Risk in review
Decoding uncertainty, delivering value

How leading companies use risk management to drive strategic, operational, and financial performance

April 2015

pwc

Table of contents

The heart of the matter — 1

Risk management enables growth

An in-depth discussion — 5

The importance of risk management leadership

What this means for your business — 21

Five steps to risk management program leadership

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The heart of the matter

Risk management enables growth

Our senses are an early-warning system that keeps us alive in a world of constant risk. Those who attune their senses to their environment are armed to succeed. Those who don't might not survive.

It's the same in business: Companies that treat risk management strategically are arming themselves with the knowledge to make efficient and well-informed business decisions—anticipating and mitigating risk, seizing opportunities, and enabling better overall business performance.

This past year offered ample proof that uncertainties and threats pervade today's global business environment. On the plus side, the US and UK economies grew vigorously, and declining oil prices gave a welcome lift to most of the world. However, plunging oil prices, a tumbling ruble, and international sanctions tied to the Ukraine crisis all combined to push Russia toward recession. China and Brazil also saw their economies decelerate, and the threat of deflation hangs over the European Union. Meanwhile, technology continues to disrupt, both through innovations like cloud computing and the Internet of Things and also as a result of cybercrime and cyberterrorism.

The short story? Business risk is everywhere—external and internal, interconnected, growing, and ever-changing. Executives and boards know it, and they're concerned.

In this year's PwC *Risk in Review* survey of 1,229 senior executives and board members, 73% of respondents agreed that risks to their companies are increasing. Today's business leaders often have to respond quickly to a changing world, even as they are obliged to supply more data to regulators and potential deal partners, better understand the risks embedded within their global supply chain, guard their firms from market uncertainty, and protect their intellectual property and customer data from increasingly sophisticated and widespread cyberthreats.

But as our survey shows, companies are not, largely, responding to this environment with improved risk management programs. Despite the fact that survey results show clearly that an eagerness to confront business risks boosts management effectiveness, prevents costly misjudgments, drives efficiency, and generates higher profit margin growth, only an elite group of companies (12% of the total surveyed) have put in place the processes and structures to make them true risk management leaders.

Business risk is everywhere—external and internal, interconnected, growing, and ever-changing. Executives and boards know it, and they're concerned.

These risk management leaders understand how today's multiplicity of business risks interconnect. They create resilient risk management strategies that allow them to move faster in the digital age. Their risk management programs are highly aligned with their business units, and they clearly communicate their appetite and tolerance for risk across the business. They're better able to manage and monitor potential vulnerabilities from third parties. They're able to take greater business risks, bringing an informed perspective to decision-making that steers them past threats and helps identify strategic opportunities to move forward in the face of uncertainties.

Rather than inhibiting performance, these leading companies' focus on proactive risk management actually helps them build a stronger bottom line. They're able to link business risks with their strategic imperatives, and are more likely to have achieved an annual profit margin of greater than 10% over the past three years, and better profit margin growth. These vanguard companies have sharpened their senses, and are reaping the rewards in better business results. Another telling statistic from the survey: Companies that are growing most quickly are nearly twice as likely to report they are increasing the size, scale, or responsibilities of their risk management programs, as compared with companies seeing declining or flat growth.

Risk management practices lag at most companies

Given the current world of high-speed decision-making, technology-linked enterprises, and interdependent functions, the benefits of taking an aggregated view across multiple lenses of risk—regulatory compliance, technology, operations, culture, financial, brand, product portfolio risks, and others—are undeniable. But our analysis shows that the overwhelming majority of companies are not yet developing risk management strategies that link enterprise risk management (ERM) to strategic imperatives. For example:

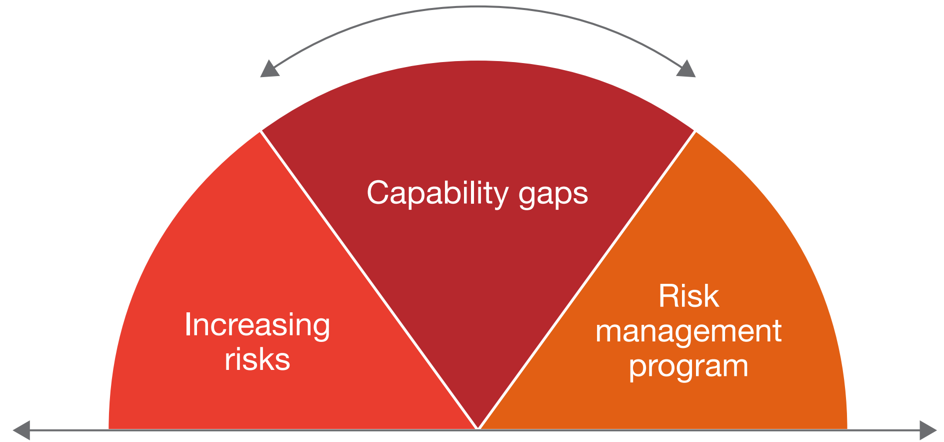
- Only 38% of respondents have a formal risk appetite framework that is clearly communicated across the company and clearly defines the level of risk the organization is prepared to accept in relation to its overall risk capacity. Even fewer (36%) effectively monitor their risk appetite and related risk tolerances using key risk indicators and other monitoring tools.
- Less than one third (31%) of respondents have a fully integrated risk management strategy that ties risk management to the strategic planning process.
- Only 14% say risk management and strategic management are "fully" aligned in their companies.

