

A new risk equation?

Safeguarding the business model



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Many company risk processes fared poorly in dealing with the impact of the recent recession. This report, written in cooperation with the Economist Intelligence Unit, reviews issues around the success of risk management practices over the past 18 months and how they may fare in the future.

A key finding of the research indicates a poor perception of current risk processes, with the majority of respondents believing they do not genuinely influence decision making or add value to the business.

While many companies were able to identify their key business risks, a failure to effectively stress test their business model left them unprepared for managing the impact of risks.

We believe that this report will stimulate boardroom discussions about the importance of risk management in shaping the business model to reduce risk and maximise opportunity.



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About the report

The recent recession has proven that economic cycles, and the dangers attendant on them, are very much alive. Financial difficulties, however, are just one of the risks that companies have to address.

Indeed, acting in the face of uncertainty to maximise potential benefits and minimise dangers – a broad definition of risk management – is the core of doing business. An earlier study in this series¹ revealed a high degree of complacency among British and Irish companies about the need to change their business models in the wake of the downturn. This study,

based on a survey of over 450 senior executives as well as in-depth interviews with practitioners, suggests that the complacency extends to corporate approaches to risk management. As the pain caused by the recession eases, there is a danger that so too will the pressure on companies to re-think their risk management practices.

fresh thinking

The analysis in this study is based on a survey of 396 senior executives in the United Kingdom and 69 in the Republic of Ireland – 465 respondents in all. The survey sample was senior, with half of respondents being C-level executives, and hailed from a wide range of industries and company sizes. To complement the survey, the Economist Intelligence Unit also conducted a series of in-depth interviews with corporate leaders in the UK. The research for this study was conducted between October 2009 and April 2010.

All content was written by the Economist Intelligence Unit with the exception of the foreword and Grant Thornton and other external perspectives presented throughout the report. Please note that not all survey data shown in the charts add up to 100% because of rounding or because respondents were able to provide multiple answers to some questions.

Defining the business model

For the purposes of this study, we identify five components of the business model:

- **The value proposition**, or the benefits that a company's products or services provide to its customers
- **Target markets**: the customer segments and product and geographic markets a company aims to serve
- **Revenue-generation mechanisms**: an organisation's revenue and pricing models – for example, its decisions to earn revenue through direct sales, licensing, franchising, subscription or other mechanisms
- **Cost structure**, or the balance of fixed, variable and other costs within the organisation
- **Value chain**, combining a company's supply chain and the sales and distribution channels it uses to deliver its products and services to market

¹Retrench or Refresh? Do existing business models still deliver the goods? March 2010.

Executive summary

Risk management practices prepared companies poorly for the downturn.

British and Irish companies saw widespread failure of their risk systems to help them foresee or address the recession. Nearly half of surveyed executives report that their reviews of strategic risks prior to the crisis did not adequately capture its extent, and only 30% think that their risk management processes helped to minimise its impact. How companies engage in risk management should shoulder part of the blame. Professor Michael Power of the London School of Economics notes that often it “is essentially compliance-based... This has let us down because it creates an illusion of things being under control.”

Today's heightened attention to risk management is probably temporary.

Sixty-eight percent of executives say their companies have changed how they value risk because of the downturn, and 71% say they review it more often. Management interest in risk typically increases after a large shock, but usually lessens as conditions improve. As might therefore be expected, the focus today is more on the financial dangers just suffered rather than on addressing risk

more broadly. Business leaders, for example, see financial risk as the biggest danger they face, a view reinforced by Economist Intelligence Unit assessments, which see the banking sector as the greatest source of risk in the UK and Ireland.

Companies' risk appetite will change little in the near term as worries about the economy persist.

In each type of business model risk covered in the survey, the most common sentiment among respondents is that their company's level of risk aversion will remain the same over the next 18 months. These findings are in line with expectations that economic growth will be well below the average of previous years for some time to come, and that the recovery will be fragile, with fears of another reversal stoked by the eurozone debt crisis of April-May 2010.

Current risk management systems are failing to provide what companies need in many areas.

The survey paints a disappointing picture about the effectiveness of risk management in general: processes have created a common awareness of risk from top to bottom at just 37% of companies, and they add value to the business at only 34% of all firms surveyed. Interviewees say that to improve these figures, risk management must go beyond the mechanistic calculation of risk based on specific metrics in order to produce compliance with regulation or best practice. Rather, risk managers should consider using scenario building, stress testing or other techniques which incorporate a diverse range of relevant information – not merely hard data – about the surrounding risk environment. The risk function will then be in better shape to help companies with the variety of strategic issues they face.

Risk management under the microscope

A downturn is more than a difficult economic period, it can be a time of immense change within an organisation. Companies must gear up to face the challenges of the present, but must also prepare to seize the opportunities which a sustained recovery might bring.

Rivals will certainly be doing as much, as will hungry new entrants. However, as the first publication in this series – *Retrench or Refresh?* Do existing business models still deliver the goods? – showed, most businesses in the UK and Ireland are not seizing the moment. Overly cost-conscious, too often complacent, they are preoccupied with cost reduction rather than more substantial business model renewal.

Changing the business model – the fundamentals of what the company does and how it operates – entails risk. In adjusting models and charting strategy, companies make assumptions about economic conditions, demand for their products, availability of supply, technology, regulation and many other factors. The recent recession demonstrated that most companies in the UK and Ireland underestimated the risk of a significant deterioration of the economy, and thus of demand and the availability of finance, among other

things. Over the past decade, many have also failed to gauge the likelihood that technology advances or new regulatory requirements, for example, would upset their business plans. Risk management at both the strategic and operational levels is deservedly under the microscope. As Chris Hill, CFO of Travelex, a foreign exchange and business payments company, puts it, when looking back at how companies were affected by the downturn, “a lot of the lessons learned will be around risk management.”

