

Being smart about the risks you take

Get up to speed*



Being smart about the risks you take

Most risk management systems aim to avoid risk. But, if a business doesn't take risks, it can't grow. So how can you ensure that you understand the risks you choose to take and manage them successfully?

When serious problems occur – such as the current financial crisis or the spate of accounting scandals that took place at the start of the decade – regulators and companies alike tend to become more cautious. Regulators consider additional oversight response while corporates tend towards extra layers of control, in an attempt to mitigate risks that have already been identified. But, in reality, the rate of change is accelerating and new risks are emerging all the time.

Moreover, risks aren't just about avoiding the downside; they're also opportunities. Companies which try to avoid all risk will miss new opportunities – particularly those that will emerge in the current market conditions.

Companies with an appropriate and measured appetite for risk – i.e. those that can see beyond the risk to the opportunities they present – are much more likely to prosper.

That doesn't mean companies should be reckless in seeking to exploit opportunities. Good risk management is a process of making informed risk-based decisions, thereby maximising the chances of success.

In short, it's not only impossible to eliminate all risk; it's unhealthy even to try. How can you get the balance right? How can you ensure that you take the most appropriate risks for your business – risks that aren't too hot or too cold, but 'just right'?

Highlights

1. **Decide what sort of risks you want to take:** Make sure that you fully understand the market, your strategy and operations, and define the kind of risks you're willing to accept.
2. **Be selective:** Concentrate on the risks you can control and those that will give you a competitive advantage.
3. **Embed your attitude to risk in your culture:** Establish a robust risk-monitoring system and build an agile, adaptable organisation.
4. **Empower your people:** Ensure that your employees know what they can and can't do.

Making smarter risk decisions

- The costs associated with managing risk are increasing. Yet some of the risk management systems that have been put in place have actually made companies more vulnerable. As every investor knows, the past is no guarantee of the future – but a lot of risk management systems have been designed to eradicate what went wrong yesterday, not to manage risks and opportunities proactively.
- Many companies have also adopted a piecemeal approach to managing risk. They haven't understood what kinds of risk or how much risk they should accept, or used this to inform their business strategies or embedded a consistent attitude towards risk-taking.
- Sometimes regulation can exacerbate the situation by requiring additional layers of control and creating a misplaced sense of comfort that risk can be eliminated. The real cause for concern isn't 'the burden of compliance', but what happens if you try to suppress all risk-taking, rather than working out which risks you should take and ensuring your organisation understands your approach.
- How can you make risk work for *you*? There are four imperatives:
 - Decide what sort of risks you want to take
 - Be selective
 - Embed your attitude to risk in your culture
 - Empower your people

Recent research conducted by PwC shows that top executives are particularly concerned about three key criteria and their performance in regard to each:

- Defining and shaping strategic objectives
- Measuring risk management and performance clearly; and
- Aligning and improving risk management culture

1 Decide what sort of risks you want to take

- **Know yourself.** Make sure that you fully understand your business model and the context in which you're operating. Choose your strategy, bearing in mind the uncertainties that attend each route. Remember that risks aren't static; they have lifecycles and change as new options, competitors or circumstances emerge.
- **Recognise that some risks are interdependent.** Little risks can become big risks if they interact with other risks or aggregate across global enterprises.
- **Establish a common risk language** within your organisation, so that everyone understands what you mean by risk and which risks you're dealing with. Many companies use different terms to describe the same risks – and some even use different terms in different business units.
- **Define your risk appetite.** Define the amount of risk you're willing to accept in pursuit of value. Consider ethical as well as practical issues in deciding which risks, and how much risk, you're prepared to assume.
- **Align your risk appetite with your strategic objectives.** Link your risk appetite with your business strategy and operations, so that you can choose the best way of operating without compromising your commercial performance. Too much risk endangers an organisation, but too little prevents it from exploiting new opportunities to create value. Good risk management enables an organisation to optimise its risk-adjusted performance.

Enhancing performance through effective risk-taking

A leading financial institution wanted to increase its market capitalisation by more effectively linking its decisions about risk and return to its growth objectives. With PwC's help, it explicitly articulated its risk-management goals, governance structure and processes, and risk appetite.