Navigating today's business environment without a proactive and well-integrated risk management program is like piloting a ship without charts: You just don't know where the shoals, reefs, and other navigational hazards lie. But a strategy to identify, manage, and monitor risks does more than help companies avoid pitfalls; it also helps leaders identify opportunities worth seizing. Among the risk management leaders in our survey, two thirds (67%) reported that they are likely to proactively involve risk analysis in the decision-making process even when a strategic decision is needed quickly, compared with just 43% of non-leaders. Rather than slowing things down, the active involvement of risk management is an aggregate time-saver on the front end of a business decision, and also relieves the cost and time challenges of responding to a previously unseen risk on the back end.

"Integrating risk management into the life cycle of your business gives you the opportunity to do two things," says Dean Simone, PwC Partner and Risk Assurance Leader. "First, it helps you understand the implication of risk at the point of decision rather than afterward. And second, it allows you to move very quickly and confidently, knowing that you've anticipated the risk and are less likely to have made a mistake that could slow you down."

Leading companies have proved it's possible to hit the sweet spot where risk management becomes a strategic enabler. While the path to proactive risk management differs for every company, the driving force is the same: a resolve by senior leadership to use the tools and techniques of modern risk management to push their company to greater heights of efficiency, effectiveness, and profitability.

Figure 1: Without a strong risk management program, capability gaps develop



Companies that are able to link business risks with their strategic imperatives are more likely to have achieved an annual profit margin of greater than 10% over the past three years, and better profit margin growth.

An in-depth discussion

The importance of risk management leadership

More than half of risk management leaders identified in our survey recorded increased profit margins over the past three years (55%, compared with 43% of non-leaders). In addition, 41% of leaders were likely to have achieved an annual profit margin of more than 10% over the past three years, compared with 31% of non-leaders.

Companies that lead in risk management actively anticipate, measure, calculate, and accept risks that provide growth without jeopardizing their business. By leveraging the knowledge they develop from creating and constantly updating their risk tools, they can execute rapidly, integrating strategic direction with financial and operational goals.

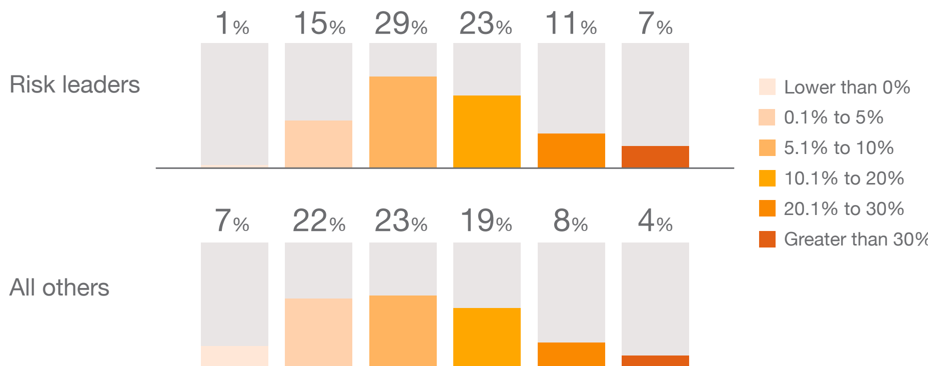
In such companies, statements of risk appetite aren't just reviewed at the board level. They are re-examined, reinforced, and made relevant within individual business units, and are well-communicated across the company.

As Carlos Cardoso, former CEO of Kennametal, principal at CMPC Advisors LLC, and a current board member at Stanley Black & Decker and Hubbell Inc., explains, "You may have a group of people who really own the deployment of risk management, but unless you have risk management processes that are integrated throughout the whole business, you haven't really conquered the risk challenge."

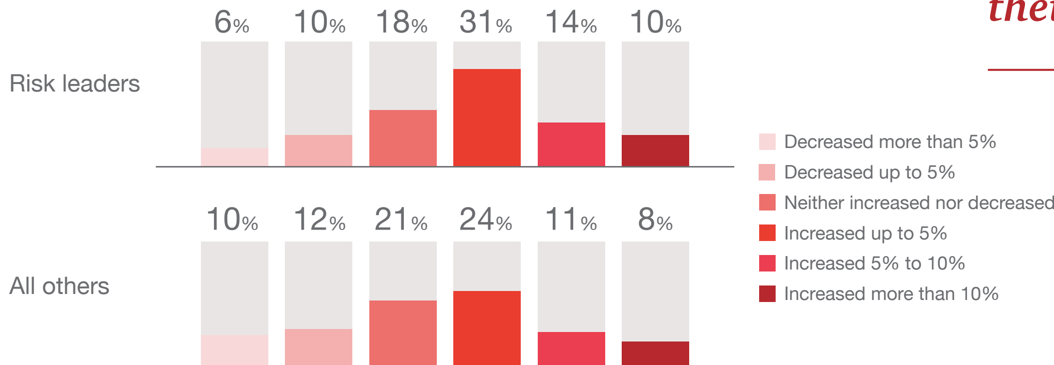
Companies that lead in risk management actively anticipate, measure, calculate, and accept risks that provide growth without jeopardizing their businesses.

Figure 2: Risk leaders tend to have higher profit margins—and profit margin growth

What was your company's average annual profit margin over the past three years?



On average, how has your company's profit margin changed over the past three years?



