

10 Minutes on Managing Risk and Performance*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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Aligning risk and performance in a connected world

Highlights

- Siloed approaches to risk management often fail to produce meaningful impact on a company's overall performance.
- Boards and management are under pressure to reform how risk is assessed and to measure its effect on a company's performance.
- Linking risk and performance gives companies the confidence to take smart risks.
- Non-financial information is crucial to managing both risk and performance.

The loss of \$50 trillion in global wealth between September 2007 and March 2009 is focusing minds on the role of risk management.¹ In hindsight, it's clear many companies took on excessive risk amid unreasonable expectations for long-term performance.

Extreme volatility—even financial crisis—isn't unprecedented for US businesses. Yet this downturn has revealed something new: narrow, compliance-focused approaches to risk management create dangerous blind spots for businesses, threatening not only growth but also the moorings of survival.

Breaking down the silos

- 1. Linking risk management to performance management is a new business imperative.** Only 37 percent of senior executives surveyed by PwC across industries said that their companies linked key risk indicators with key performance indicators.²
- 2. Start building the connections now.** Bring risk specialists and operations managers together to assess risks at the strategic planning phase. Identify the most important risk-informed performance measures, and monitor them to discover emerging risks.
- 3. Embedding the linkage between risk and performance may require significant organizational changes.** Risk management that is disconnected from performance management may be a symptom of other misalignments in the organization. Incentives, compensation, roles, and information flows may have to be redesigned.

¹ Asian Development Bank; Lawrence Summers, Remarks to the Brookings Institution, March 13, 2009.

² PricewaterhouseCoopers, 2008: Q2 Management Barometer, 2008.

At a glance

Operating in an interconnected world requires a fresh approach to managing both risk and performance

Questions for Operations Managers:

- Have I spotted the risks that pose threats to business objectives?
- Have I identified the types of risks that reveal opportunities for improved performance?
- Do I fully appreciate the company's appetite and tolerance for risk?
- Do I have access to information that could help anticipate events posing risks to performance?
- Do I work closely with risk managers to tie performance management with risk management?
- Am I clear on the reliability of the performance metrics used to gauge progress toward business objectives?

Questions for Risk Managers:

- Is the company's risk profile aligned with the performance objectives based on corporate strategy?
- Am I using non-financial information (along with financial information) to build the company's risk profile?
- Am I adequately assessing how risk events can potentially affect business strategy?
- Have I identified the smart risks that create opportunities for success?
- Do I interact frequently with operations managers to ensure that risks are well integrated with operational management goals?
- Am I continually monitoring risks to the performance indicators used to gauge progress toward business objectives?

Traditional approaches to risk management are no longer making the grade

In today's mercurial global economy, companies are responding to new and unforeseen risks with little incentive to view the opportunities often underlying those risks. To exploit those opportunities, business leaders must develop a greater appetite for the strategic risk taking that improves business performance, both financially and operationally.

"Risk is really a potential cost on capital," says Prof. Neil A. Doherty, chairman of the Insurance and Risk Management Department at the Wharton School. "So you can think of managing risk as really the other side of the coin from managing capital." Doherty contends that a sophisticated approach to risk management can increase a company's value 3 to 5 percent.³

Narrow approaches to risk management hamper an organization's ability to monitor critical risk interdependencies. This leaves them less prepared to discern the bigger, smarter risks they should take in an increasingly volatile business environment.

One historically risk-averse company that benefited from an integrated risk and performance strategy is Westinghouse Electric, which builds and maintains nuclear power plants. Faced with intense competitive pressure, leadership turned the organization's risk culture on its head, aligning incentives for engineers around smart risk taking with a rigorous focus on performance results. Managers are evaluated and rewarded on criteria connecting innovation with business objectives and performance metrics. Encouraged to pursue risks grounded in performance goals, engineers have since recommended two new services that the company has taken to market.⁴

While more companies recognize the importance of systematically linking risk and reward, a gap between awareness and action still exists. Ninety-two percent of recently surveyed CEOs agreed that information about risk is important or critical to long-term success, but only 23 percent believe they have comprehensive information about risks to their businesses.⁵

³ Wharton School, "Leveraging Risk Management," Knowledge@Wharton, March 1, 2006.

⁴ Brian Hindo, "Rewiring Westinghouse," *Business Week*, May 19, 2008.

⁵ PricewaterhouseCoopers, 12th Annual Global CEO Survey, January 2009.

