Global Emerging Risks Survey

Steering the Course, Seizing the Opportunity

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Emerging Risks:
Steering the Course, Seizing the Opportunity

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Introduction

Alex Wittenberg, Managing Partner, Global Risk Research Center
Oliver Wyman

Three years since the financial crisis started, 71% of recently surveyed executives still view global recession as the greatest risk to their businesses. More than half are also concerned about volatile financial markets, the credit crunch, and an ever-changing regulatory environment.

Given how profoundly companies have been affected over this time frame, we wanted to examine how executives view, and are preparing for, a much more complicated and volatile risk landscape. To achieve this goal, Oliver Wyman collaborated with FT Research to conduct the second global survey of senior executives on the state of their risk management practices. The 650 respondents all worked for global companies with revenues in excess of $1 billion. The survey was supplemented with individual interviews and a series of roundtable discussions held in New York, London, and Hong Kong that concluded in April of 2010.

We discovered, through our research, that senior executives are still struggling to manage emerging risks. We define emerging risks as both new risks, such as this year's eruption of volcanic ash in Iceland, and familiar risks in unfamiliar conditions, as when volatile commodity prices suddenly become some of the largest costs for businesses such as airlines and consumer products manufacturers. While most executives surveyed have made significant investments to strengthen their organizations' processes to detect and evaluate emerging risks, they continue to view their firms as "ineffective" or only "moderately effective" at integrating analytics around such risks into their strategic and operational decision making.

This study highlights several reasons why executives still experience a serious disconnect between their approaches to assessing emerging risks and effectively using this information to make better business decisions:

- Many organizations continue to rely on basic, "static" risk analytics and tools rather than multidimensional approaches that take advantage of a wide range of outside data. They do not make sufficient use of more robust risk management tools such as probabilistic modeling and scenario analysis. As a result, their businesses are poorly equipped to derive necessary insights, leaving them potentially vulnerable to a wide range of sudden shocks.
- Many key decision makers receive information about emerging risks on an inconsistent basis. That makes it difficult for them to evaluate changes that have occurred from one period of time to the next or to be informed of emerging external trends in the marketplace.
- Only half of executives surveyed integrate emerging risk information into their strategic planning process.

Many of the current approaches to managing emerging risks do not provide companies with the information they need to act on insights from risk data. Going forward, executives must focus on developing the analytical capacity and tools to understand the potential business impact of emerging risks on their corporate performance.

At a time of systemic uncertainty and volatility, we hope this report assists your management team in developing the critical capability of transforming risk data into business insights for risk-adjusted decision making.

Alex Wittenberg
August 2010

Alex Wittenberg is the Managing Partner of Oliver Wyman's Global Risk Research Center, with over 20 years of cross-industry experience in risk management advisory and risk transfer solutions. Alex specializes in integrating risk into strategic decision making and financial performance, designing risk governance for Boards and Management, and developing corporate risk monitoring, mitigation and transfer frameworks.
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Foreword

by Gillian Tett,
US Managing Editor, the *Financial Times*

What will be the next big risk to hit the global economy? That is the question which business leaders and politicians often pose these days.

No wonder. In the last six months, there has been growing evidence that the global financial system has stabilised following the tumultuous banking shocks of late 2008. The world economy has also rebounded, while on the geopolitical front, events in 2010 – so far – have hitherto been relatively calm.

Never the less the current business climate of 2010 remains marred by a sense of fragility and vulnerability, as far as many business leaders are concerned. Instead of rejoicing too visibly in the rebound, in other words, many executives appear to be warily watching for the next potential shock. Nagging unease and uncertainty appears to be the order of the day.

There are at least two reasons for this. Firstly, the actual outlook for the global economy does certainly look unusually hard to predict right now. During the last year, Western leaders have managed to stabilise the banks and avert a global depression by pouring an unprecedented quantity of liquidity into the world's financial system. The International Monetary Fund, for example, estimates that some $11 trillion of funds was earmarked to prop up the financial system, a sum almost equivalent to the size of the entire US economy.

But while lavish public spending might have bought some economic peace, what is crucially unclear now is whether this government support can be withdrawn without triggering new shocks. After all, the Western world has never tried to implement an exit strategy before on quite such a gargantuan scale. Nor does anyone know whether it will be possible for the Western world to pay down its swelling volume of public sector debt, without triggering inflation, default – or extreme political tension.

These extreme uncertainties are occurring alongside another set of "unknowns", triggered by a longer-term shift of geopolitical and economic power to the East, as the economies of countries such as China continue to boom. Taken together, then, the global economic system is now in uncharted territory – and it is utterly unclear how its political systems will respond.

The second reason for the gnawing sense of anxiety among many executives lies with the events of the last two years: namely, that the shocking bank collapses of 2008 have left business leaders with a heightened awareness of risk. Before the financial system came to the very brink of collapse in late 2008, most Western leaders had never seen with their own eyes a world that was facing genuine systemic collapse. After, the climate of the second half of the 20th century was a relatively benign one in the West, and what shocks occurred tended to be idiosyncratic, not systematic, in nature.

Now executives have confronted the possibility that a banking system could fail. They have also seen once-unthinkable events occur, such as the failure of Lehman Brothers. That has taught them a lesson they will not easily forget, namely that unpleasant, and supposedly rare events, do sometimes come to pass. "Fat tails", to use the statistical jargon, exist. As a result, many executives no longer feel the type of complacency or confidence about the future that they once did. The world now seems a far more uncertain place.

That makes for unnerving times. However, it also – might possibly – mean that executives will be better prepared for what the future now holds. Either way, don't expect this new mood of gnawing unease to vanish soon. Risk will remain firmly on the business radar screen during 2010.

Gillian Tett
August 2010

Gillian Tett is the US managing editor of the Financial Times. She leads the editorial development of the paper's US edition and of US news on FT.com. Ms Tett was named Journalist of the Year (2009) and Business Journalist of the Year (2008) by the British Press Awards and Senior Financial Journalist of the Year (2007) by the Wincott Awards.

Survey Overview

Responding appropriately to new developments in an ever-changing risk landscape is crucial to an organization's performance. To do so successfully, companies must develop the capabilities and the tools to correctly identify and analyze emerging risks.

Oliver Wyman and FT Research have conducted a joint examination of how large multinational corporations track and apply such crucial information to their businesses. Several years since a subprime mortgage meltdown first triggered the financial crisis in July of 2007, the goal of this survey is to determine whether global corporations show an increased ability to effectively identify and analyze emerging risks.

This study explores how 650 executives at companies around the world with $1 billion or more in revenues handle risk management from two perspectives. The first part examines what executives consider to be their key emerging risks over the next 18 to 36 months. The second part looks at the evolution of companies' risk management practices and their continued struggles to identify and assess emerging risks. At the end of the report, we make five recommendations for senior executives to improve their management of emerging risks. There is also a check list of questions to help executives, boards of directors and risk managers to evaluate their current emerging risk management analytics and processes. The survey was conducted from November 2009 to January 2010.

Key Findings

- Nearly all respondents report that their companies have increased resources devoted to identifying and assessing emerging risks in the past year.
- Yet 62% of senior executives surveyed rate their companies as only "moderately effective" or "ineffective" at integrating risk information into ongoing business decisions.
- Less than 10% of respondents are focusing on potential threats that are seemingly unrelated to their businesses like climate change and pandemics.
- Nearly one-third of executive committees and members of boards of directors receive information on emerging risks on an inconsistent basis.
- Half of strategic planning groups are infrequently informed of emerging risks.
- Nearly one-third of respondents consider their biggest challenge to be aligning risk data to strategies and operations, while one-quarter believe their greatest difficulty is securing appropriate resources to manage emerging risks.
- More than half of the companies that have focused efforts on improving risk analytics believe they are very effective at integrating and applying risk data.

Definition of Emerging Risk

It is difficult to identify and analyze emerging risks, in large part because of their inherent characteristics. In this report, emerging risks are defined as "new" risks or "familiar risks in new or unfamiliar conditions." [1]

Emerging risks present the following challenges to decision makers:

- Many are perceived to be potentially significant, but they may not be fully understood.
- Their consequences cannot be clearly defined in monetary terms.
- Conventional approaches to projecting their relative frequencies, their probability distributions over time, as well as the severity of the resulting losses and other consequences may be ineffective.
- It is difficult to establish causality between the source of the emerging risk and its consequences.
- They are typically outside of an organization's control.
- They may be systemic, as with climate change or the aging population.

1. Emerging risks: sources, drivers and governance issues, International Risk Governance Council. Revised edition, March 2010.

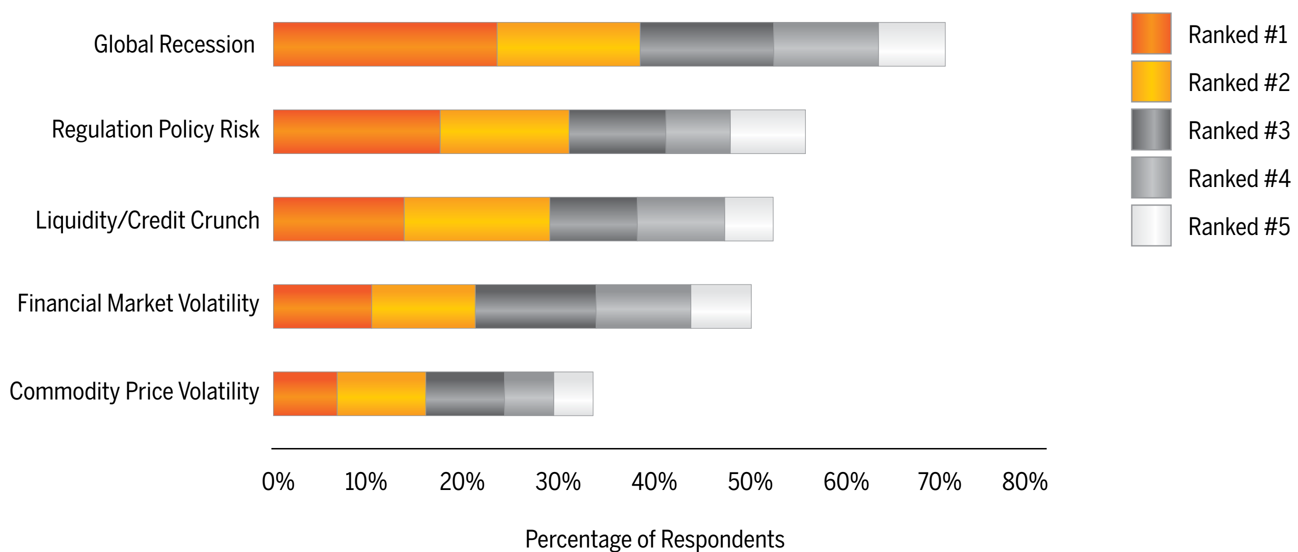
The Survey

The Financial Crisis Fall-Out

Several years after the financial crisis began, executives continue to consider global economic recession their biggest risk over the next 18 to 36 months. Nearly one-quarter of respondents selected recession as the biggest risk to their company. Seventy-one percent of executives listed global recession as among their top five concerns.