What it takes to be a risk management leader

From our survey of 1,229 executives, we identified 12% of respondents companies that, based on answers to specific questions, qualified as leaders in risk management. While financial services companies represent a sizeable portion of this group, most industry sectors are represented. Risk leaders are also more likely to be publicly traded, by a margin of 75% to 25%. These risk management leaders report that they:

- Have a fully integrated risk management strategy that ties risk management to the strategic planning process
- Have risk management programs that are "fully" or "highly" aligned with a range of business stakeholders, such as senior management, external stakeholders, IT, and the business units
- Use a broad range of risk management tools and techniques

What outcomes set risk management leaders apart? They are more likely to:

- Have experienced a profit margin increase over the past three years
- See how risks are interconnected and cascading, and take an aggregated view of risks when making decisions
- Have a deeper understanding of their own risk appetite across a range of areas
- Say they are increasingly taking a risk-enabled approach to growth
- Say that increasing speed to market is a significant priority, and involve risk management even when they need to move quickly

"Having an enterprise-wide view of risk gives a company a very clear and realistic understanding of operational issues and market opportunities."

—Dean Simone, PwC Partner and Risk Assurance Leader

Key strengths of risk management leaders

Risk management leaders distinguish themselves from others in four key areas.

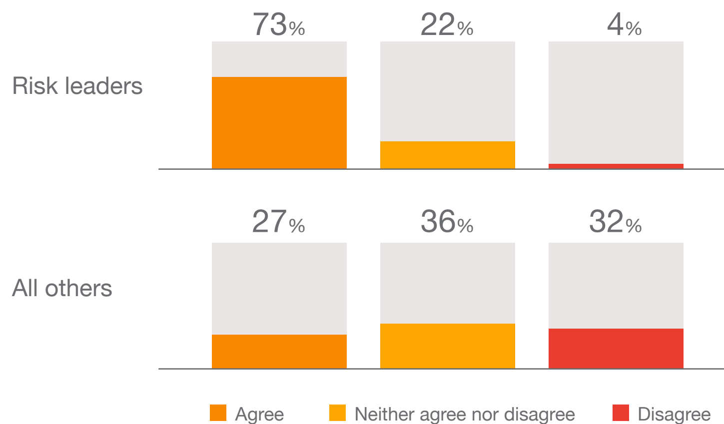
1. Risk management leaders understand how risks interconnect and impact their business

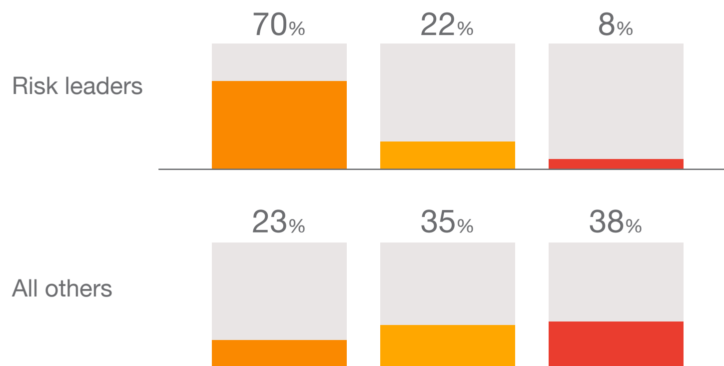
Risk management leaders are far more likely (70% vs. 23% of non-leaders) to say they can see how risks interconnect and cascade. These leaders are also far more likely to say they compile an aggregated view of risks when making business decisions (73% vs. 27%).

"Having an enterprise-wide view of risk gives a company a very clear and realistic understanding of operational issues and market opportunities," says Dean Simone, PwC Partner and Risk Assurance Leader. "It allows you to make more informed business decisions that align to your strategic imperatives."

Risk management isn't simply about taking the first risk that comes in the door and rejecting the next one because there's no longer any headroom, says Ryan Zanin, Chief Risk Officer at GE Capital. Instead, "It's about creating a view of enterprise risk, creating a risk appetite statement for the overall firm and for each significant business that is tailored to match each unit's unique risk profile. The sum of those parts contributes to the whole."

Figure 3: Risk management leaders take an aggregated view of risk





2. Risk management leaders are far more likely to be aligned across business units

The vast majority of risk leaders (90%) say their risk management program is fully or very aligned with their company's strategic planning process, compared with just 36% of non-leaders. Alignment is especially strong in the financial services and healthcare sectors, where complex and increasingly demanding regulatory requirements help drive investments in risk management programs. Across the board, leaders also demonstrate greater cross-functional alignment than non-leaders, particularly through aligning their risk function with the finance function (97% vs. 58%), internal audit (95% vs. 65%), and corporate compliance (93% vs. 55%). Likewise, the risk management programs of risk management leaders are more likely to be leveraged during the strategic planning process (78% vs. 38% of non-leaders).

Even though rapid-fire business decisions are frequently required, risk management leaders are far more likely to say they involve risk analysis in their decision-making process (67% vs. 43% of non-leaders). "One of the biggest risks is missing opportunities if you are not agile and fast," says Luis Custodio, Chief Risk Officer at IBM. "We do not slow down our business units. The last thing that business leaders want is bureaucracy. Risk management is viewed as an enabler and a support function to the business."

This alignment is critical. It lets executives at risk-leader companies see the impact of risk across the organization, empowering them to act quickly and proactively. This speed and effectiveness helps these companies avoid mishaps, and can also boost profitability and revenue growth.

Some 46% of risk management leaders say they spend more time calculating and preparing for risk rather than reacting to it, compared with just 21% of non-leaders.