This study explores the lessons that companies are learning about managing the strategic and operational threats to their business. The risk management arrangements in place before the recession left too many companies ill-prepared for what was to come. While they are now paying more attention to risk, the question remains as to how fundamentally their approaches to risk management will change as economic conditions gradually improve.

Unprepared for the downturn

Risk management within a company, whether embedded in dedicated departments and formal processes, or simply a set of considerations for executives when making decisions, should at the very least do what the name suggests: prepare companies for the possibility of things going badly wrong.

By this measure, British and Irish companies saw widespread failure of their risk systems to help them foresee or address the downturn. Of the executives in our survey, 49% say that the review of strategic risks at their companies prior to

the crisis did not adequately capture the impact of the downturn, against 44% who believe that it did. Worse still, only 30% of respondents think that risk management processes at their businesses helped to minimise the impact of the recession.

Risk managers are not entirely to blame: the initial impact of the financial crisis was overwhelming. Simon Peckham, COO of Melrose – a company which purchases underperforming industrial companies in order to turn them around and sell them – remembers: “For a period of time, the world froze because nobody knew what was going to happen. Everyone became massively risk averse. Whatever risk management you have, it isn’t going to make a difference in that kind of a fundamental situation.”

Do you agree or disagree with the following statement?
 “Our review of strategic risks prior to the crisis adequately captured the impact of the economic downturn.” (% responses)

Strongly agree	Agree	Disagree	Strongly disagree	Don't know
7.2%	37.0%	42.0%	7.4%	6.3%

Source: Economist Intelligence Unit

Certainly, risk processes were not going to enable companies to sail through such troubled waters unscathed, but they might have done better at preparing them for the storm. There were plenty of signs for those willing to see them.

Mr Peckham notes that in the summer of 2008, “it was looking pretty certain something was going to happen.”

The problem may have been that executives were keeping an eye on the wrong potential dangers. Adrian Fawcett, CEO of General Healthcare Group, a provider of private healthcare services, recalls that after years with relatively easy access to capital, many companies were no longer focused on financing risk. The tendency for financing arrangements to have grown not only in quantum but also increasingly complex only added to the difficulty, he contends, because executives typically focus on the things which interest them. “Too many leaders and managers of UK companies were not

Grant Thornton comment

There is an increasing focus on the role risk management plays in corporate governance. The UK Corporate Governance Code, for companies listed on the London Stock Exchange, requires the board to establish an ongoing process for identifying, evaluating and managing the significant risks faced by the company. They are also required to

annually review the effectiveness of their risk management systems and report the results to their shareholders.

The Turnbull report, which provides guidance to companies on risk management and internal control, is being reviewed by the FRC in late 2010. It is anticipated that this will result in an increased focus on risk processes.

alert to balance sheet and financing risks as the extended period of low inflation, low interest rates and increasing sources and availability of capital had left them principally paying attention to company operational risks that remained more consistently present in front of them.”

This issue of focus points up a widespread weakness in the practice of risk management. Michael Power, Professor of Accounting at the London School of Economics, says “the essential question” is why risk systems did not prepare companies better for the downturn. “Quite a lot of risk management practice is essentially compliance-based, following rules that

are often dictated by regulation” he says. “This has let us down because it creates an illusion of things being under control.”

Professor Power complains that, rather than being linked into strategy and decision making, current practice tends to relate risk management to high-level objectives only in a bureaucratic way. Jeremy Bentham, Shell’s VP Global Business Environment and head of the company’s scenario team, agrees: “Risk management is often seen as a mechanistic, analytic issue, whereas we live in the realm of human activity with rational and less rational choices.”

Techniques which quantify risk helped companies surprisingly little. Of survey

respondents whose firms quantified strategic risks before the downturn, under half (49%) say that their risk reviews adequately captured the potential impact of the recession, slightly more than the entire survey sample. The greater ability of this group to understand the scope of the problem does not seem to have conferred any particular advantage: only 30% think that their risk management processes helped to minimise the effect of the recession, the same as the overall survey average.

Which of the following areas of your company's business model will be subject to the greatest degree of risk over the next 18 months? (% responses)

	Total	Financial services	Media & entertainment	Construction & property	Healthcare services	Retailing
Revenue-generation mechanisms (eg, pricing model, licensing versus direct sale, etc)	24.2 %	31.5 %	23.8 %	11.9 %	28.8 %	19.6 %
Cost structure (balance of fixed, variable and other costs)	23.8 %	16.7 %	19.0 %	28.8 %	32.7 %	23.5 %
Target markets	13.5 %	11.1 %	12.7 %	23.7 %	7.7 %	9.8 %
Value proposition (ie, the benefits that the firm's products or services provide to customers)	13.1 %	14.8 %	15.9 %	5.1 %	11.5 %	11.8 %
Distribution channels (how the firm delivers its products/services to market)	8.7 %	11.1 %	14.3 %	3.4 %	7.7 %	11.8 %
Supply chain	7.9 %	5.6 %	1.6 %	11.9 %	5.8 %	15.7 %
None of these areas will be subject to risk	4.6 %	5.6 %	6.3 %	8.5 %	1.9 %	5.9 %
Don't know	2.4 %	3.7 %	3.2 %	3.4 %	3.8 %	2.0 %
Other, please specify	1.7 %	0.0 %	3.2 %	3.4 %	0.0 %	0.0 %

Source: Economist Intelligence Unit

How companies are reacting

Bolting the barn door after the horse is gone.

