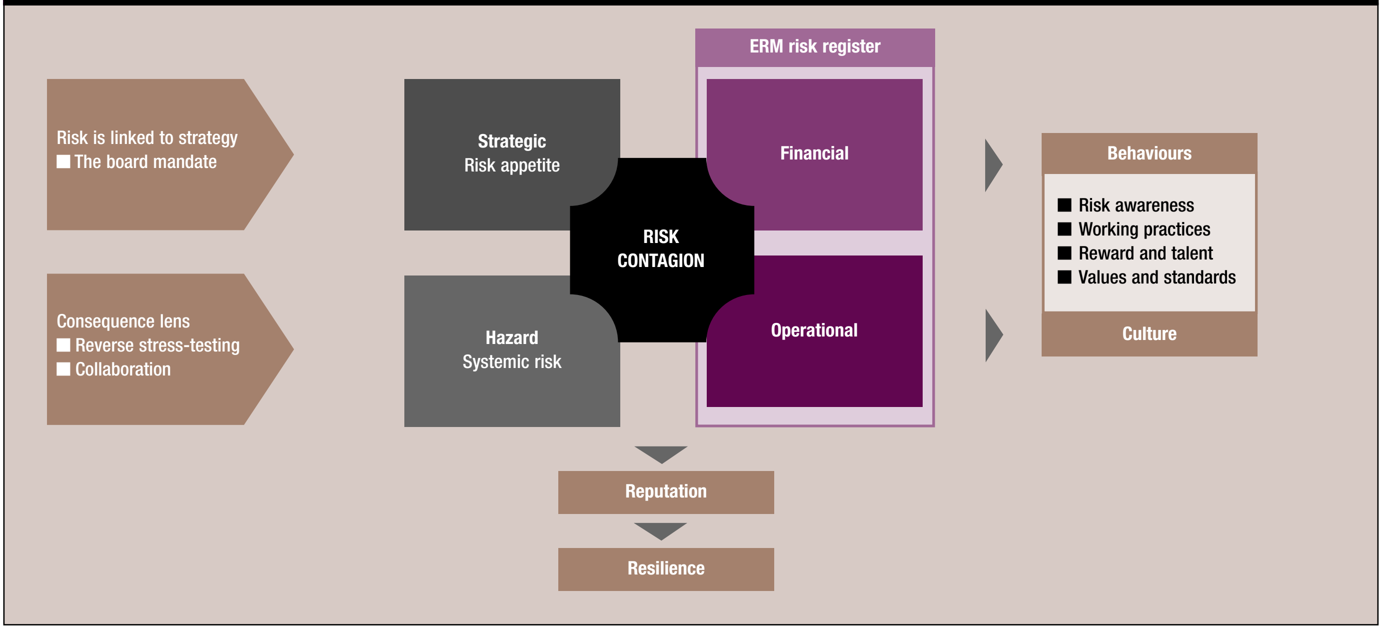
You also need to understand the linkage and interdependencies that exist between financial, operational and strategic risks. Looking at each category in isolation from the others could leave gaps in your organisation's armour.

2. UNDERSTAND CONSEQUENCES Identify how you can enhance your existing risk management framework and achieve ERM-plus through adding tools and techniques such as scenario modelling, predictive indicators and, in particular, reverse stress-testing.

The reverse stress-testing approach effectively accepts that it is no longer possible to forecast events themselves, and instead focuses on managing their knock-on effects or consequences. For example, an airline might test the impact of most of Europe's airspace being closed down (as happened with the volcanic eruption in Iceland in 2010). Such reverse stress-testing can be an effective way of focusing on extreme events and protecting organisations against "unknown" risks.

3. DEVELOP A RISK-AWARE CULTURE The organisation needs to move beyond merely identifying, measuring and prioritising the various risks it faces, and towards a broader focus on the resilience of whole systems within which it operates and contributes value. These include the organisation's industry, political and financial environments. This means progressing from explicit risk controls to a risk-aware culture in which risk

Figure 1: The role of the board



is managed in a co-ordinated way across different interests, organisational units and external relationships. Risk management should not be seen as the preserve and responsibility of risk professionals, but as a vital issue for every employee.

Actions by one individual can inflict huge damage on any organisation. An employee negotiating a supplier or customer contract in an emerging market needs to be aware and incentivised around not only commercial risks (such as price and fulfilment), but also ethical and legal risks such as child labour, environmental protection and money laundering.

ENCOURAGE YOUR BOARD TO BE MORE EXPLICIT ABOUT THE ORGANISATION'S RISK APPETITE, AND THEN BUILD AWARENESS AT ALL LEVELS OF WHAT RISKS IT IS WILLING TO BEAR.

4. FOCUS EXPLICITLY ON RISK APPETITE The uncertainty of today's environment means that just analysing historical data is no longer a reliable way of predicting future events and impacts. Overwhelming boards and audit committees with risk information can actually hamper understanding of key risk issues. Instead, you need to encourage your board to be more explicit about the organisation's risk appetite in pursuing its strategy, and then build awareness at all levels of what risks it is willing to bear. Greater clarity on risk appetite can aid board effectiveness; non-executives, for example, sometimes criticise executives on their boards for being too cautious in terms of risk.

5. ALIGN RISK AND STRATEGY Champion the alignment of risk and strategy – a key requirement for enhancing your organisation's risk resilience. The board needs to take the lead by clearly articulating its attitude to integrity, risk and safety, linking this to its view of the organisation's environment, culture and value proposition in a "board mandate". In this way the board will be taking a more holistic view of risk management, and the interplay between risk appetite and strategic goals.

Figure 1 tries to capture this within one overall framework. Financial and operational risks are the prime focus of the ERM system, risk and strategy are linked through the use of risk appetite, and systemic risks can be better understood through the use of the consequence lens.

If the behaviour and the culture of the organisation are also aligned with the focus on risk and strategy, then the organisation's ability to preserve its reputation and strengthen its resilience will be enhanced.

Aligning risk and strategy can help the organisation strengthen its relationships with external stakeholders, enabling the board to communicate more clearly how the business is positioned to withstand nasty shocks, including "grey swan" events.

The risk landscape is changing, and established risk management approaches need to be updated to keep pace. Many organisations currently have the wrong focus. They major on financial and operational risks and, crucially, regard risk and strategy as separate, rather than seeing risk-taking as a key source of value creation. But the world where risk events could be predicted – and their impacts controlled – is fast disappearing.

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PwC's report, Black Swans Turn Grey: The Transformation of Risk, is available at: http://bit.ly/yL5xiB