Figure 4: Risk management leaders show alignment across the board

3. Risk management leaders apply more sophisticated techniques to anticipate and address risks

Risk management leaders' operational behavior also shows how their approach can yield greater results. For example, some 46% of leaders say they spend more time calculating and preparing for risk than reacting to it, compared with just 21% of non-leaders. Leaders are also more likely to say they currently use and plan to continue to use a variety of tools to effectively integrate their analysis. This checklist of techniques includes:

- Identification and forecasting of emerging risks (96% vs. 59% of non-leaders)
- Building organizational resilience to risk (88% vs. 42%)
- Horizon scanning/early-warning indicators (81% vs. 33%)
- Monitoring via key risk indicators (80% vs. 27%)
- Scenario planning (77% vs. 33%)
- Stress testing (75% vs. 30%)
- Risk rating (96% vs. 62%)

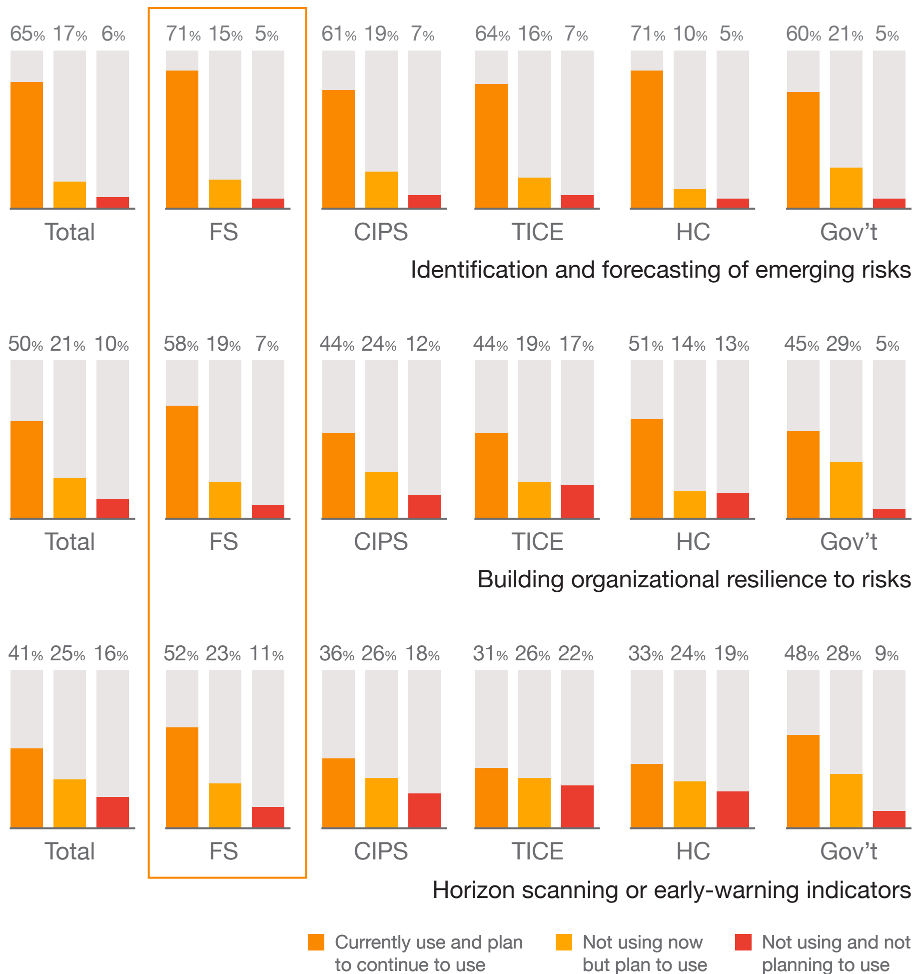
Looking at the overall results from our survey, it's easy to see that respondents across sectors have different approaches to anticipating risk. For example, as a result of the global financial crisis and subsequent changes in regulatory requirements, financial services firms are more likely than other sectors to build horizon scanning or early-warning systems, and to invest in creating organizational resiliency to risks. Other sectors favor certain other tools, for various reasons. Healthcare companies, facing an exponential increase in regulation (including the Affordable Care Act), are at the forefront of using enhanced due diligence, our survey shows. That makes sense, says Scott Lammie, Chief Financial Officer of UPMC Health Plan. "We see consolidation and integration of healthcare happening at a pretty rapid pace over the next decade. In the end, every major market will be served by two or three integrated healthcare delivery systems." Meanwhile, consumer and industrial products and services (CIPS) companies are more likely than other sectors to perform environmental, health, and safety audits.

Whether a company is based in an emerging or developed market can also impact the way it approaches risk management. Firms in developed countries, for example, are much more likely to say they identify and forecast risk than those in emerging markets (68% vs. 56%).

While financial services firms and those companies located in developed markets are leading the way in the overall use of risk management tools, it is clear that advanced risk management strategies can drive improved performance across all types of companies, regardless of size, geography, or sector.

Figure 5: Financial services firms lead in using risk management tools

Which of the following techniques for managing external risks does your company currently use or plan to use over the next 18 months?



Note: FS = financial services; CIPS = consumer and industrial products and services; TICE = technology, information, communications, and entertainment; HC = healthcare; Gov't = government agencies

4. Risk management leaders have a strategic understanding of their risk appetite, and are willing to take risks

Risk management leaders are more likely to articulate a “high” or “very high” appetite for risk in 10 out of 12 areas we examined. The variances are most pronounced for accepting financial risk (31% vs. 21% for non-leaders), diversification and concentration risk (35% vs. 26%), regulatory and compliance risk (20% vs. 13%), earnings and volatility risk (27% vs. 20%), and culture and incentives risk (27% vs. 20%).