The recession has pushed companies to become more active risk managers. Sixty-eight per cent of respondents say that they have changed how they value risk as a result of the downturn, and 71% say they review risk more often. Moreover, 56% of those who did not quantify strategic risk before the downturn have decided to do so because of it.

Awareness of some risks has certainly risen. Mr Fawcett points out that people “are more familiar with risks that were not thought about before,” noting that even tabloid readers now recognise terms such as leveraged debt, asset-backed financing, covenant cover, tier one capital ratio and Ponzi scheme.

The difficulty, however, is knowing how much of this is simply a temporary reaction to a traumatic experience, and how much is a considered improvement based on a learning experience. As Professor Power puts it, business leaders “have learned from the crisis; whether that will be embedded in companies, only time will tell.”

The importance attached to risk management tends to be highly cyclical. According to Professor Power: “It inevitably gets most attention after the threat you wish to prevent has materialised. There is no magic bullet – people are prone to group-think and optimism, so those who said in 2005 or 2006 that this would end in tears simply weren’t heard.”

The evidence so far is that the current heightened risk management activity is part of the traditional cycle rather than a fundamental re-think. For one thing, the severity of economic hardship seems to affect the openness to change. For example, in Ireland, where the recession hit harder than in Britain, 84% of companies in the survey have changed how they value risk and 83% review it more often. In the construction sector, which was particularly hard hit, the equivalent figures are 81% and 80%. In both cases these are well above the overall survey averages. As Professor Power notes: “If you have been badly hurt, it will shape your attitudes over the next year.”

Grant Thornton comment

Grant Thornton’s eighth annual review of UK corporate governance disclosures noted that on average FTSE 350 companies disclosed 10.7 principal risks of which 3.4 were financial, the largest category of risks for all industry sectors. Operational risks (1.7), macro-economic and political (1.6) and regulatory (1.5) were the next most commonly disclosed risks. Surprisingly, there was an average of only 0.6 business growth risks disclosed, despite 26.9% of respondents identifying this as one of their two most significant risks.

What are the two most significant types of risk currently facing your business? Select up to two. (% responses)

	Total	Financial services	Media & entertainment	Construction & property	Healthcare services	Retailing
Financial	53.6 %	46.3 %	53.1 %	52.5 %	54.7 %	70.6 %
Business growth	26.9 %	14.8 %	29.7 %	28.8 %	5.7 %	35.3 %
Operational	24.1 %	18.5 %	26.6 %	27.1 %	24.5 %	31.4 %
Regulatory	21.0 %	53.7 %	14.1 %	10.2 %	26.4 %	9.8 %
Macroeconomic	19.1 %	29.6 %	12.5 %	22.0 %	3.8 %	17.6 %
Political	14.3 %	7.4 %	4.7 %	22.0 %	39.6 %	0.0 %
Reputational	8.7 %	20.4 %	12.5 %	6.8 %	7.5 %	11.8 %
Human resources	7.8 %	1.9 %	12.5 %	6.8 %	15.1 %	3.9 %
Technology	7.4 %	3.7 %	18.8 %	3.4 %	3.8 %	3.9 %
Environmental	4.8 %	0.0 %	1.6 %	10.2 %	1.9 %	3.9 %

Source: Economist Intelligence Unit

Of greater concern is that, having been stung in one area, companies might become less aware of dangers in others. When asked about the leading risks their companies face, by far the biggest concern of survey respondents is financial risk (cited by 54%). Far down the list come macroeconomic (19%) and political risk (14%). The heightened attention to financial risk may be understandable given that the survey was conducted in October 2009-April 2010. Nonetheless, this focus on one type of risk worries Mr Peckham: “The impact of massive government borrowing and the attendant macroeconomic dangers, particularly in the UK, are not small.” If nothing else, the fiscal stabilisation measures put forward by the new coalition government will subdue wider economic growth, but sustained banking-sector weakness and external shocks similar to the Greek debt crisis (see box on page 9) could threaten even the central low-growth scenario.

Findings

Evolving perceptions of risk

The Economist Intelligence Unit's risk scores for Britain and Ireland suggest the dangers foreseen by the survey respondents are not misplaced.

These assessments are based on over 60 indicators – including existing data and likely future developments – which are then combined into scores to represent the level of risk for each country. The scores range from zero (equivalent to an AAA rating) to 100 (equivalent to a D rating).

In both countries, the banking sector is the source of greatest risk – which may help explain why our survey respondents are so concerned about threats to their firm's financial position. It is also noteworthy that while the Economist Intelligence Unit's risk scores for Ireland have declined slightly in recent months, those for the UK have generally risen. Beyond the financial sector, risk concerns in both countries derive from fiscal weakness (particularly in light of the eurozone debt crisis of April-May 2010) and expectations of a fragile economic recovery this year and next.

Of course, attention to risks is not a zero sum game. Peter Kaye, Group Head of Business Protection and Continuity at the John Lewis Partnership, points out that the emphasis on cost reduction in a downturn leads to a greater concern for efficiency and therefore more detailed definitions of processes. This provides an

United Kingdom

Criteria	July 2009	January 2010	April 2010
Sovereign risk score	34	35	37
Currency risk score	33	34	35
Banking sector risk score	42	42	41
Political risk score	23	24	25
Economic structure risk score	23	25	28
Overall country risk score	36	37	38

Ireland

Criteria	July 2009	January 2010	April 2010
Sovereign risk score	35	37	34
Currency risk score	25	32	29
Banking sector risk score	43	43	42
Political risk score	17	17	17
Economic structure risk score	38	38	38
Overall country risk score	39	40	38

Source: Economist Intelligence Unit Country Risk Service

opportunity for a specialist risk manager “to have a much more meaningful conversation” with those responsible for the processes.