Executives cited regulatory policy as their second-largest risk. While regulatory changes involving the financial services and health-care industries seem to dominate the news, this survey shows that there is widespread concern over regulatory changes across all industries. Fifty-six percent of respondents listed regulatory risks as one of their top five concerns.

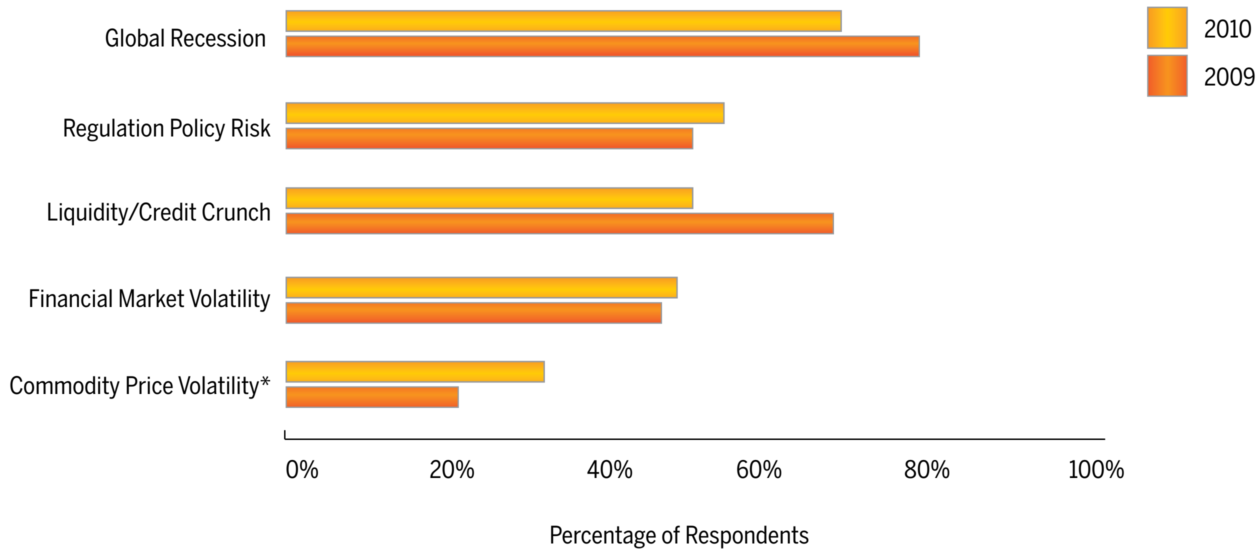
The Top Five Perceived Global Emerging Risks



> **"There's more complexity and there's less hope about the future, because of all this re-regulation or regulation..."**
>
> –Chief Risk Officer, Construction Sector

Overall, executives are less concerned about global recession than they were in 2009. Our research also reveals that their unease has spread to risks related to other aspects of the fall-out from the financial crisis. In spite of many efforts to prop up the global economy, executives are now more worried about the risks to their businesses posed by volatile financial markets and regulatory risks than they were in 2009.

The Top Five Perceived Global Emerging Risks: 2009 vs. 2010

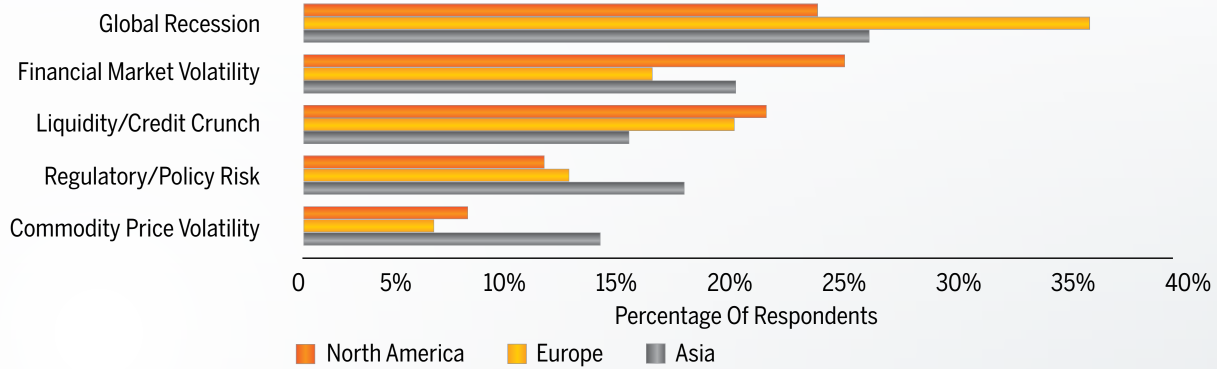


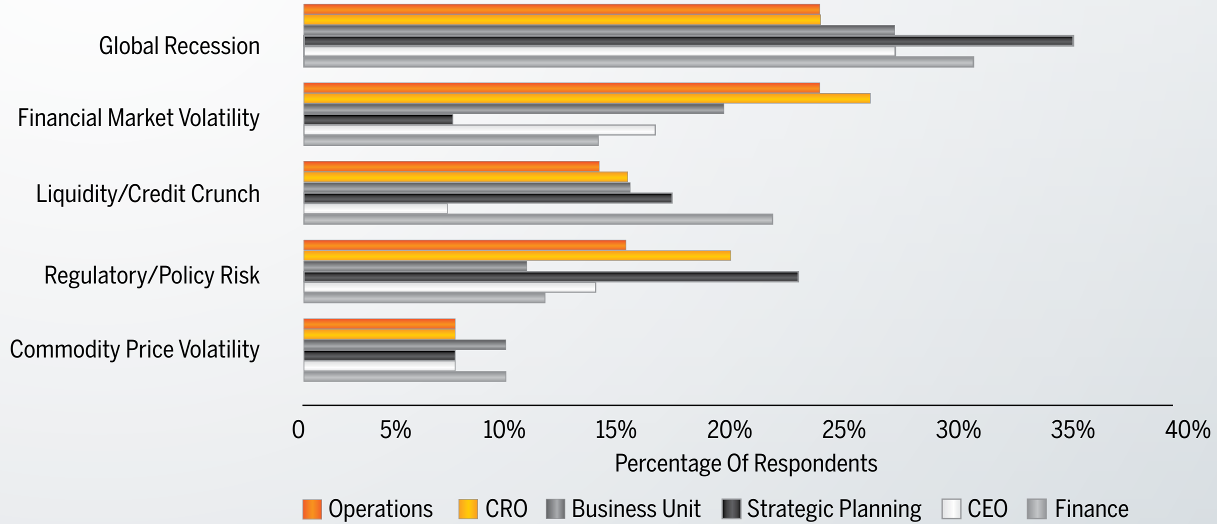
**In 2009, Commodity Price Volatility was the sixth-ranked perceived emerging risk noted by survey respondents.*

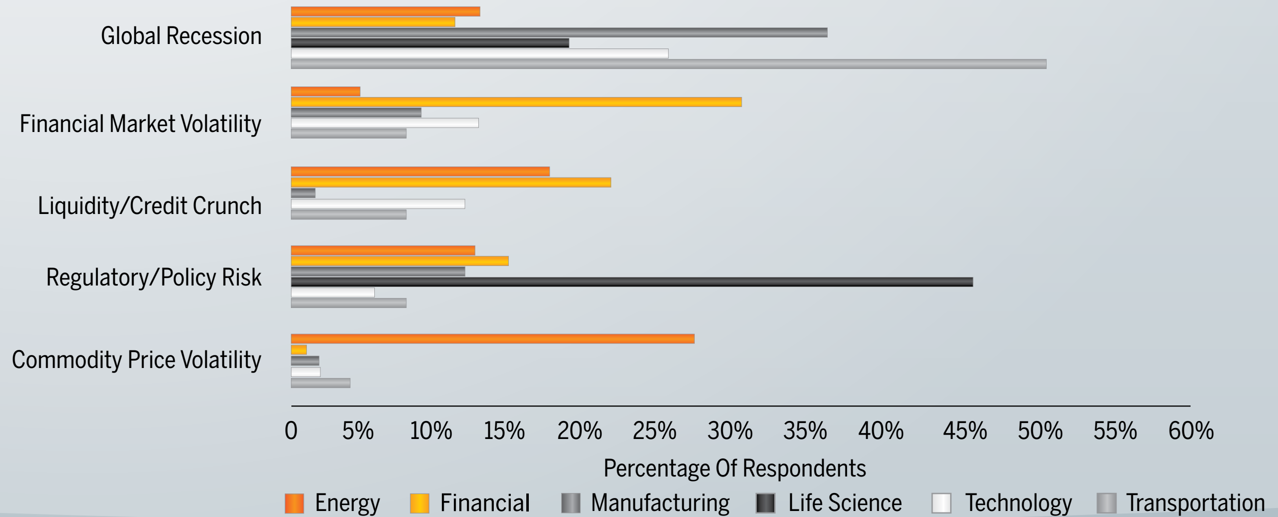
The perception that recession is the largest risk for corporations is nearly universal. Most executives around the globe and at various levels of organizations cite global recession as their largest risk.