Analyzing and assessing how different business risks affect one another is an essential step in achieving a holistic and accurate risk management perspective, explains Brian Schwartz, PwC’s Performance Governance, Risk and Compliance Leader. “Companies typically track their top 10 or 20 key business risks at the board level. Because companies obviously have many more enumerated risks, it’s important to perform a risk interconnectivity analysis that will help leadership and the board understand what other threats impact or catalyze those key risks. So if risk number 28 happens, does it trigger risk number 4?”

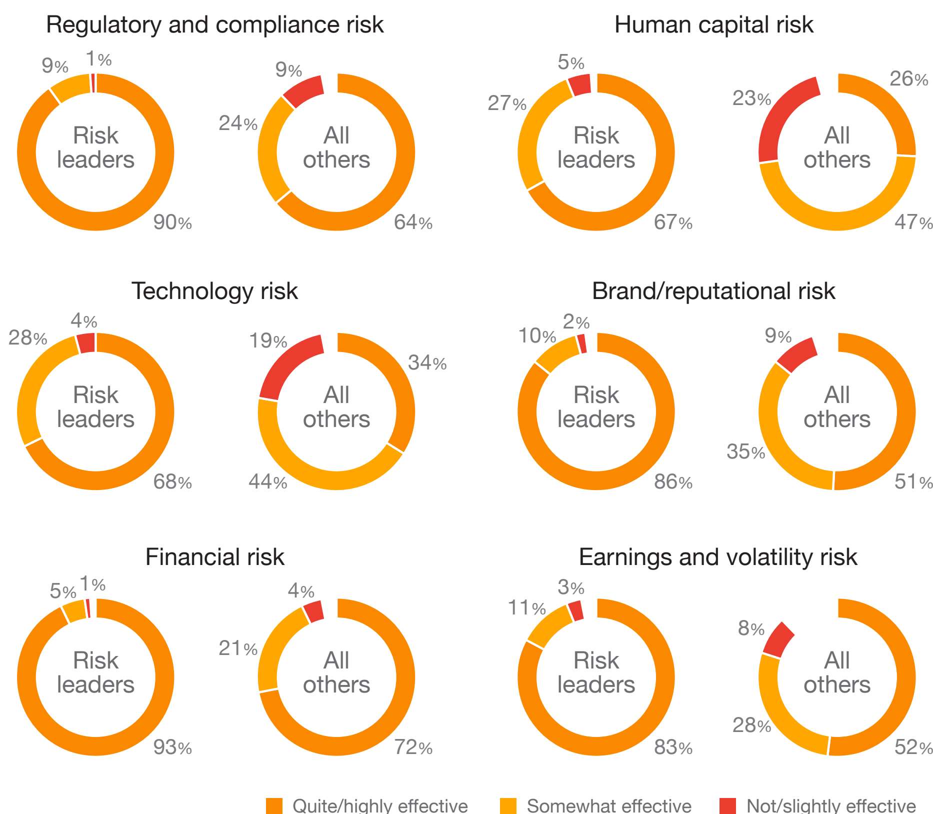
Undertaking a systematic review that determines what amounts of risk a company will take—and ensuring that all business units understand those limits—remains a central tenet of risk management leadership. Among risk leaders, we found that 68% have a corporate risk appetite statement that is well communicated and understood (vs. 20% of non-leaders).

These findings could well explain why, across the board, risk management leaders feel significantly more confident about how well their risks are managed compared with non-leaders. This is true even in areas where leaders are more willing to take greater risks (e.g., financial, earnings, or volatility risk). Naturally, having confidence in their risk management programs allows managers to be more decisive. Efficient, confident decision-making can help a company compete more effectively in a rapidly evolving business climate.

Perhaps most critical, risk management leaders say they are increasingly taking a risk-enabled approach to growth, examining both the risks and opportunities to help them understand where they should focus their efforts (88% vs. 32% of non-leaders).

Figure 6: Leaders are more confident about how risks are managed

For each applicable risk factor previously selected, how effective is the risk being managed?



Using the right tools to avoid drowning in data

In a business world being transformed rapidly by the power of analytics and Big Data, many risk executives say that they still face significant challenges in identifying the right data—and the right amount of data—to bring to the board's attention in a timely fashion.

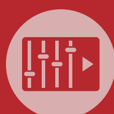
Lakshmi Shyam-Sunder, The World Bank Group's Chief Risk Officer, says it can be challenging to sort out what's really critical for board members versus what's "nice to know" or nice to give. "The key," she says, "is to continually communicate with the board to understand what is important for them." John Nichols, the Chief Risk Officer at Fannie Mae, knows that too much information can handicap his board. "You think you are doing the board a service by providing more data and information," he says, "but in fact you are just making it harder for them to prioritize the information."

Executives know that data is powerful. But indeed, "What I am seeing is that they are overwhelmed," says John Sabatini, PwC Principal and Risk and Compliance Systems and Analytics Leader. "For many years, there was the idea that we could avoid risk by putting controls in place. But controls alone don't give you the detail you need, and in many cases there are workarounds to override them."