Nevertheless, the intense focus on financial risk means other dangers might be missed. Although financial threats have certainly not disappeared, companies should be looking more closely at the possible implications of the macroeconomic and other risks they face.

Risk appetite: A slow recovery amid continued money worries

Although companies are expecting to spend more time looking at risk, what is likely to happen to their appetite for it? As documented in *Retrench or Refresh?*, executives are not betting on a rapid or strong recovery. As a result, they are expecting to see only a small change in their own willingness to take on risk.

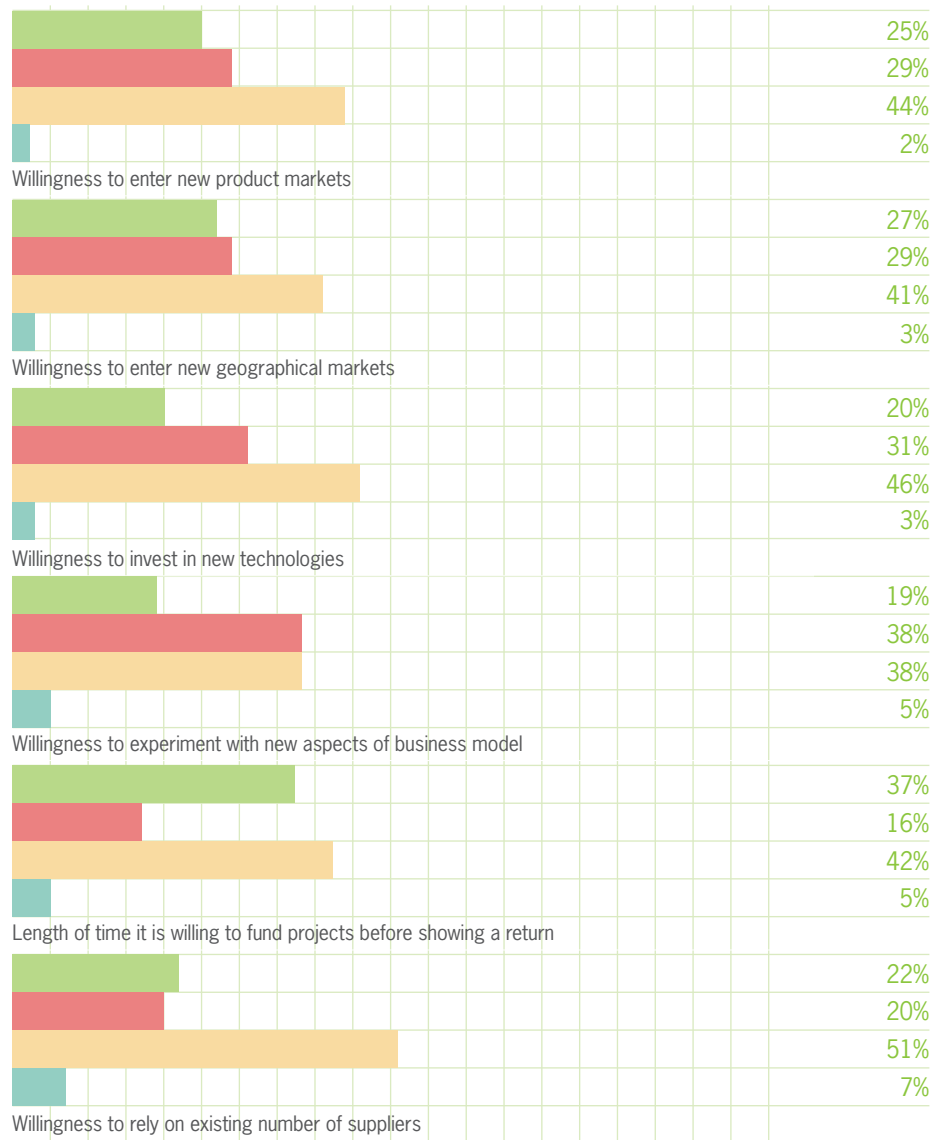
When asked how their degree of risk aversion will develop over the next 18 months, a plurality of survey respondents say they expect no change. When it comes to entering new geographic or product markets, experimenting with new business models, and investment in new technology, more respondents expect risk appetites to increase rather than to lessen. The downturn's effect, however, is not yet finished working its way through corporate attitudes. Nearly 40% of respondents, for example, suggest their firms will shorten the time frames required for projects to show a return. Professor Power surmises: "Companies have definitely learned lessons, and quite specific lessons about the way they got hurt. It is probably making them more risk averse in those areas. On other aspects of risk, they might have the same attitudes as before the downturn."

This picture is not uniform across the economy. Companies in the financial sector – the epicentre of the downturn and among the first to feel the pain – expect to start accepting risks faster than most industries. Manufacturing respondents, on the other hand, predict growing risk aversion in most areas. Mr Peckham explains that acting conservatively rather than trying to engage in a price war – the only way to grow market share in last year's conditions – has so far probably saved many companies from bankruptcy and may remain the best strategy for some time.

Perhaps more important, however, is that just as risk management goes through cycles based on economic conditions, so does risk perception. Notes Mr Peckham: "Nobody knows what will happen in the UK economy in the next 12 months. There will not be a big change [in risk perceptions] until people have a better view of what is going on. If the economy is in real trouble, risk aversion will remain high. If it improves, people will forget quickly."