Executives' perceptions vary greatly, however, when examined across industries. Manufacturing and transportation executives consider global recession to be the greatest risk to their business. Life science executives are far more concerned than the rest of the group about regulatory risks. Financial services executives are more worried about volatile financial markets. Energy industry executives, meanwhile, perceive volatile commodity prices as the greatest potential threat to their companies' results.

Perspectives on Top Emerging Risks







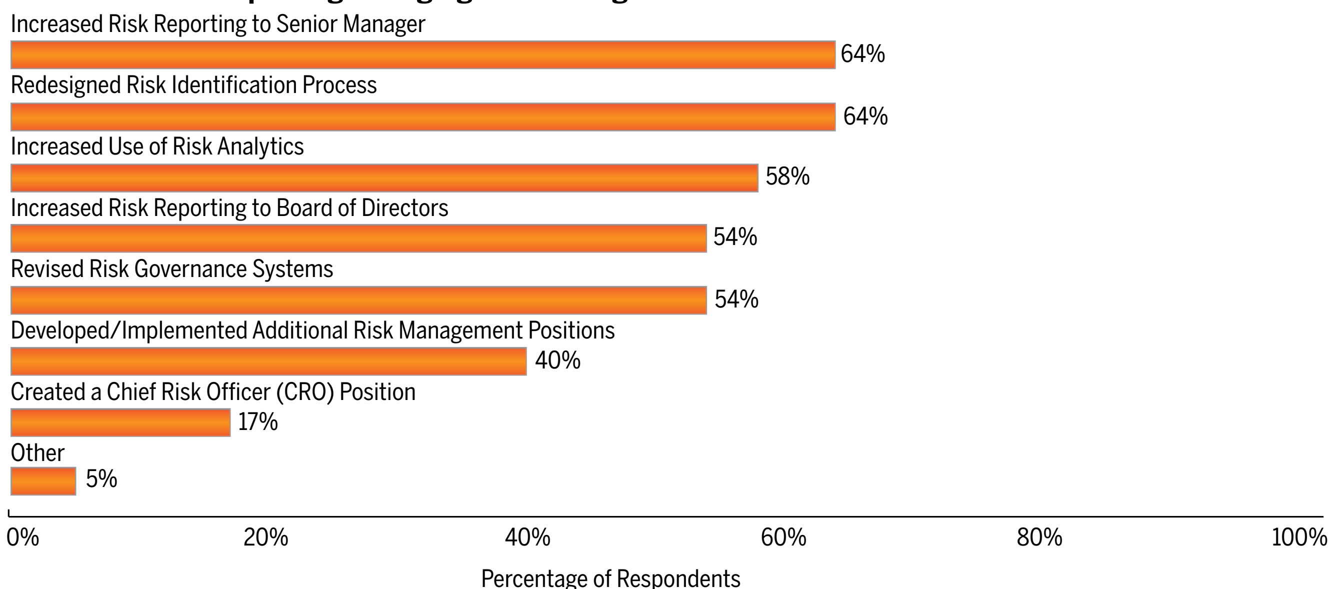
Risk Management Capability Improvements in 2010

The scale and impact of the financial crisis has prompted many organizations to focus more intently on increasing their capacity to detect and analyze emerging risks. Ninety percent of respondents reported that their organization had made efforts to increase their ability to identify emerging risks in the past 12 months.

Organizations that Increased Their Focus on Emerging Risk

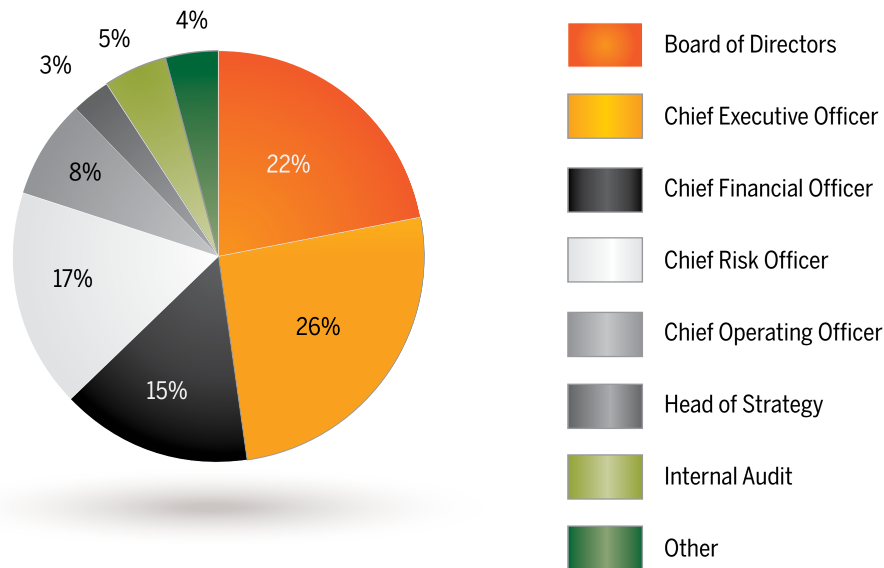
Nearly two-thirds of respondents said their organizations have redesigned their process to identify emerging risks. They also distribute more information about emerging risks to their senior management. Many respondents have augmented their use of risk analytics, while more than half report on risks to their board of directors more than they did before.

Focus Areas for Improving Emerging Risk Management



Companies' top leaders are generally driving these initiatives to improve emerging risk management. Nearly half (48%) of respondents cited their chief executive officers and boards of directors as the primary drivers behind improved risk management practices. Thirty-eight percent of respondents in the financial services sector said that chief risk officers drove changes in risk management practices, as did 26% of respondents in the energy sector. In the manufacturing sector, 33% of respondents felt their chief financial officers played a leading role.

Driving Risk Management Improvements Across the Organization

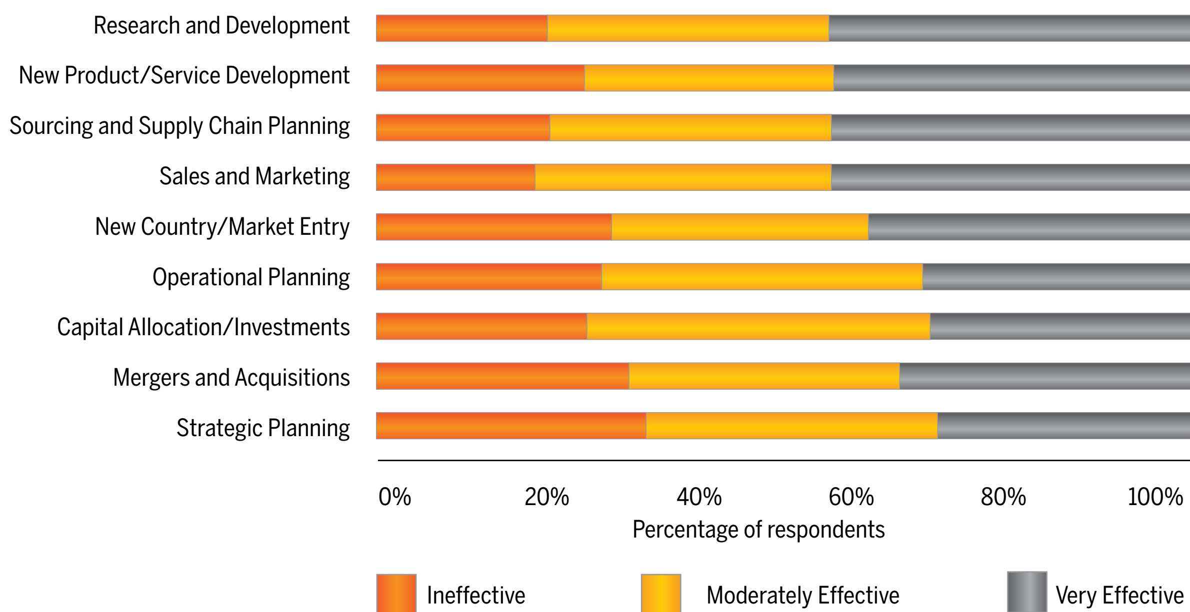


> **"We are constantly upgrading. We are constantly improving [our risk management processes] to identify the ever-changing environment around us..."**
>
> –Chief Risk Officer, Financial Services Sector

Blind Spots in Identifying and Assessing Emerging Risks

Despite the high level of attention and investment, however, most respondents say they believe their amplified risk management practices still do not provide meaningful information to enhance decision making. Sixty-two percent of respondents, on average, rate their organization as "ineffective" to "moderately effective" at integrating emerging risk information into their operations. Only 38% consider their organization "very effective." Just as striking, executives surveyed said their risk management practices were least effective in the critical areas of operational planning, capital allocation, and strategic planning.