With data analytics, the facts are the facts. "When you have the data, you create the transparency you need to find the truth," says Mr. Sabatini. New analytics systems make it significantly easier to bring disparate data together to create powerful insights. "We can now do things that weren't possible a decade ago," says Mr. Sabatini. "We are leveraging multiple data warehouses and bringing in both structured and unstructured data and external sources to analyze and challenge business assumptions. This allows for much better decision-making."

The key is creating the systems and processes that then allow those insights to be continually monitored and addressed by top decision-makers. Mr. Sabatini suggests a three-tiered approach:

Surveillance systems. These are systems that focus on a particular area, whether it's trading risk, corruption, or fraud. "We build models that look at all the transactions under a certain area, monitor the environment, and identify behavior that may be malicious or indicate the avoidance of controls and processes," says Mr. Sabatini.



Heat maps and dashboards. These are tools that allow board members and top management to regularly review key risk management metrics, which can range from anti–money laundering to excessive spending to commission tracking, depending on the company's key issues.

Ad hoc analytics. "You want the ability to question your data as the market changes," Mr. Sabatini says. "You may need to create new dashboards, for example." Ad hoc analytics serve as an incubator to ensure current surveillance systems and dashboards remain relevant.

When executives have access to these tools, the results are powerful. "They reduce the complexity of the data and get right down to the things that will help make your business stronger," Mr. Sabatini says. "And that leads to growth."

Why it matters: Risk management is critical to improving performance

Today's macroeconomic picture remains clouded with uncertainties. Third-party risks grow as companies engage innovative but relatively less-established outsourcing vendors, contractors, and sub-contractors. New financial and healthcare regulations compel new compliance needs. Financial crime is growing more sophisticated, amid recent reports that hackers may have compromised ATM networks across many countries. Meanwhile, disruptive technologies are developing at the speed of light. In less than a decade, we've gone from the mass adoption of smart phones to the first generation of self-driving smart cars. As new technologies disrupt traditional business models, companies are moving beyond their comfort zones, diversifying their businesses and converging into other sectors. But to do so successfully, they need to work from a deep understanding of the pace of technological change, its impact, and its risks.

In this environment, the need for proactive risk management has become even more pronounced. Thanks to the rise of cloud-based solutions, "Data and processes are moving outside of the area of traditional control of a company," notes Grant Waterfall, PwC Partner and Risk Assurance Cybersecurity and Privacy Strategy Leader. With important data now being transferred wholesale to various vendors and third-party contractors beyond the walls of traditional IT departments, "you need an entirely different approach to how companies secure their most important data and intellectual property."

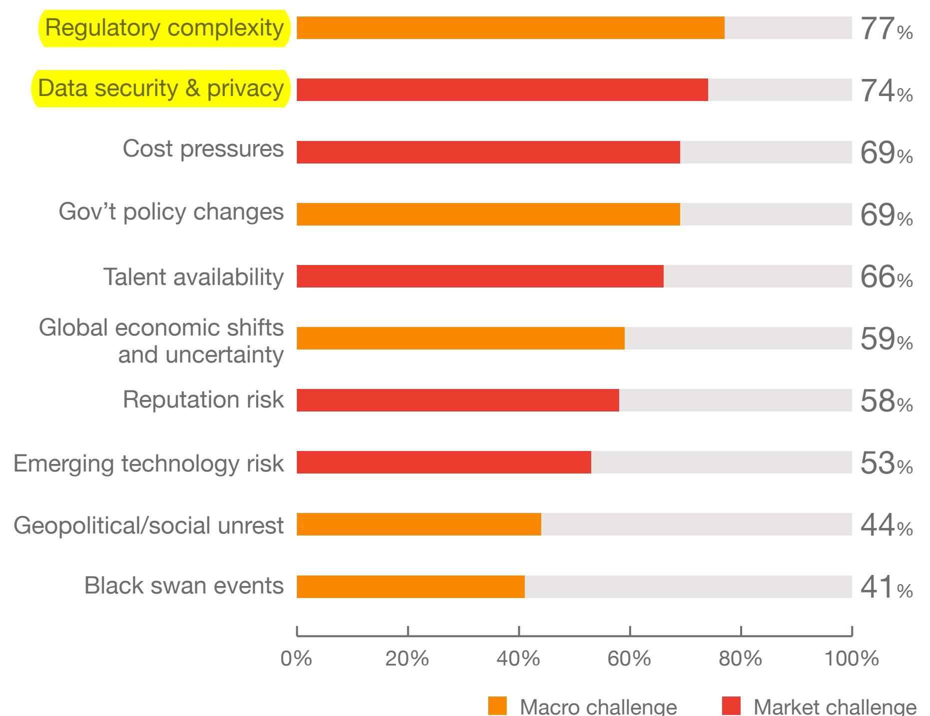
Scott Lammie of UPMC Health Plan agrees. "As a healthcare provider, there are cyber-risks inherent in everything we do," he says. "There are privacy issues related to the Health Insurance Portability and Accountability Act (HIPAA) and identity theft considerations. We are constantly under a barrage of possible cyberattacks."

Outsourcing vendors need to standardize their reporting techniques to assure their clients that their vital data will be kept secure. "Using Service Organization Controls (SOC) reports can significantly reduce the cost of compliance while boosting transparency," says Todd Bialick, PwC Partner and Risk Assurance Third Party Assurance Leader. "Best-in-class firms share the most information; not just the positives, but also the negatives they run into and how they are dealing with them." The right tools, he adds, enable firms "to develop trust and transparency with their customers."

Following damaging data breaches against large retailers and health insurance firms, concerns over cybersecurity surged among US CEOs last year, according to PwC's *2015 CEO Survey*. Among survey respondents, 45% say they are "extremely" concerned, up from 22% a year ago.