In the next 18 months will your company become more or less risk averse than it is now in the following areas? (% responses)



Percentage of respondents

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%

More risk averse Less risk averse No change Don't know

Source: Economist Intelligence Unit

A more fundamental problem

If the only issue for risk management was a lack of attention, then the increased focus described on page 12 might be an adequate response as companies slowly accept more risk again. The problem, however, is that risk processes are failing to deliver on a range of basic requirements at too many companies.

According to the survey:

- Risk processes have a genuine influence in decision making at less than 50% of companies
- In only 41% of companies is risk managed at all levels of the business
- At no more than 37% of firms is there a common awareness of risk from top to bottom
- Just 34% of executives say their risk management processes add value to the business

Although these figures are higher at larger companies – which are more likely to have a dedicated risk function – only a minority are seeing a benefit from their risk systems. Among firms with annual sales of over £1 billion, for example, risk management processes have a genuine influence on decisions at 54%, they are seen to add value at 46% and they have created a company-wide awareness of risk at 36%. Even in the financial services sector, which has perhaps the most extensive experience of risk management, only 52% of executives believe that it affects decision making and 43% that it adds value.

What should companies consider doing to improve their risk management? Our interviews suggest that a starting point is to break out of the two silos in which risk management is often confined: how it perceives risk, and how this perception is used in the broader business.

According to Professor Power: “Risk management has too often been made into an audit practice, and risk officers feel that the thinking part of the job has been squeezed out. An audit practice won’t help you anticipate when things are going vastly wrong or provide for flexibility of response.” He suggests that, rather than a largely metrics-based approach to risk, one which includes consideration of alternate futures, including what could go wrong – such as stress testing or scenario building – is necessary. The natural optimism of people makes such an approach vital, he believes, as “organisations find it difficult to project failure of business cycle.”

Shell’s Mr Bentham, as a scenario practitioner, also stresses the need to use the many appropriate analytical approaches to risk while having an understanding of the deeper personal and cultural drivers that influence human choices. “One of the areas that we’ve enhanced over the last year, and which has always played a role in our scenarios, is that of social-cultural-behavioural modes of choice,” he says. “This is not only about understanding how business confidence swings; it is beginning to educate us about our own behaviours.” (See box on page 15)

A more fundamental problem

Which of the following statements is true of the risk management process at your company? (Select all that apply.) (% responses) The risk management process...

	Total	Financial services	Media & entertainment	Construction & property	Healthcare services	Retailing
has created a common awareness of risk from top to bottom	36.7 %	48.1 %	18.8 %	49.2 %	37.7 %	35.3 %
has ensured that risk is managed at all levels of the business	40.6 %	57.4 %	31.3 %	37.3 %	52.8 %	33.3 %
adds to the value of the business	33.6 %	42.6 %	28.1 %	30.5 %	22.6 %	27.5 %
genuinely influences decision making	49.2 %	51.9 %	42.2 %	52.5 %	39.6 %	41.2 %
drives cost savings	37.5 %	18.5 %	31.3 %	45.8 %	22.6 %	51.0 %
has helped to avert a potential major incident, which could have harmed the business	18.9 %	27.8 %	25.0 %	20.3 %	20.8 %	9.8 %
has helped to minimise the impact of the economic downturn	29.7 %	35.2 %	32.8 %	37.3 %	7.5 %	27.5 %
helps to educate and inform non-executive directors, which enables them to provide real challenge to the executive team	18.2 %	18.5 %	10.9 %	13.6 %	34.0 %	15.7 %

Source: Economist Intelligence Unit

Shell; scenarios and assessing risk in the downturn

Shell is well known for its use of scenarios – a structured approach to imagine a range of possible futures and to consider their implications for strategy. The technique has even occasionally allowed the company to have considered the best response to dramatic shocks – such as the Soviet Union’s collapse – before they occurred. How useful were scenarios, however, when the downturn struck?

Jeremy Bentham, Shell’s VP Global Business Environment and head of the scenario planning team, believes that “elements of the approach were very helpful, although of course some things were missed that everybody missed. Overall, I believe they helped us to avoid both under-reacting and over-reacting to events.”

One important benefit of scenarios in any such situation is the behaviour which their long-term use inculcates. Stories may be the most visible part of scenarios, but more important is how these are used within a corporate culture – through both formal processes and informal means –

to habituate senior leaders to thinking about things in different ways. Since early in the decade, Mr Bentham says, Shell’s macroeconomic and geopolitical scenarios had included possible large, negative shifts. “People were thinking about the long-term trends and the potential for discontinuity,” he adds. “There was a grounding of preparation” when the downturn hit.

In autumn 2008 Shell’s analysts, although aware of building tensions in the financial system, were not predicting that an imminent crisis was inevitable. Mr Bentham recalls, however, that “when Lehman Brothers went down, we recognised that it was likely to cascade through.” Within two weeks the scenario team provided the executive committee and board with details on the seriousness of the situation, the uncertainties involved and the relevance of other long-term trends. Bentham adds that the leadership recognised that, in such circumstances, “the only way to address this outlook was through scenarios, and they were needed quickly.” By January Shell had highly detailed recession and recovery scenarios. One even involved a great depression,

“not because we felt it was a high likelihood but to educate senior leadership to recognise the signals – what was a significant event and what was part of the noise – and to prepare them for what it might look like.”