Effectiveness at Integrating Risk Information into Business Decisions



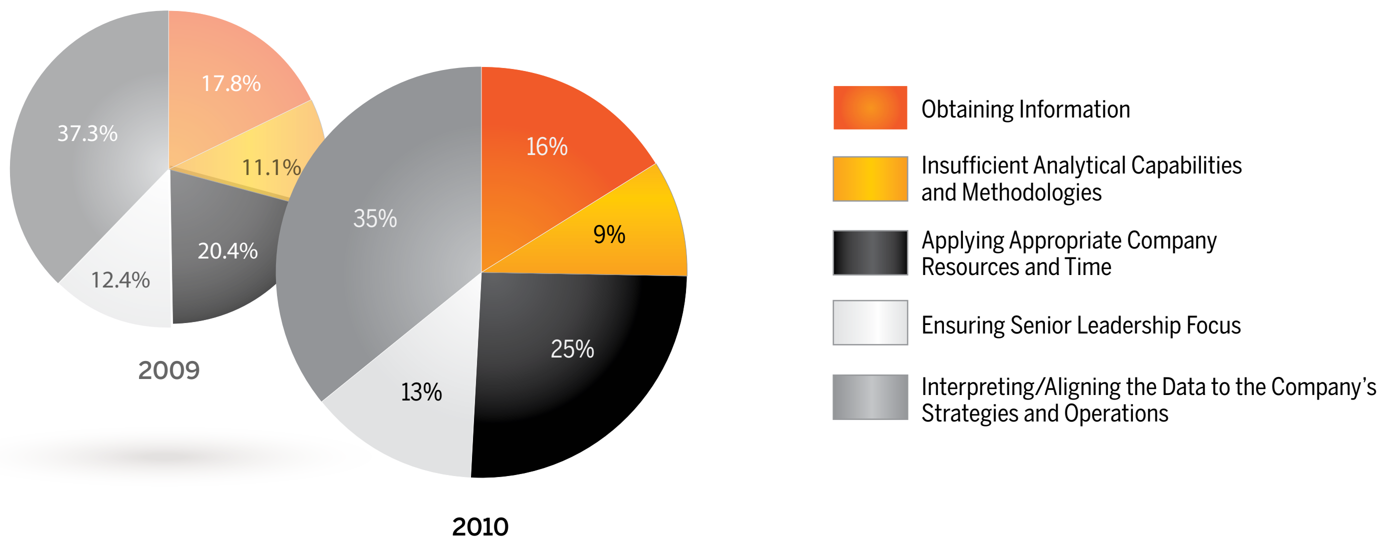
When examined by industry, executives in consumer products companies have the greatest confidence in their ability to incorporate risk data into decision making, with 39% rating their companies as "very effective" in that area. Manufacturing industry executives have the least confidence: Only 26% rank their organizations as "very effective." Thirty-seven percent of financial services executives rank their companies as "very effective" at integrating risk data into decisions made on multiple fronts.

Surprisingly, companies have only marginally improved their ability to translate emerging risk data into valuable business insights over the last year. Thirty-five percent of respondents consider aligning risk data to a company's strategy and operations to be their greatest challenge. That percentage was only marginally higher (37%) in 2009.

One reason for this difficulty is that more respondents feel they don't have sufficient resources, even though most have augmented their risk management practices. Twenty-five percent of executives surveyed consider obtaining enough time and resources to be their primary challenge, up from one-fifth of respondents last year. Twenty-five percent of respondents still experience difficulty in obtaining information and sufficient analytical capabilities, compared with 28.9% in 2009.

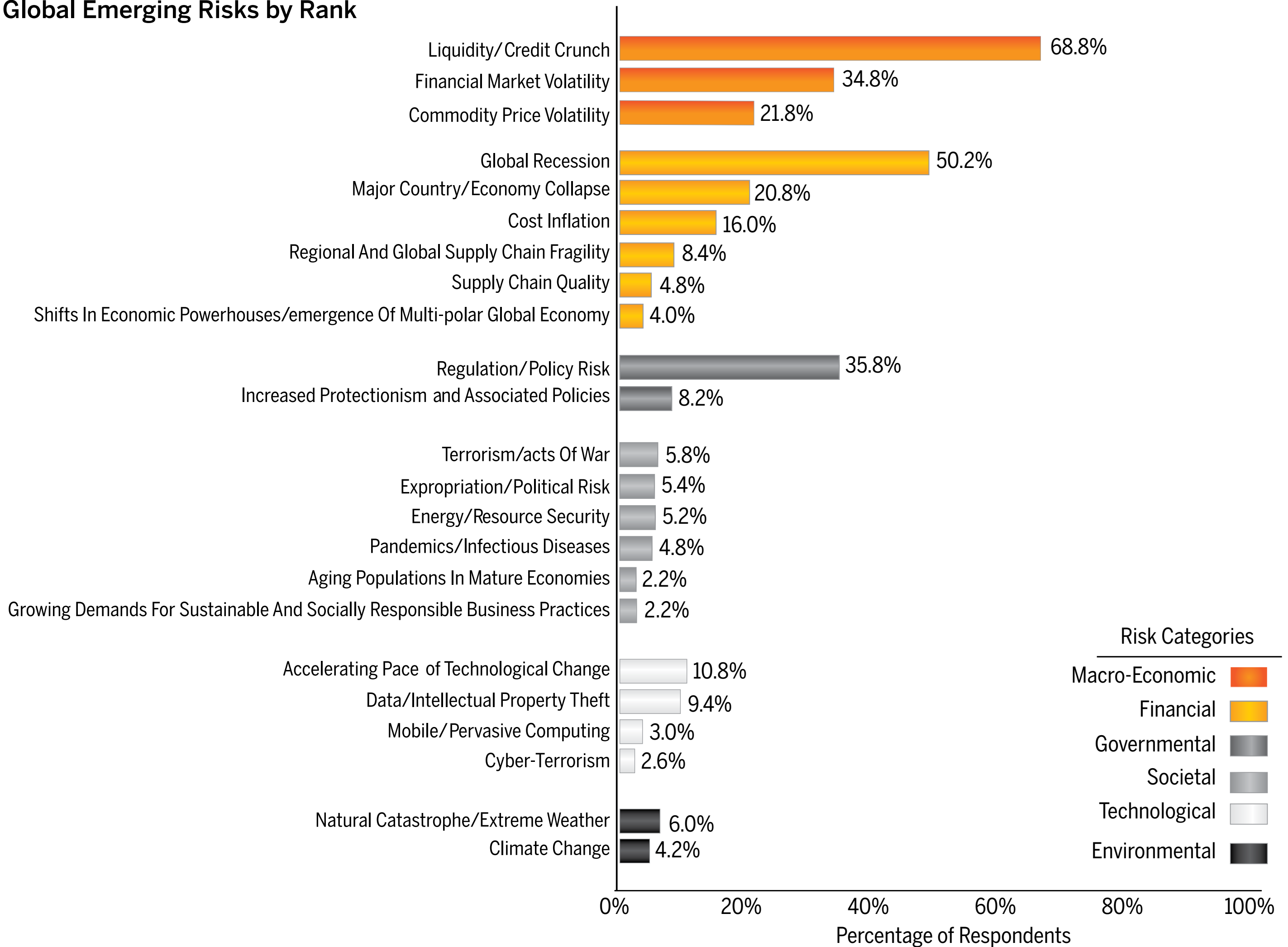
Until such problems are resolved, there's a serious risk that executives may fail to take into account potentially important risks simply because they feel overwhelmed. "We've cut down the frequency of our risk assessments because we end up with too many risks on our register and not enough time to do anything about them," notes the chief risk officer of a technology company.

Primary Challenge of Respondents' Companies in Identifying and Assessing Emerging Risks



> **"[It's important to make] sure there's a culture where people understand that it is okay to identify issues that can create major problems in the future even if you are half-sure..."**
>
> –Chief Executive Officer, Financial Services Sector

In fact, most of the executives surveyed are not focusing on more slowly emerging risks in the next 18 to 36 months. Immediate and pressing financial events have pushed risks that involve issues such as climate change or pandemics off most executives' radar screens. Less than 10% of executives surveyed consider potential threats related to environmental issues, societal risks, or technological concerns as major risks. This result is especially troubling given the high-profile events related to these issues that have emerged in the last 12 months, including the eruption of volcanic ash in Iceland and the sudden emergence of the H1N1 flu.



"The biggest challenge is recognizing that the future will not look like yesterday."

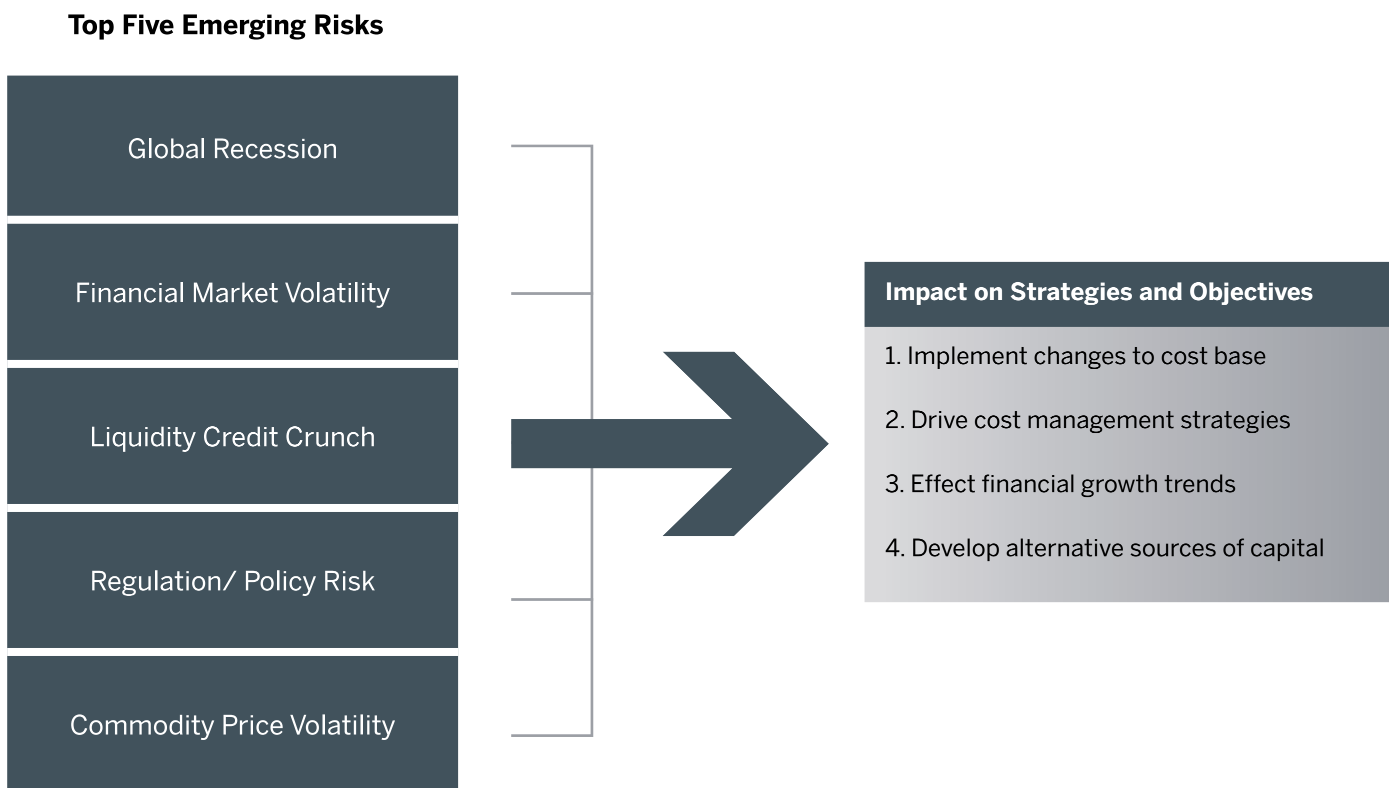
–Head of Internal Audit, Manufacturing Sector