It then communicated its aims – in terms both of risk management and of growth – to everyone in the organisation and embedded the changes.

This enabled it to build a comprehensive assessment of risk into all its business processes and take more calculated decisions. It was also able to channel resources into the areas that offered the highest potential returns; control expected and unexpected losses more effectively; minimise its earnings volatility; and boost its market value.

2 Be selective

- **Assess the impact of your risks.** Use modelling and other such techniques to identify how the major risks you've assumed could affect your business. Distinguish between the financial and non-financial effects.
- **Identify the risks that will give you a competitive advantage.** Ask yourself where your expertise lies and which risks you can manage better than your competitors. Focus on the risks that will give you a competitive advantage.
- **Concentrate on the risks you can manage.** Don't waste limited resources trying to manage random risks. Invest in the opportunities that carry risks you can control – or risks you can't control but believe you understand better than others do.
- **Measure your risk-bearing capability.** Evaluate the amount of risk you're assuming relative to the strength of your balance sheet. This will tell you how much risk you can bear.
- **Make your risk appetite explicit.** Spell out the implications of your risk appetite in terms of your strategy, business plans and the risk/reward ratio you want. A clearly articulated risk appetite will help you decide which bets

you should make – which new markets or customers to target, which new products or services to develop and so forth.

- **Spread the risks you take over time.** Don't take too many big risks simultaneously. And don't take too few risks to stay competitive. It's a question of getting the balance right.

Assessing risk accurately

When a global oil and gas company was considering whether to make one of the largest private asset investments in Australian corporate history, it concluded that it needed an independent opinion. So the board called in some risk experts to assess the proposed investment in terms of the risk it represented and the value it might bring, and determine whether the investment was credible. Within four weeks of embarking on the review, the risk experts had completed a full analysis of the risks associated with the project, enabling the board to make its investment decision armed with a much better understanding of the risks and a more robust plan for managing them to maximise the value of the deal.

Creating a robust risk management framework

A global engineering company decided to review its risk management framework, after going through a period of massive growth. The directors were concerned that the risk management processes it was using were too weak to support the enlarged business – and several incidents in which the company had been taken by surprise suggested that they were right.

Beginning with their growth strategy they initiated a comprehensive review of the existing risk management framework. Through a series of executive-level workshops they identified the major opportunities and risks for the business. Once the management team had defined these risks, it was able to pinpoint the stages at which key decisions were made and ensure that risk management became an integral part of its day-to-day business processes. It was also able to build a risk management framework that could grow alongside the company itself.

3 Embed your attitude to risk in your culture

- **Put effective systems and processes in place.** Establish a robust risk-information system to capture information about your major risks and monitor them continuously.
- **Learn from experience.** Analyse your own experience and that of other companies in your sector, so that you can learn from best practice and avoid making the same mistakes.
- **Break away from the herd.** Look beyond your own industry and markets to identify new risks and opportunities. A broader perspective can help you anticipate problems and capitalise on opportunities your competitors haven't spotted yet.
- **Take a leaf out of nature's book.** Think of risk management as an evolutionary process – a process of learning continuously and adapting to alterations in your environment.
- **Create an agile organisation.** If you only pay attention to changes that have actually happened, you may not be ready for unexpected changes. So you need to create an organisation that's flexible, speedy and ready for *anything*.
- **Spread the word.** Risk management is everyone's responsibility – not just the job of the people in the risk control function. Make sure that your employees treat risk management as an intrinsic part of everything they do.
- **Be proactive.** Take calculated risks.

Taking an integrated approach

When a leading telecoms company wanted to upgrade its business systems, it recognised that it had two choices; it could either incorporate risk controls as part of the upgrade or install them afterwards, as it had previously done when making major changes. Since retrofitting the controls had proved very expensive, it decided to do everything at the same time.

The company began by setting up a controls advisory office staffed by people with risk and controls experience. It then appointed individual advisers to each of the teams responsible for changing a business system or process, to help them design controls into the systems or processes before going live.

The company is now partway through the upgrade and confident that the switch to new systems will go smoothly. It also believes that it has embedded its attitude to risk much more firmly within its corporate culture by putting controls advisers on the business teams involved in making the changes.