An advantage of scenarios in such conditions, Mr Bentham explains, is the steadying influence they provide. “In the beginning of 2009, our recession and recovery scenarios, including the deep recession scenario, were teaching us collectively not to panic. This became self evident within our leadership thinking,” even while popular opinion was frequently over-reacting. Now, he adds, the scenarios, which are reviewed regularly, are “cautioning against overconfidence in what is emerging. There is still a relatively significant level of fragility in the recovery.”

This steadying influence does not come simply from executives reading a particular set of scenarios; more important, says Mr Bentham, is the large amount of dialogue that goes on around them. This conversation is a continuous, ongoing part of how the company operates.

More than disaster prevention

Even the best risk assessments in the world are not much good, however, if nobody uses them. Travelex's Mr Hill believes that problems are inevitable if "risk management is seen as a separate discipline and separated from how the business is run. The best way to make risk management work is to make sure it is integrated."

For risk management to go beyond simple compliance and play such an integrated role, Professor Power maintains, it needs a champion – be it a chief executive or CRO (chief risk officer) – who can ensure that risk considerations are brought into decision making and strategy making early on, rather than being a box to tick prior to completion. Companies need some way – whether through risk officers or other executives – to challenge ideas constructively. Similarly, Mr Kaye notes: "If you are going to deal with [a risk] problem in a business-led way, then you really need to get the right top-down governance in place. You have to have management engaged." Simple strategies can help to achieve this. Mr Kaye says that because John Lewis's risk reviews and strategy reviews take place simultaneously, there is a much greater chance that executives will integrate risk considerations into strategic choices.

By helping the leadership decide on, and understand, the implications of an appropriate risk appetite, risk management can also help with the identification of opportunities to improve operations. Even what might seem on the surface like a simple compliance exercise can greatly improve processes. Mr Kaye notes that

new data security standards imposed by banks to reduce fraud are causing a broader rethink of information security and information handling. Similarly, the new Solvency II regulations facing the insurance industry, although imposed from the outside by European regulators, hold out the possibility of better informed decision making and improved use of capital.

General Healthcare Group's Mr Fawcett believes that risk considerations should play an integral role in how a company is run. "Risk management covers a far broader spectrum of things than the word 'risk' brings to mind. If the senior management team is tasked to look at efficiency, market awareness, organisational effectiveness and customer satisfaction, it has covered most of what a good risk audit would address." Mr Fawcett reminds, for example, that working with customers to ensure that they are getting what they want, and with suppliers to avoid problems of obsolescence or shortages, are not traditionally "risk management, but just good business practice. They are driven by the approach of how can we reduce risk and maximise opportunity."

Risk management can even go beyond helping with strategy to providing a selling

point for the company itself. Mr Hill explains that Travelex handles a lot of cross-border payments for companies for which this is not a core part of their operations. Such transfers, however, are coming under increasing regulatory scrutiny, so expertise in addressing compliance risk is attractive to customers. "Because risk management is a key part of what we do, it is an opportunity to differentiate ourselves," he says. "For example, because we understand the anti-money laundering environment, that provides comfort for our customers based upon our expertise in this field."

Professor Power sees risk and opportunity coming together best in the risk appetite process. "Risk appetite," he maintains, "should be understood as a value creating proposition. The policy should be symmetrical between losses and gains, and as widely understood as possible among top management." He adds that the very process of discussing risk appetite can and should capture both the upside and downside of risks and, most importantly, serve as a reminder that new ventures are expected by the company. Risk, then, should be about where a company wants to go as much as where it will not go.

Travelex learns lessons from the downturn

The downturn hit two of the core markets of Travelex, a currency exchange and payment services company. Less travel by people has meant less money-changing, and a reduction in trade volumes has reduced the flow of international payments. Even though revenue has declined, the company is still in a position to expand its airport footprint and consider introducing its FX products into new geographies and industries.

Chris Hill, Travelex's CFO, credits the placement of risk considerations at the centre of corporate management with much of the company's ability to adjust to the harsher environment. "Many businesses are now questioning 'why didn't my risk management processes tell me this would happen?'," he explains. "You've got to have a process for managing risk, and that process has to be embedded in how you manage the business on an ongoing

basis." For Travelex, this in particular means the orderly management of liquidity risk – a must for a business that sees £2.5 billion moving through its systems during a month. The company collects highly detailed data on cash flow, which the CFO reviews daily and uses in fortnightly calls with all the divisions. More broadly, Travelex remaps its risks in detail once every twelve months, and management revisits this assessment several times in the course of the year. Mr Hill adds, "It is about having the right processes that keep risk on the agenda. The key is to identify, understand, manage and monitor risks, and then have a system to make sure the controls are working."

Travelex had the framework of its current processes in place as early as 2007, but that does not mean it stood still as the downturn arrived. "When the credit crunch hit," says Mr Hill, "we went on to stages two and three." This has meant even greater discipline in liquidity management and more detailed

information gathering about customers and other businesses with which the company has dealings, in particular looking at creditworthiness.

For example, where it might have relied on credit agency ratings before the recession began, it now looks at credit swap data and other indicators that monitor the macroeconomic picture. The data has also increased its knowledge of customers and ability to service their needs.

At the same time, the tight risk management has enabled the company to invest in expansion and other opportunities which have emerged from the downturn. Mr Hill explains that "In an environment where lots of people are nervous, we have to be careful that we back the opportunities that are truly going to pull through. We are continually looking at opportunities, and it is the risk management that will help us to make the best of them."



Chris Tam
Grant Thornton,
China

What have you seen in China, with regard to risk management process and policies over the last 18 months?