Missing Opportunities by Being Too Internally Focused

One reason such blind spots exist and companies remain only moderately effective at integrating emerging risk data into their strategic planning could be that executives have adopted a defensive stance in the wake of the financial crisis. Most respondents are preparing for their top five perceived risks by taking steps that can be easily controlled internally. They're launching cost-cutting initiatives designed to increase their cash flow and seeking out new forms of capital. "We are looking at many, many different sources to make sure we can fund growth," explained the chief credit risk officer at one financial services firm.

Few executives are responding to emerging risks by going on the offense and creating new opportunities. Only a small percentage said they are developing new products, expanding into new markets, increasing their distribution channels or establishing new business partners.

Making Internal Changes to Cope With Emerging Risks

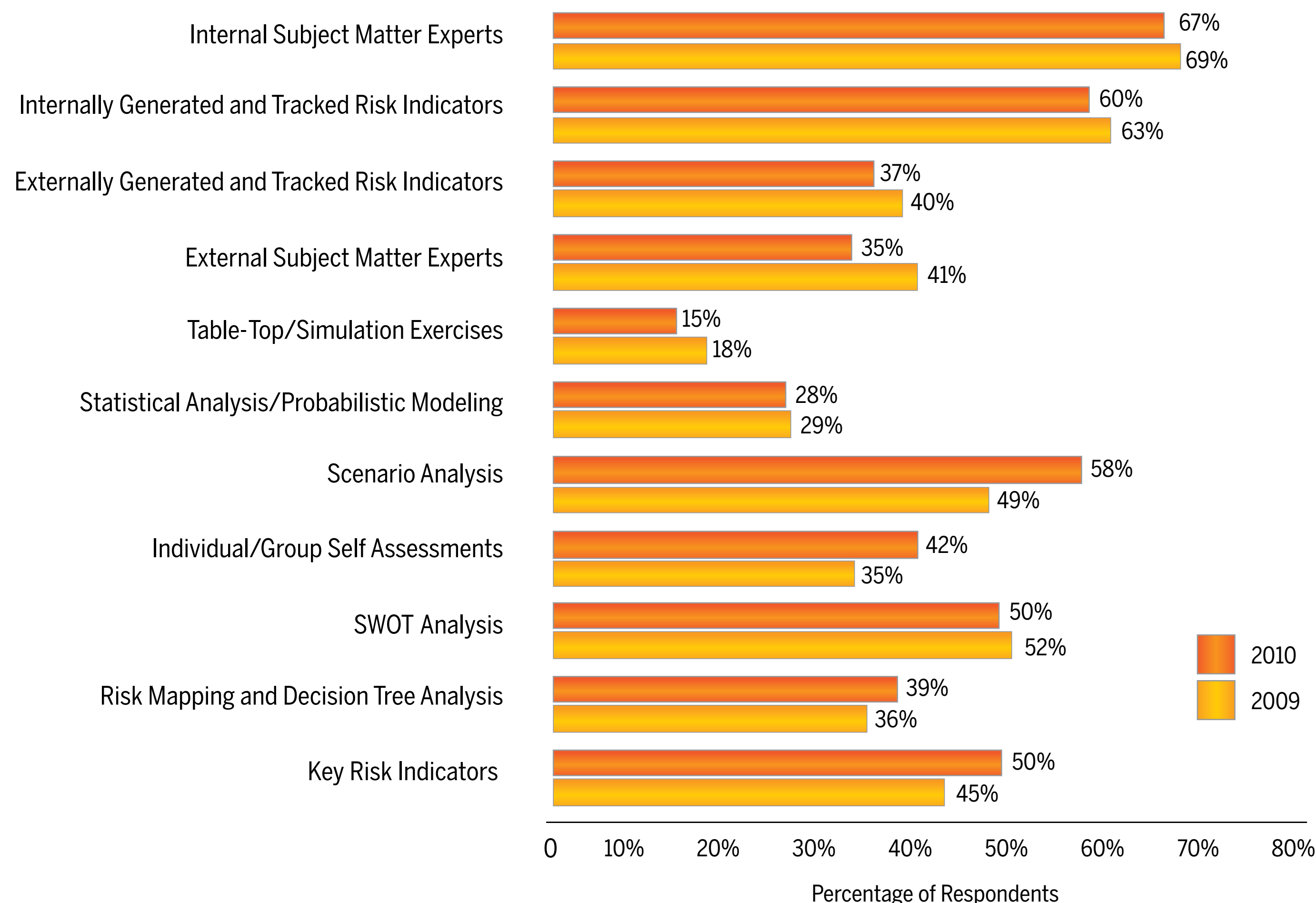


> **"We're still coming out of the economic malaise... Getting people comfortable with spending money is the constant challenge."**
>
> –Business Unit Leader, Manufacturing Sector

The Need for a Multidimensional Approach

Another problem is that companies are relying too heavily on internally generated data to make risk-related decisions. Although many respondents recognize the importance of using more externally generated data to identify emerging risks, only 35% incorporate external subject matter experts into their risk management practices. Thirty-seven percent use externally generated risk indicators. By contrast, 67% use internal experts and 60% rely on internally generated and tracked risk indicators.

Heavy Reliance on Internal Analytics



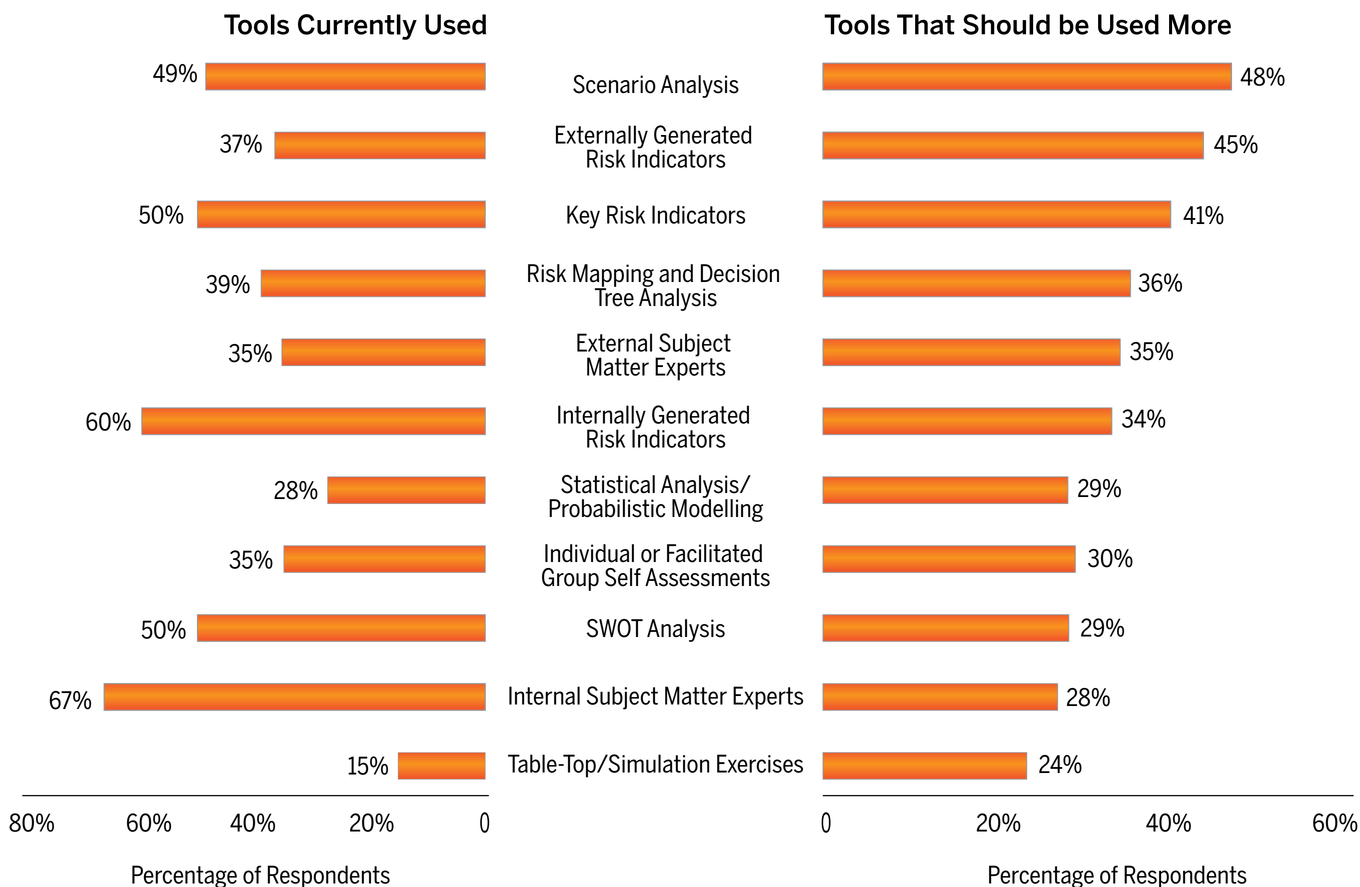
"We will rely on external resources to help us remediate risks. Especially if it's something that [involves] a technical capability or a derivative."