Figure 7: Regulatory complexity tops the risk list

Which of the following external forces will create the biggest risk or threat to business performance or growth plans?



"Companies need to be thinking about the implicit risks as they design their new systems," says Shawn Panson, PwC Partner and Risk Assurance Cybersecurity and Privacy Leader. "They need to be thinking end-to-end across their entire environment, mapping their control environment into a new world which is not within their perimeter and is out of their control. Leading companies are increasingly seeing that good security and data protection adds value and enables business."

Across sectors, nearly three quarters of our respondents agree that risks to their businesses are increasing either significantly or moderately. Some 77% of respondents cite regulatory complexity as their top macro challenge, followed by government policy changes (69%) and global economic shifts and uncertainty (59%). Data security and privacy (74%), cost pressures (69%), and talent availability (66%) were selected as the top three market challenges. But respondents also cited reputation risk (58%) and emerging technology risk (53%) as prominent concerns.

"You have digital regulatory upheaval going on like it's never happened before," says PwC's Mr. Panson. "Regulators are getting more teeth. The challenge for businesses is not what's coming from their own governments; it's dealing with the emerging web of global regulation focused on privacy, cybersecurity, resilience, and critical technology platforms. That's creating a lot of complexity for companies," especially when firms do business in the US and the European Union.

Amid these threats, however, the ability to leverage a strong risk management program can help companies avoid the biggest pitfalls, enhance profitability, and improve performance. The goal is to mesh strategy, enterprise risk, and business continuity systems to generate company-wide risk resiliency. "Having an enterprise-wide view of risk creates value," says Brian Schwartz of PwC. "A more resilient business strategy allows a company to exploit opportunities to gain competitive advantage while minimizing the downside."

Figure 8: Risk resilience

Case study: GE Capital's perspectives on how it manages risk

In a world of record-low interest rates, high liquidity, and narrowing credit spreads, GE Capital has to be nimble to navigate what feels like a riskier world. Ryan Zanin, the company's Chief Risk Officer, emphasizes stress testing and scenario analysis to help manage his firm's risks.

Building a comprehensive risk analysis framework allows GE Capital to "connect the dots in our risk profile—not just 'I lent money and I got it back,' but understanding each of the material risks that affect the company today and under various scenarios in the future."

"As risk managers, we can't plan with certainty around assumptions," Mr. Zanin says. He describes the kind of iterative process his company employs. "You need to understand ranges of outcomes and regularly test your hypotheses. You have to make sure you have the wherewithal to survive things you can't control. We develop hypotheses, test them, and make sure we understand what the risk outcomes could be, so that we don't put the firm at undue risk if we are wrong about any of those things."

Among other features, GE creates a risk appetite statement at the board level, and then develops an additional statement for each large business unit that fits within the broader, firm-wide risk appetite but is tailored specifically to that unit's operations. He notes that communicating risk appetite and embedding risk thinking across the company is critical.

"We all have to understand that managing risk is everybody's job," Mr. Zanin adds. "This is a company-wide effort. Risk management is broader than just the efforts of the independent risk organization. You have to make sure that people throughout the organization understand that managing risk is their responsibility. The risk management program has a mandate. It has its independence. It is there to challenge. But it is not there to absorb all the risk outcomes, or all the risk management effort for the organization."

The world of risk and opportunity: Two sides of the same coin

Real economic growth is taking shape across much of the world, despite new risks. Oxford Economics recently upgraded its global growth forecast to 2.9% for 2015, an increase from 2.6% growth last year.[1] While the decline in oil prices has created greater uncertainty in some parts of the world, it's also put money in the pockets of global consumers.

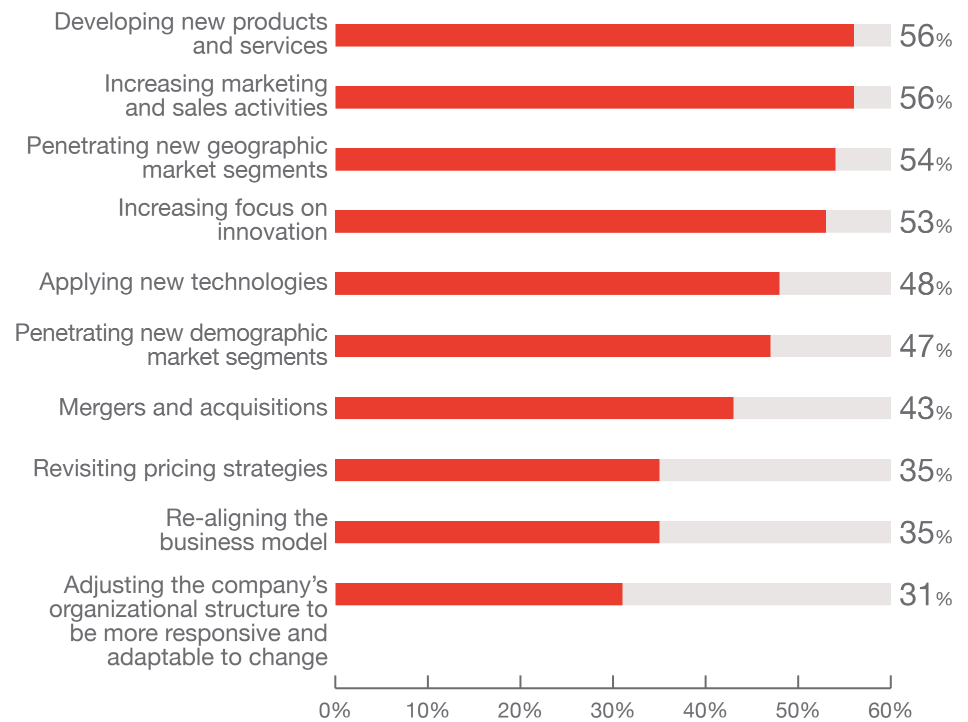
PwC's 18th Annual *Global CEO Survey* noted that company leaders are equally cognizant of the threats and opportunities in today's environment. "When we surveyed CEOs, we found that 59% see greater risk this year than they did three years ago," says Dennis L. Chesley, PwC Global Risk Consulting Leader. "But, we also found that 61% of CEOs believe there are more opportunities. This suggests that to survive and evolve today, companies need to prepare their entire organizations to take advantage of big shifts ahead of the competition, look around corners to anticipate risk and be ready to respond to disruptions to come out stronger on the back end."

