

Planning for the unknown*

Mitigating unknown and unknowable risks through effective Enterprise Risk Management

Issue

Emerging risks, such as climate change, food insecurity, energy supply disruption, and global liquidity crisis are but a few risks once thought unlikely that have now risen to the forefront. The impact of emerging risks on global business has been dramatic: venerable companies in financial services have felt the impact; entire industries have been remade. Such risks can be larger than the enterprise itself and have, not surprisingly, become boardroom issues. Some risks could be identified and anticipated, but some were not (the unknowns) or could not have reasonably been foreseen (the unknowables).

While companies have made progress in integrating risk management into strategic planning and operational management, we believe there has been, on balance, an underinvestment of financial and human resources toward managing emerging risks. We believe companies that can intelligently and effectively identify, assess and manage emerging risks will have a competitive advantage in the future.

Action

In response to the emergence of previously unknown or unknowable risks, we believe leading companies must begin to use a systematic approach to the identification and management of emerging risks. Applying the principles of Enterprise Risk Management (ERM) to this unique category of risk can help companies establish firmer footing with regard to emerging risks. Key steps include:

1. Identify emerging risks relevant to the organization
2. Assess the significance and implications of such risks to the business
3. Identify partners and establish a process for collaboration on risk mitigation
4. Embed the discipline of ERM into the organization
5. Focus resources on key risks to the achievement of the organization's strategy and objectives

Impact

Recognizing that avoiding, controlling or sharing risk is no longer solely an individual organization's responsibility, organizations can benefit from collaboration with partners. Preparedness and monitoring of risks becomes a shared responsibility and therefore requires a shared investment in resources. PricewaterhouseCoopers' ERM approach helps decision makers rationalize the implications of emerging risks to their respective organizations and mitigate emerging risks through techniques that supplement traditional ERM approaches. The results can be measured in the form of better preparedness and response, the ability to capitalize on opportunities, and enhanced shareholder value.

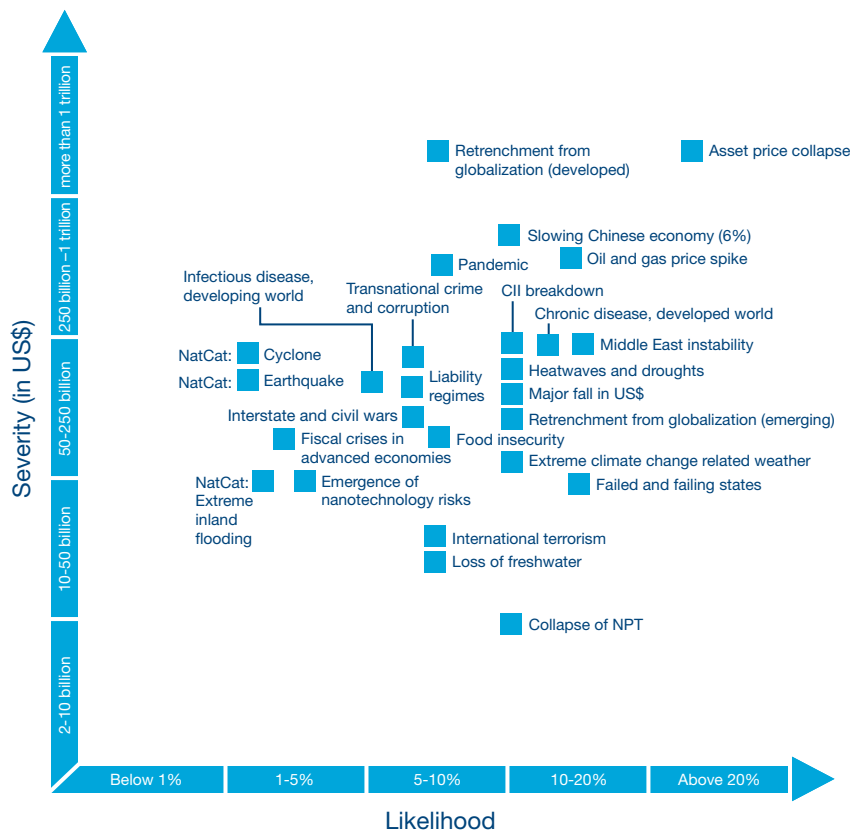
Additional considerations in addressing emerging risks

Q: What are emerging risks?

A: Emerging risks (also referred to as ‘emerging enterprise risks’ or ‘global risks’) are those events or circumstances that span beyond the entity’s control and can have a significant effect on the achievement of its strategy and objectives. They encompass larger issues and emerge from second-order consequences, as demonstrated by the US sub-prime mortgage meltdown turning into a global credit crunch. These risks can transform from long-term trends or speculative scenarios into headline catastrophes virtually overnight.

The World Economic Forum has assessed the expected likelihood and severity of 26 emerging risks¹:

The 26 core global risks: likelihood with severity by economic loss



Q: Why are emerging risks challenging to assess and manage?

A: While well-managed companies have demonstrated success in integrating risk management into strategic planning and operational management, through business impact analysis, business continuity planning and formalized ERM programs, emerging risks are typically not systematically addressed. Why do these low probability high impact risk events seem to elude robust risk management processes?