Rethinking risk is becoming a business imperative

Credit rating agencies, institutional investors, and regulators—often under scrutiny themselves for their roles in today’s financial crisis—are beginning to formalize the linkages between risk and performance. As a result, these external stakeholders are forcing companies to reform their approaches to risk and performance management, including board oversight.

Companies must respond by appointing independent directors qualified to assess risk, evaluate performance, and make the connections that link risk and reward.

Meanwhile, in its central task of determining creditworthiness, Standard & Poor’s has begun to take the enterprise risk management analysis used for financial services into sectors like industrial products, retail and consumer, technology, automotive, and entertainment and media. Consequently, risk management practices will more directly influence credit ratings of far more companies and, naturally, their costs of capital.

Other stakeholders are weighing in. The California State Teachers’ Retirement System, the second-largest

public pension fund in the US, has identified 20 risk factors—ranging from monetary transparency and corporate governance to workers’ rights and environmental compliance—which will factor into its evaluation of current and potential investments.⁶

Further inducement to link risk and performance lies in the American Recovery and Reinvestment Act of 2009, which sets executive compensation rules for companies that have received or will receive assistance under the Troubled Asset Relief Program. The regulation imposes limits on compensation plans, bonus packages, and golden parachute payments. It further includes clawbacks of any bonus or incentive compensation paid to senior executives based on performance statements that are later proven to be materially inaccurate.⁷

Companies must take the lead in redefining risk in the new economic climate. The market has indicated it will reward effective implementation with higher price-to-book multiples, according to PwC analysis.

⁶ California State Teachers’ Retirement System, www.calstrs.com.

⁷ American Recovery and Reinvestment Act of 2009, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.pdf.

An integrated approach offers a new view of the old balance sheet

The market values good risk management



Source: PwC analysis, based on Bloomberg data, 2007

Unlike traditional—often siloed—approaches, integrated risk and performance management can help companies:

- Quantify risk appetite and tolerance.
- Identify potential risks across the business portfolio.
- Assess risks to performance goals.
- Channel financial and operational resources to maximize the risk-reward proposition.
- Align financial incentives for risk taking with potential outcomes.

PricewaterhouseCoopers analyzes risks in a variety of categories—strategic, financial, operational, regulatory—across the breadth of an entire business, and plots those risks against their likelihood of occurrence. The analysis then links the impacts of specific risks to key

business initiatives by using metrics such as earnings volatility, capital adequacy, and capital optimization.

One such PwC assessment of 52 North American, European, and Japanese financial institutions found that the market tends to assign a higher price-to-book multiple to companies with more effective, sophisticated risk management programs, as measured by certain key performance indicators (see figure at left).

These organizations integrated risk and return across the business, analyzed risk-reward relationships on new initiatives, balanced qualitative and quantitative views of risk in management decisions, and measured market, liquidity, and operational risks.

Such a holistic view of risk and performance allows companies to make smarter decisions about which risks may improve operations and cut costs.

The foundations for an integrated approach

Start at strategy setting

Linking risk and performance starts at strategy setting: the resulting objectives should reflect a clear understanding of where a company's leading sources of shareholder value creation and destruction lie. With this integrated approach, business leaders can better identify the smart risks—or opportunities—to pursue and the dangerous risks to avoid as they shape strategy.

Develop integrated performance metrics

A portfolio of key risk indicators must include the operational metrics essential to improving business performance: A 2007 PricewaterhouseCoopers' survey of 193 senior executives at European multinationals found that companies reporting better-than-expected financial performance over the previous three years relied on operational metrics—in addition to financial metrics—far more than their underperforming peers.⁸

⁸ PricewaterhouseCoopers, Management information and performance: CFOs face new demands for high-quality data that drives decisions, June 2007.

Mine existing data across the company

Some business leaders mistakenly assume that they'll need new systems in place to assess key risks to performance objectives. At most companies, however, a wealth of data already exists throughout the organization. The problem is not necessarily an information gap but, rather, a synthesis gap, requiring leadership to identify which information is critical and to pull it into reports or dashboards that can be easily and regularly monitored.

Collaborate on accountability

Companies are largely split in their approach to oversight of risk and performance. While 51 percent of the executives said that one person (most frequently the CFO) or group is responsible for both risk management and performance management, 49 percent reported that oversight resides with a combination of executives.⁹ Incentives and compensation structures will likely need to be redesigned to reshape the management habits formed in functional silos and to foster collaborative accountability.

⁹ PricewaterhouseCoopers, 2008: Q2 Management Barometer, 2008.

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