In mainland China, the government has recently introduced new regulations which require public companies to establish internal control and risk management systems, annually evaluate the effectiveness of internal control and disclose any material deficiencies in their annual report. External auditors will be required to express an audit opinion on the effectiveness of internal control that their strategy is aligned with their desired risk profile.

In light of the credit crunch has there been a change in attitude?

While the credit crunch in US and Europe did not significantly impact on domestic consumption in China, there was a large impact on exports. As such, the Chinese government promoted increases in domestic consumption with many export oriented businesses repositioning their strategies to domestic markets.

The recent downturn has also created opportunities for Chinese companies to move outside of the country. In 2008-2010, we have seen increasing amounts of outbound investments by Chinese companies acquiring international brands and technologies, natural resources and distribution channels in the US and Europe.

However, many Chinese companies are not familiar with managing overseas businesses and do not have experience in managing unfamiliar risks such as labour relations, international regulations and political issues. This will pose a challenge to many of those companies and require a step change in their risk management processes.

What are the key challenges/risks to firms wanting to do business in China?

We advise UK investors to conduct a thorough risk assessment by consulting your business advisers with local knowledge. However, we would like to highlight the following risks.

Taxes – despite relatively low operational costs in China, there are many hidden costs. For example, tax rules are governed by state and local governments and these vary from province-to-province or city-to-city. Also, following tax reforms in 2008, there are very few preferential tax benefits for foreign investors compared to domestic companies.

Labour – skilled labour costs in major cities have been increasing by 15-20% per annum for the last 2-3 years. We expect to see this momentum continuing in the mid term due to shortages of skilled labour. In addition, compulsory social insurance and benefits top up approximately 34% to base salaries.



Cian Blackwell
Grant Thornton,
Republic of Ireland

The impact of the global economic situation on Irish companies has been exacerbated by two specific local factors – the deflating of a significant property bubble, and the financial and reputational damage to the country as a result of governance scandals in a small number of companies, notably Anglo Irish Bank.

Although most Irish companies are surviving the recession – and some are thriving – many of the casualties can be attributed to a failure to manage risk. Two risks in particular proved to be widely underestimated: firstly, that banks which were so eager to lend in the boom times would be so reluctant to do so in the recession, cutting off many companies' credit entirely; and secondly, that property values could plummet, in some cases by over 80%. The latter risk was of particular relevance where so many companies, particularly private and owner-managed companies, couldn't resist the allure of diversifying into the 'guaranteed returns' of the property market.

What we are seeing in the Irish market at the moment is reflected in the survey results, particularly the view that risk management practices prepared companies poorly for the downturn. However, opinions tend to be divided as to whether that was because the companies themselves implemented poor risk management processes, or whether it points to a general inability of risk management to deal with significant events such as those of the past two years. This latter scepticism has produced some reluctance to invest in risk management, particularly among smaller and medium sized companies.

The majority of companies are paying more attention to risk management, and are both increasing the resources allocated, and reviewing the approach being taken. This is particularly noticeable among medium to large private companies that may not previously have been convinced of the benefits of investing in risk management. Although the survey suggests that the heightened attention may only be temporary, if companies can use this opportunity to review and strengthen their risk functions then the benefits may be long term.



Sandy Kumar
Grant Thornton, UK

How companies are reacting

We have seen a renewed interest in developing effective risk systems over the last year. In many cases this has involved a move from a compliance-led risk minimisation approach, often at a detailed process and business unit level, to a more strategic risk function. This process has enabled some companies to improve the effectiveness of their risk function while reducing its cost.

As the economy continues to emerge from the recent downturn, it is those companies with the best risk processes which are best placed to take advantage of opportunities as they arise. They are able to quantify the potential risk and reward arising from specific decisions and improve their strategic decision making. These companies often have enhanced risk mitigation activities, as management are able to allocate resources more precisely.

Risk appetite

Historically, the risk appetite of many companies has not been formally defined and can only be implied through decisions made by the board and management. This is often subjective, inconsistent and not always communicated effectively.

We have noted growing interest in developing risk appetite statements which set limits on the level of risk that a company is willing to accept.