–Treasurer, Consumer Manufacturing Sector

Such an internal focus has serious limitations. Without externally generated input, organizations are limited by the experience and expertise of the people who are in their organizations. “It’s difficult for us if we don’t have the credibility of industry experts to back up some of the observations and the findings that we come up with,” said the head of risk at one technology company.

Most respondents recognize their improved risk management analytics have serious shortcomings. Forty-eight percent of respondents believe they should incorporate more multidimensional approaches, such as scenario analysis, into their risk management practices, while 45% believe they should use more externally generated and tracked risk indicators.

A Desire for More Multidimensional Tools

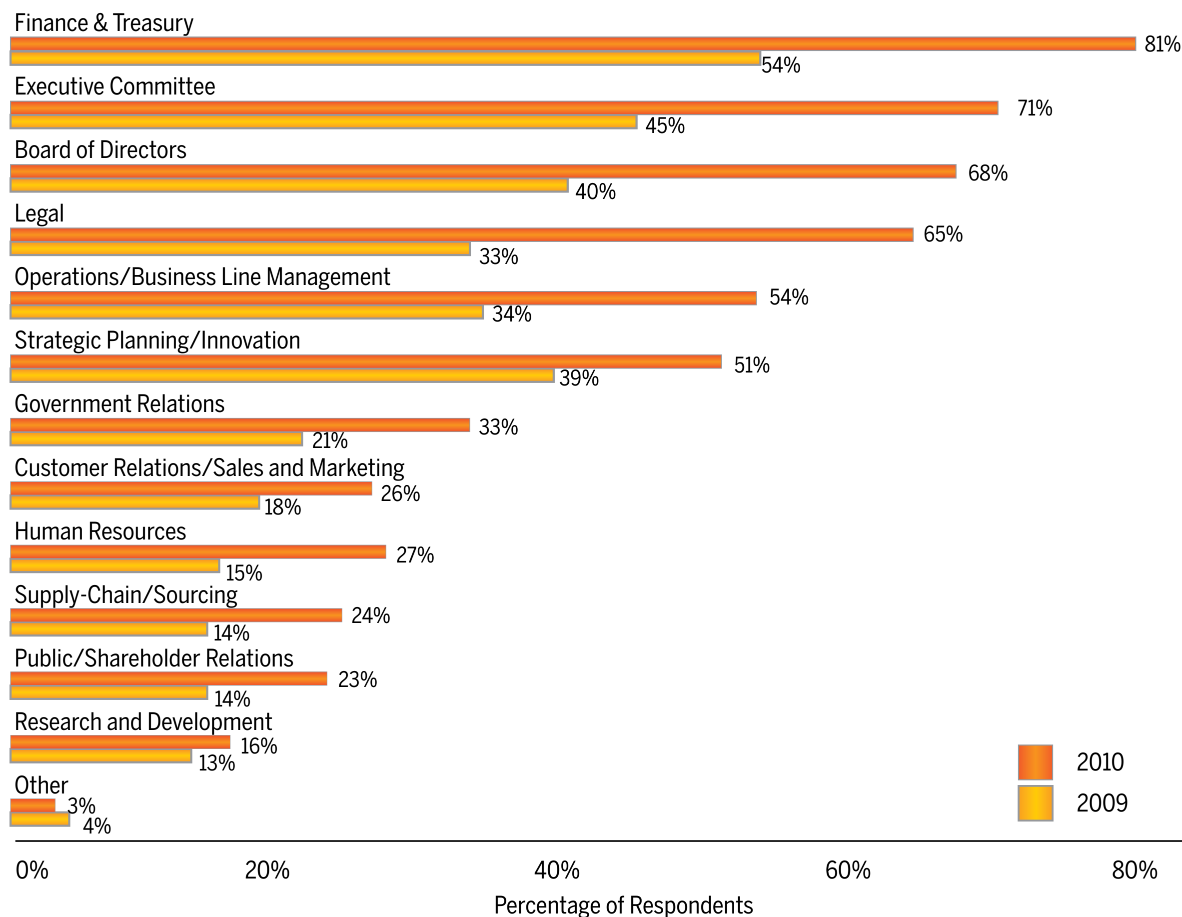


Emerging Risk Communication Gaps

Respondents also struggle with how to distribute risk-related information effectively. Of the executives surveyed who said they are broadening their distribution of risk information, 54% say they have increased reporting to their boards of directors. Sixty-four percent say that they report more often on emerging risks to senior management.

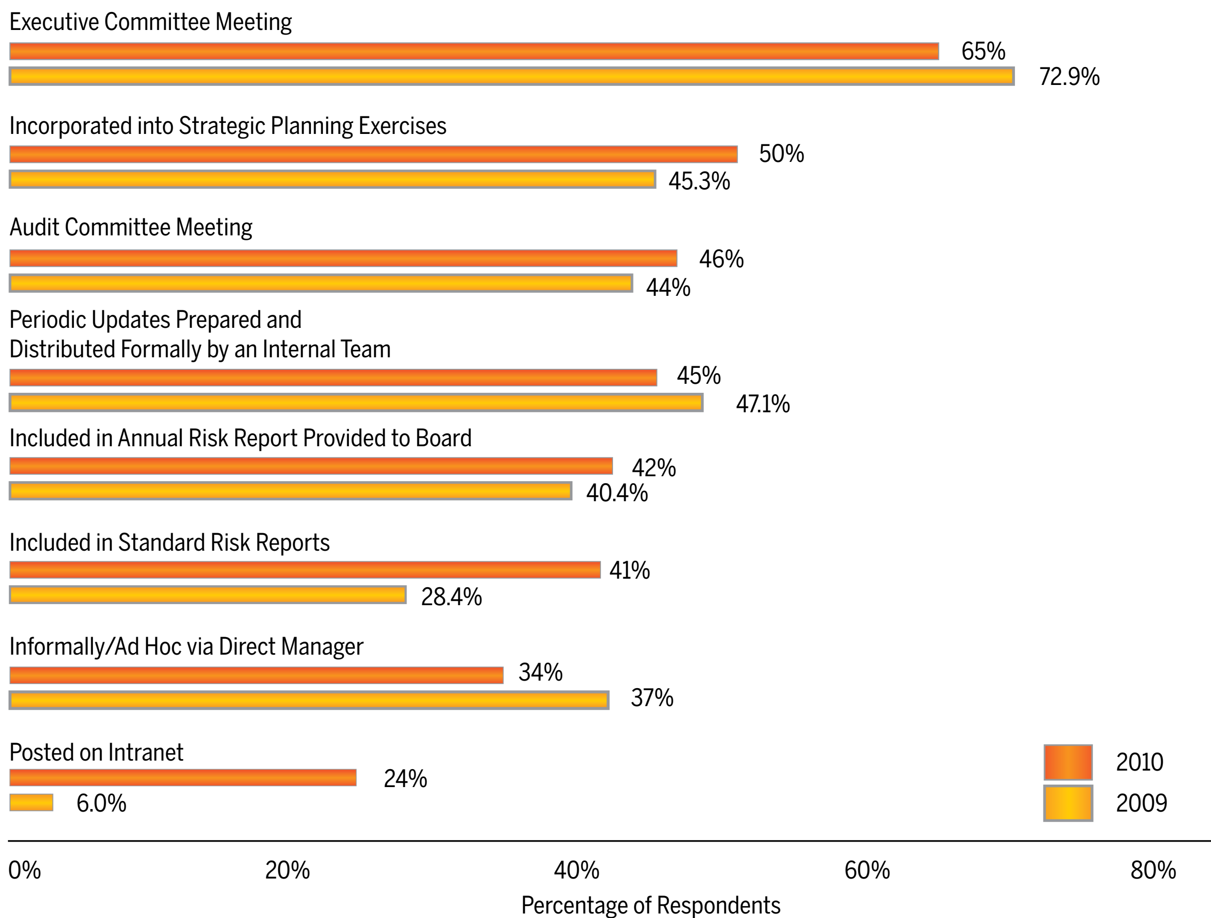
However, emerging risk information remains only irregularly distributed to top executives: Though 81% of finance and treasury departments regularly receive emerging risk information, almost one-third of boards of directors and executive committees receive such information only on an inconsistent basis.

Departments that focus on the organization's customers, suppliers, employees, and future offerings also receive scant information about emerging risks. About two-thirds of sourcing and research and development departments receive information about their company's identified emerging risks only irregularly. Just as surprising, about two-thirds of respondents say that their government relations departments receive emerging risk information infrequently—even though respondents cite regulatory risks as one of their top concerns.



Unfortunately, many organizations still appear to treat emerging risk information as separate from ongoing business planning and management. Only two-thirds (65%) of respondents share emerging risk information at executive committee meetings, despite efforts made to improve emerging risk management capabilities. Half of the respondents embed emerging risk information into strategic planning exercises, while 41% include it in standard risk reports.

Surprisingly, risk information is also distributed rarely to boards of directors, especially given their important oversight role. Only 42% of respondents articulate emerging risk information in the annual risk reports provided to the entire board, and 46% of respondents provide the information only to the board committee most commonly chartered to provide risk oversight—the audit committee. Reporting practices clearly need to continue to evolve, given increased focus from regulators such as the United States Securities and Exchange Commission (SEC). In December 2009, the SEC issued a final set of rules that require companies to disclose "whether and how the board, or board committee, monitors risk" in their proxies.