- Managers tend to focus on what they know; risks that are more likely to occur in the short-term often take

precedence over those that may occur in the longer term or unknown timeframe

- Emerging risks may be known, but there are also many unknowns—and unknowables; assessing these is challenging
- Measuring the level of required investment as well as the benefits of avoided disaster requires more data points than may be readily available
- The unpredictability, complexity, and scale of emerging risks often undermine efforts aimed at risk mitigation—why allocate resources to events that may not materialize?

¹ Source: “Global Risks 2008, A Global Risk Network Report,” World Economic Forum, 2008

- Solutions to emerging risks may be capital-intensive and require long-term vision

Yet emerging risks merit attention, particularly as they present interdependencies that can cause more far-reaching commercial consequences collectively than they would individually.

Q: What can I do to better manage emerging risks?

A: Effectively identifying and managing emerging risks requires a systematic and disciplined approach. PricewaterhouseCoopers recommends the following five step approach:

1. Identify emerging risks relevant to the organization

Based on the corporate values and goals of the organization, all relevant emerging risks should be identified and assessed to the extent possible. A carefully developed set of relevance criteria forms the basis for addressing emerging risks. To go beyond known risks, consider not only historical data but also forward-looking analysis and scenario analysis. Arguably, a well managed organization executing a disciplined approach can eliminate the unknowns, and focus instead on management of known risks and developing agility to address the unknowable risks when they arise.

Emerging risks may present a threat or an opportunity for the enterprise as a whole, a certain business unit or geography. By definition, they also affect other organizations, positively or negatively. Thinking therefore needs to extend beyond the boundaries of the enterprise.

2. Assess the significance and implications of such risks to the business

Effectively assessing emerging risks requires consideration of the significance of the risk to the entity and its stakeholders (both internal and external). Likelihood, impact and correlation (interconnectedness) statements are formulated through simulations, as opposed to traditional risk assessments. Risk rating scales need to consider the cross-organizational impact and potential scale of these risks, as well as interdependencies with other risks.

In addition to assessing threats to the organization, it is equally important to assess how certain events or circumstances may call on the organization's core activities to help other organizations manage their respective exposures to catastrophic risks. The ability

to capitalize on such opportunities requires adequate information flow internally and externally.

3. Identify partners and establish a process for collaboration on risk mitigation

Risk responses vary depending on the assessment of the risk and the organization's tolerance for variation from its objectives. Where the organization determines it should seek to mitigate the risk, yet the risk spans beyond the control of the organization, risk mitigation must explore collaborative approaches.

Considering how emerging risks affect other organizations, determine which external parties stand to benefit from or contribute to collaborative risk mitigation. Barriers to collaboration must be candidly recognized such that they can be effectively addressed and overcome. This approach changes the calculus for each party's investment in managing an emerging risk by leveraging partners' capabilities for mutual benefit.

A mitigation strategy that draws on shared investments and resources enables each party to manage elements within its control, the combination of which can help mitigate the risk at a holistic level.

4. Embed ERM into your organization

The discipline for addressing emerging risks should become part of the organization's strategic planning, business execution, and performance evaluation and reward. PricewaterhouseCoopers' ERM approach leverages the principles upon which ERM is based and provides a governance framework for establishing coordinated responses to emerging risks.

How does this differ from traditional risk management activities? Applying ERM principles to emerging risks is an opportunity to broaden the traditional risk assessment and risk mitigation view to include external parties and enable a collaborative sharing of costs and benefits by multiple parties². Emerging risks therefore require enhancement of certain components of an organization's ERM program—notably, scanning the internal environment, setting objectives, event identification, and risk assessment—to address emerging risks. The other ERM components—risk response, control activities, information and communication, and monitoring—remain unchanged. These should transcend all levels of the organization and remain in alignment with the organization's strategy and objectives.

² Developed by PricewaterhouseCoopers in collaboration with the World Economic Forum's Global Risk Network and the Wharton Risk Management & Decision Processes Center.

5. Focus resources on key risks to the achievement of the organization's strategy and objectives

Emerging risks are typically under-resourced, resulting in potentially catastrophic consequences for organizations. With an enhanced ability to identify and assess emerging risks through a disciplined ERM process, such risks should receive the allocation of financial and human resources necessary to limit their effect on the organization's achievement of strategy and objectives.

What is the role of such resources in focusing on emerging risks? While management of risk is the responsibility of every employee, "champions" can help instill such discipline, in particular:

- Link emerging risks to strategic business drivers
- Drive input and analysis by an adequate mix of resources
- Revisit traditional risk indicators and controls in relation to changing market conditions
- Listen for "weak" market signals (or "whispers") by investing in technical capability to monitor emerging risks
- Formulate dynamic risk management strategies by aligning performance and conformance

Q: What is the value in applying ERM to emerging risks?

A: Avoiding, controlling or sharing risk is no longer an individual organization's responsibility, but one that will require collaboration with partners and a shared investment of resources in preparedness and risk monitoring. ERM helps decision-makers rationalize the implications of emerging risks to their respective organizations, and mitigate emerging risks through techniques built upon traditional ERM approaches.

Emerging risk management should be viewed through a prism that encourages entities to capitalize on their inherent strengths. Existing enterprise risk management efforts can be leveraged to provide a structure and process for analyzing and tracking those risks, allocating resources, and determining adequate risk response strategies. Specifically, businesses should focus on demonstrating how their core activities help others manage their respective exposures to catastrophic risks. If advertised appropriately, companies that naturally assist in mitigating the socio-political aspects of emerging risk, have the potential to earn significant goodwill and enhance shareholder value.

Contact

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