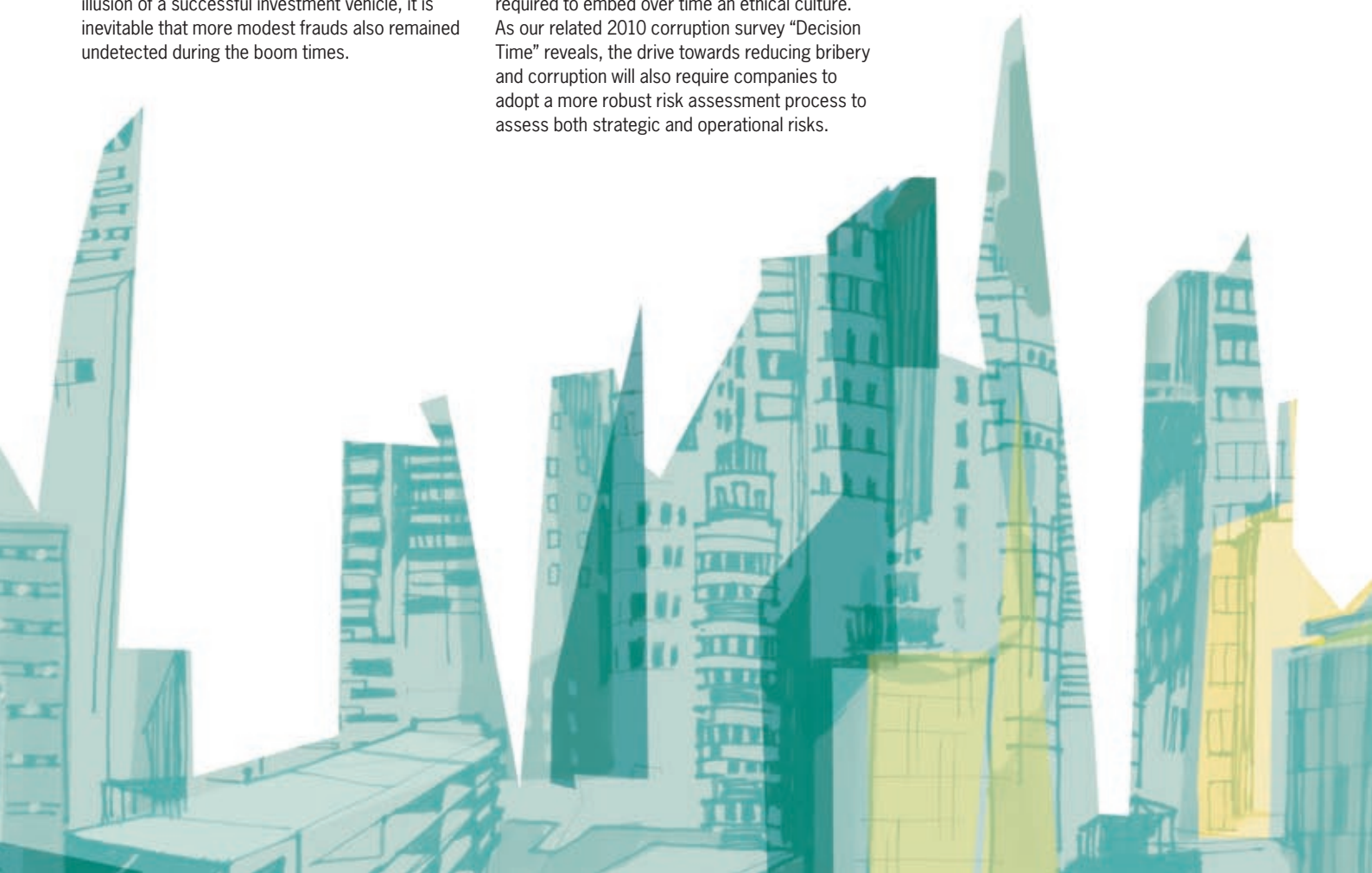
The best examples are clearly linked to a company's strategic objectives, include quantifiable measures, have regard to stakeholder expectations and are set by the board and senior management. By defining their risk appetite, companies can improve the quality and consistency of their decision making and ensure that their strategy is aligned with their desired risk profile.



Sterl Greenhalgh
Grant Thornton, UK

An increasingly important aspect of the risk management spectrum is mitigating financial crime and related risk in the light of increasing legislation and enhanced intervention by law enforcement and regulators. While the recent liquidity crisis exposed several major frauds (such as Madoff) that typically relied on an ever increasing number of investors to maintain the illusion of a successful investment vehicle, it is inevitable that more modest frauds also remained undetected during the boom times.

The failure to prevent or identify financial crime is entwined in a lack of secondary and pervasive controls. These can be created through fraud awareness training and effective management supervision which in turn ensure compliance and create effective deterrents. Without these two essential components, organisations will struggle to drive the necessary behavioural changes required to embed over time an ethical culture. As our related 2010 corruption survey “Decision Time” reveals, the drive towards reducing bribery and corruption will also require companies to adopt a more robust risk assessment process to assess both strategic and operational risks.



Put risk management review on the board agenda

Here are some suggestions from our own experts on the areas of risk management that will help you to discuss and assess the quality of your risk management framework. We measure this against five levels of risk maturity. These are as follows:

Risk Maturity	Key characteristics
Risk Naïve	No formal approach developed for risk management
Risk Aware	Scattered silo based approach to risk management
Risk Defined	Strategy and policies in place and communicated. Risk appetite defined
Risk Managed	Enterprise-wide approach to risk management developed and communicated
Risk Enabled	Risk management and internal control fully embedded in the operations



An illustration of a person sitting at a desk with a clipboard. The person is shown from the chest up, wearing a white shirt and a dark tie. They are holding a large white clipboard with a black border. The desk is a light green color. The background is a dark grey color.

An organisation's level of risk maturity can be assessed against the following categories.

Leadership

- Have you assessed your risk appetite in determining the business model?
- Is the board active in risk management?
- Do the right people have ownership of your risks?

Risk strategy and policies

- Do your risk processes add value to the business?
- Has risk management been embedded in the business?
- Are risk systems integrated with business processes?

People

- Are the right people involved in risk management?
- Is there a common awareness of risk throughout the business?

Processes

- Are you confident that you have identified and are managing your main risks?
- Do you utilise robust models to quantify and score risks? Is this consistently applied?
- Do you regularly monitor the effectiveness of risk responses and the operation of key controls?
- Do you make use of stress testing or scenario building to consider alternate futures?

Risk handling

- Is there a continual updating of risks by operational management?
- Have you embedded risk into your decision making processes?
- Do you have standardised risk reporting throughout your business?

Outcomes

- How is risk management built into performance management processes?
- How have risk management processes contributed to the achievement of your objectives?
- How successful have your risk processes been in preparing you for the downturn?

For a snap shot assessment of your own organisation's risk maturity, complete Grant Thornton's online Risk Maturity Assessment. The self assessment is also a useful tool for discussion around the current and planned risk processes, either internally or facilitated by one of our risk professionals. The self assessment can be found at www.grant-thornton.co.uk/riskquestionnaire

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