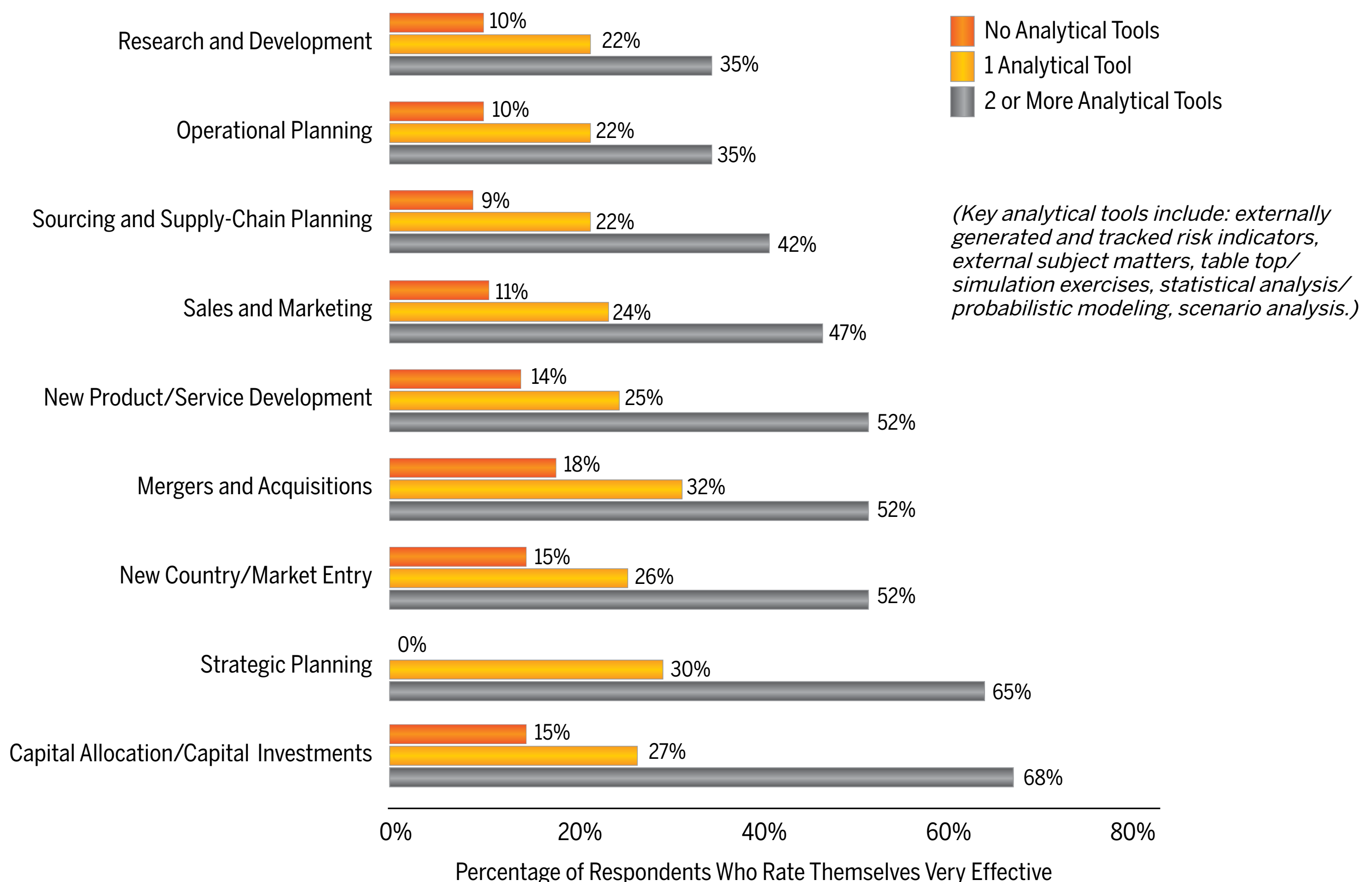
The Case for Better Analytics

Our research indicates that executives are questioning whether current risk assessment and analysis methods provide their organizations with the necessary information to make better decisions in an uncertain and volatile business environment. Many respondents are looking to revamp their risk analytics toolbox with greater external data and expertise, scenario analysis, and risk indicators.

Companies appear to benefit greatly from fundamentally reconsidering their currently used risk analytics. Organizations that increased their use of analytical tools are more effective at integrating risks into key decision-making processes. Our survey found that 69% of executives who increased their use of risk analytics in strategic planning believe they are very effective at integrating risk data. By contrast, only 44% of executives who did not increase their use of analytics in strategic planning consider themselves effective.

The contrast is even greater when it comes to executives who use more multidimensional tools that incorporate externally generated emerging risk data and statistical analysis versus those who rely on static, one-dimensional analysis. For example, as the table below illustrates, 68% of executives who use two or more multidimensional analytical tools believe they are very effective at taking emerging risk data into account in their capital investment decisions, versus only 15% of executives who rely on one dimensional analytics.

Organizations that Reported Using At Least 2 Robust Analytical Tools Significantly Increased Their Capacity to Integrate Risk Information



(Key analytical tools include: externally generated and tracked risk indicators, external subject matters, table top/ simulation exercises, statistical analysis/ probabilistic modeling, scenario analysis.)

Building Capabilities: Five Recommendations

Risk management tools and methodologies must be sufficiently robust and sophisticated to capture the complexity, uncertainty, and unknown volatility that emerging risks introduce into a company's strategy and operations. Below are five recommendations for how companies can start to improve their ability to identify and assess emerging risks.

Integrate emerging risks into your corporate strategy.

Emerging risks must be treated as trends or events that may create volatility in an organization's business environment as well as in its strategic and operational performance. The characteristics of emerging risks—external, systemic—will often demand significant strategic or operational changes to "hedge" or minimize their potential impact.

Know what drives corporate performance and value to determine and map the impact of critical emerging risks.

As illustrated by the survey results, evaluating the potential impact of emerging risks on a company's performance and its ability to create value is a tremendous challenge. Companies must explicitly identify their key value drivers in order to identify emerging risks and analyze their potential impact on the company as well as its extended enterprise of customers and supply chain.

Use analytical tools that better capture risk characteristics.

Risk assessment tools must be able to capture the potential impact of emerging risks along a broad continuum. Companies should avoid relying on one-dimensional tools that capture single static events, such as a regulatory change or a competitor's introduction of a new model. Instead, companies need access to a suite of tools that match the characteristics of the risk being assessed.

Align risk metrics with performance measures.

Developing risk measures based on existing performance measures has two benefits. First, it allows the organization to better understand the potential business impact of the risk. Second, it draws on terms and measures that are meaningful to the organization, allowing the risk data to be better integrated with strategic and operational decisions. An estimated risk impact that identifies the volatility around a company's results is far more useful than one that supplies a single, static number.

Reevaluate your emerging risk capabilities.

In the face of an uncertain and volatile future, companies must constantly assess whether their capacity to identify and analyze risks is aligned with their goals.

In the wake of the financial crisis, most executives are making efforts to improve their ability to identify and assess emerging risks. Nevertheless, our research shows that executives do not believe that these initiatives are increasing their capacity to develop the crucial business insights they need for risk-adjusted decision making. This is a handicap that executives can no longer afford in a business environment increasingly defined by global recession, major government policy shifts, volatile commodity prices, and unstable financial markets.

Evaluation Checklist: Emerging Risk Management Analytics and Processes

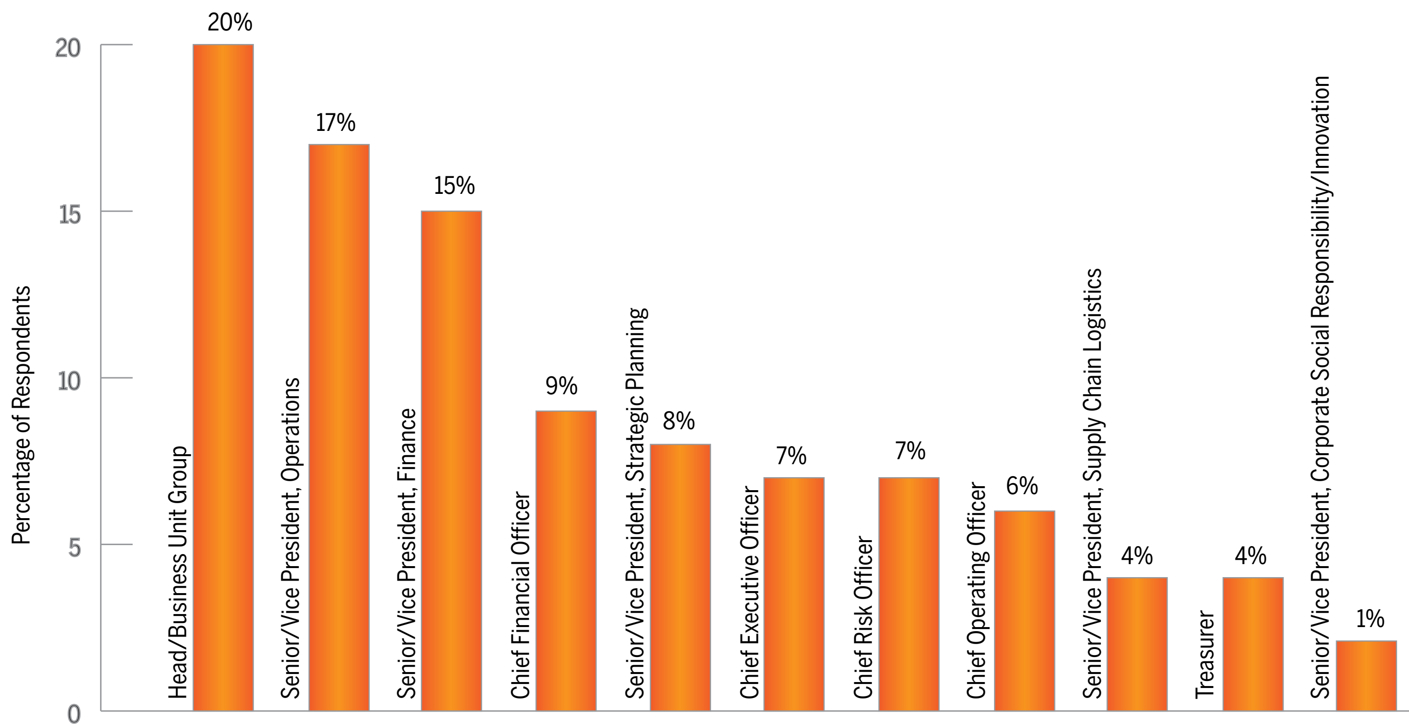
The following questions can help management, boards of directors, and risk executives evaluate their current emerging risk analysis capabilities.