4 Empower your people

- **Communicate clearly.** Be explicit about your risk appetite and risk tolerance. Tell all your employees exactly what sort of risks you're willing to take and what sort you want to avoid. Give them clear guidelines; let them know what's critical and what isn't. Don't just assume that they understand.
- **Spell things out.** Be transparent. Define the roles and responsibilities of everyone in the organisation. Make sure that they know what they can and can't do, including the level of risk they're authorised to assume.
- **Provide training.** Put a training and guidance programme in place to support the rollout of your risk-appetite framework throughout the business.
- **Stick to your word.** When you authorise people to take risks, don't blame them for taking those risks if something subsequently goes wrong.
- **Enforce the rules.** Discipline anyone who takes the right risks without being authorised to take them, and encourage anyone who sees an opportunity but isn't authorised to act on it to go to someone who is. Reward staff for taking their ideas to the right people rather than going beyond their authority.
- **Create a learning culture.** Promote a spirit of honesty and openness. Your employees will be in a better position to learn, if they don't think that they'll just be blamed for what they don't know or get wrong.

Closing the gap

Concerned by the number of customer complaints it was receiving, a leading fund manager decided to review its operations from a risk management perspective. This rapidly showed that it had two different cultures in its front and back offices, and that the people in each office were pulling in different directions.

The front office was very good at getting new products to market, but the back office lacked a proper operational framework and was struggling to keep up with the changes. Individual employees were maintaining their own records, but they were not sharing the information, so things were going wrong. As a result, the people in the front office did not respect their colleagues in the back office, and an 'us and them' mentality had developed.

The review highlighted various options for improving the back-office operations. It also identified how the gap between the two offices could be closed by giving everyone a clear role to play, empowering them to perform those roles and ensuring that their respective contributions were recognised.

The risk of failing to take the right risks is the biggest risk of all!

- You can't eliminate every risk – and it's unwise even to try. Especially in times of crises, try to resist the temptation to remove all risks.
- If you don't decide which risks to take, you'll still be at risk – including the risk of stagnating, as you miss out on promising new opportunities.
- Ask yourself how well you understand the risks your business is taking.
- Are you focusing on trying to avoid risk or making risk work for you?
- Evaluate what you're doing to define your risk appetite and communicate it throughout the organisation.
- Remember that, if you keep doing what you've always done, you'll keep getting what you've always got.

How PwC can help

PricewaterhouseCoopers works to solve complex business issues – locally and globally. Our teams draw upon skills in risk, regulation, people, operations and technology to capture opportunities, navigate risk and deliver lasting change across business networks.

We take time to listen to your situation and offer a range of smart choices to consider – choices based on independent and challenging insights, supported by facts and industry benchmarks. We help you reinvent risk and make the choices that will enable you to succeed. We can help you:

- To define and understand the risks associated with your business strategy.
- To assess and benchmark your organisation's risk maturity against core principles and industry practice.
- To engage stakeholders in the dialogue to adopt the right risk appetite.
- To identify and to define the risk appetite that's right for your business and to install reliable risk-monitoring systems.
- To embed the right sort of risk-taking in your governance processes, performance management processes, operations and culture.

To find out more about how to be smart about the risks you take, please contact one of our partners on the next page, or visit www.pwc.com/getuptospeed

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Other topics in this series:

Crisis management

An unanticipated crisis can cause immense disruption, cost a lot of money to rectify and damage your company's image if you end up on the front page of the newspapers. This paper examines how companies can take sensible precautions, recover control and extract value from the situation.

Risk culture

Establishing a culture in which the right people do the right thing at the right time, regardless of the circumstances, is critical to an organisation's ability to seize the right risks and avoid the wrong ones. This paper explains organisational culture, how it can support your business strategy, goals and risk appetite and how important it is to get this balance right.

Operationalising risk management

Most companies have responded to more regulation and increasing scrutiny from stakeholders by establishing independent oversight functions and additional layers of control. This paper looks at the steps you can take to make risk management and compliance a part of your day-to-day business, and reduce unnecessary overheads while at the same time adding value to your organisation.

Risk performance management

Many companies could enhance their corporate performance dramatically by using key risk indicators that look forward, rather than focusing on the past. This paper provides guidance on how to eliminate reporting silos and build a more rounded picture of what's happening in your business.

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