- ❑ Who currently receives emerging risk information, and in what format? Who *should* receive emerging risk information, and in what format?
- ❑ What business decisions should be informed by emerging risk information? How are these decisions informed today?
- ❑ How is emerging risk information incorporated into strategic and operational business processes? Specifically, what data from which sources are embedded in which regular (annual/quarterly) management processes?
- ❑ Do existing reports provide insights into key business trends and associated risks? Are these reports regularly discussed at management meetings?
- ❑ Do existing risk analytics provide actionable business information?
- ❑ Do the tools enable management to address the following:
  - ❑ The overall potential variability in the organization's financial performance as a result of the risk.
  - ❑ The impact on the success of an organization's future strategies.
  - ❑ How the risk interacts and aggregates under alternative future scenarios.
  - ❑ The drivers of the longer term value of the corporation.
- ❑ Does the organization have the appropriate resources to integrate emerging risk data into decision making?

Survey Methodology

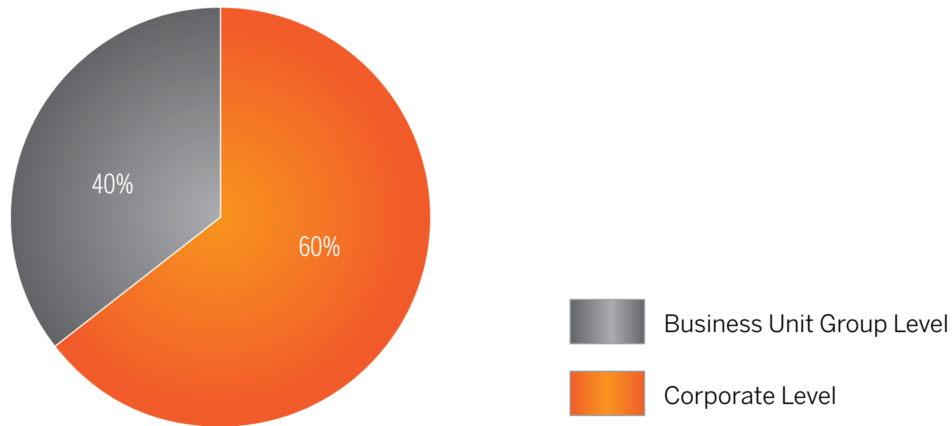
FT Research and Oliver Wyman surveyed 650 executives and senior managers of global organizations with annual revenues greater than $1 billion, to determine their capabilities regarding identifying and assessing emerging risk.

The study consisted of an anonymous survey that was tabulated and verified by an independent third party, and an interview series in which executives' titles and business sectors were included but specific identifying details were not.



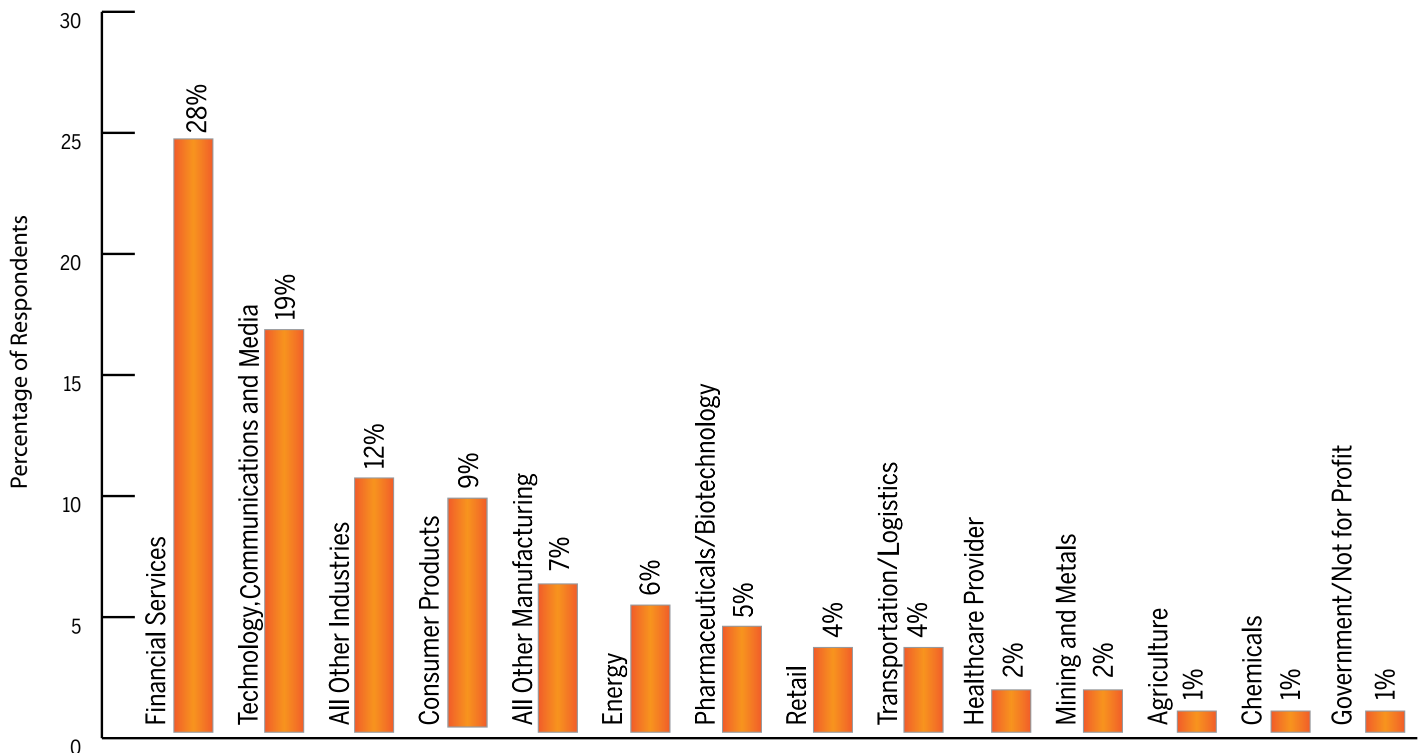
Sixty percent of the respondents' roles were at the corporate level and 40% held key positions at the business level.

Corporate/Business Unit Alignment



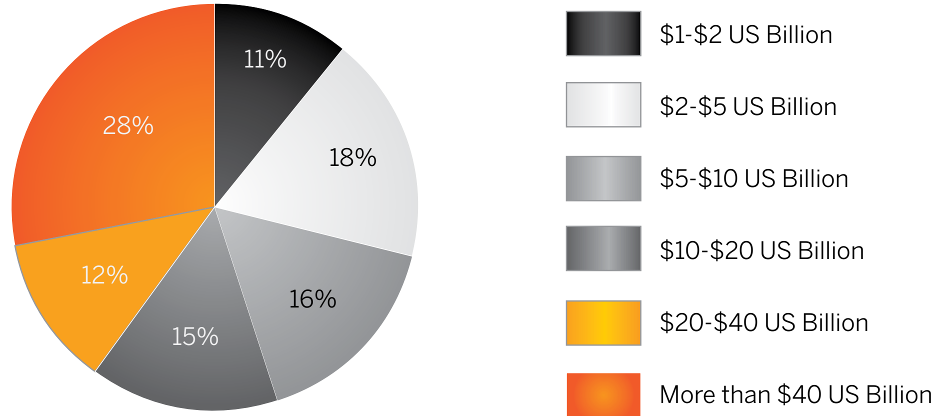
A wide variety of industry sectors were represented in this survey, with the largest group, 28%, coming from the financial services industry.

Respondents' Business Sectors



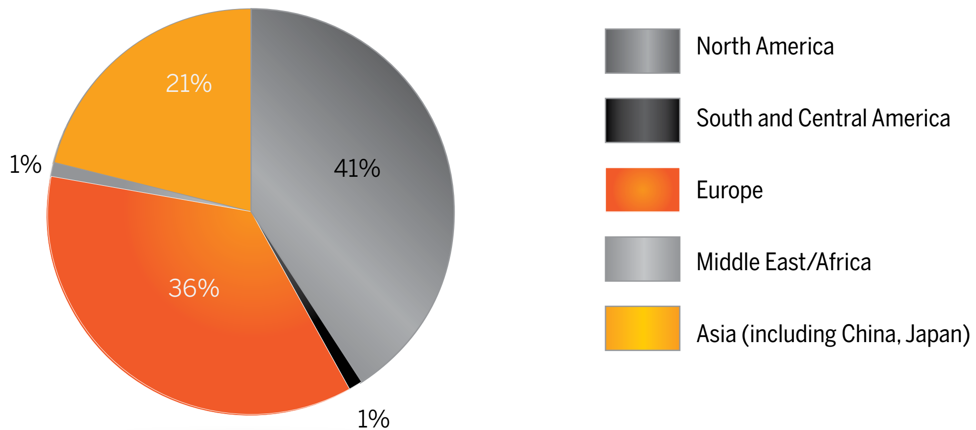
Only respondents from companies with annual revenues greater than $1 billion were included. The largest group, 28%, were from companies with more than $40 billion of annual revenue.

Respondents' Companies' Global Annual Revenue



Respondents were asked to provide the location from which they work, not the headquarters of their company.

Geographical Breakdown of Respondents' Business Locations



About Oliver Wyman

Oliver Wyman's Corporate Risk consulting practice works closely with leading organizations to effectively manage risk, enabling them to make risk-adjusted strategy, investment, and capital allocation decisions that improve performance and optimize value creation.

With more than 2,900 professionals in over 40 cities around the globe, Oliver Wyman is an international management consulting firm that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm helps clients optimize their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is part of Marsh & McLennan Companies (NYSE: MMC).
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