1 Oxford Economics, *World Economic Prospects: Oil Price Slump Boosts Growth Forecasts* (January 2015).

Most executives we surveyed are quite optimistic about their prospects in this environment, and are pursuing various activities to capture opportunity. More than three quarters (76%) of respondents expect to see revenue growth over the next two years, and 45% expect to see revenue growth of more than 5%. Across industry sectors, healthcare and technology, information, communications, and entertainment (TICE) are the most bullish, with 83% expecting revenue growth over the next two years. Small companies are also upbeat, with 26% saying they expect revenue growth of more than 10% over the next two years. This ranks them as the company size segment most likely to expect such growth, compared with 14% of large companies.

To capture this growth, some 56% of respondents intend to increase marketing and sales activities, and the same number will develop new products and services. Given the convulsions now shaking the healthcare industry, it's not surprising that 71% of healthcare respondents intend to increase their marketing and sales activities—far more than any other sector. Healthcare companies are also more likely to attempt developing new products and services. Tech firms, by contrast, are more focused on applying new technologies and increasing speed to market.

Figure 9: What companies are doing to stimulate growth



The actions companies take to pursue revenue growth generally increase risk.

The actions companies take to pursue revenue growth generally increase risk. This is especially true when it comes to mergers and acquisitions (M&A), whether it's diversification or a growth strategy driving the transaction. Says Ray Young, Chief Financial Officer of Archer Daniels Midland, "One of the greatest strategic risks to manage is major acquisitions—whether it's picking the right target, the right valuation, the right timing, or executing the proper integration."

Creating a culture of deal readiness helps support M&A. When companies rigorously examine their risk management, controls, and compliance infrastructure, it can help them ensure operational fit and integration success. This is one aspect of building a risk resiliency program to support inorganic growth.

Performance sports apparel company Under Armour is in the process of integrating two recent acquisitions—MyFitnessPal, based in San Francisco, California, and Endomondo, based in Copenhagen, Denmark—with its current MapMyFitness business, based in Austin, Texas. These assets help users track personal data about fitness and health and share their experiences with a fitness-minded global community. Under Armour's Senior Director of Global Risk & Compliance, Jonathan Schwartz, says the goal for his team is to help integrate these businesses as effectively as possible, with the strong support of Under Armour's chief financial officer. "We are constantly on the phone with the operational leaders of those businesses, working in tandem to ensure we are identifying and managing the most significant risks they face individually, as well as the risks faced by the combined UA entity now that we are the leader in the global connected fitness space. We are in constant communication with them."

Jason Pett, PwC Partner and Internal Audit Leader, underscores the importance of tying risk management with strategic planning during a merger: "We had a client that was ready to move forward with an acquisition—the financial and operational metrics all pointed toward a go. But the third line of defense—internal audit—was there alongside management in the evaluation of the target company. They identified some cultural and compliance-risk issues that ultimately took it to a no-go decision." In the end, the decision to walk away was the right one: "Had they gone forward," he says, "the cost of the compliance and risk issues would have outweighed the financial return the acquisition would have produced."

Similarly, failure to include risk managers in conversations about developing and rolling out new products or innovative services can have serious consequences, particularly as more and more products become smart and connected. "We have a generation of companies that suddenly are being reclassified as technology companies," says PwC's Grant Waterfall. "The danger is that a lot of these companies aren't used to thinking about risk management, and are not always developing their products and services in the most intelligent way." The issue extends beyond technology. For instance, when companies are operating in a variety of global markets, a failure to adequately understand and address differing rules, regulations, or even labelling requirements can prove costly.

Unlike a new product rollout, business cycles aren't always predictable. Yet because they have developed frameworks that are constantly being adjusted to anticipate risk, risk-resilient companies are better positioned for the downside of an economic cycle and are more ready to seize growth in an upturn. As Ryan Zanin of GE Capital explains, "We are not afraid to work out and work through problems. We understand that both companies and economies run through cycles and you better be prepared to live through a down cycle and weather the storm. Part of our job is to make sure that people understand the choices in the harsh light of day, that there are really no free risks. If you create the right risk framework, promote transparency, have strong domain expertise, the right culture, and strong governance, the decisions will take care of themselves."

In the aftermath of the financial crisis, Lakshmi Shyam-Sunder, Chief Risk Officer for The World Bank Group, was acutely aware that the institution's risk culture could be an advantage for serving clients. As the bank moves to make larger investments in frontier markets and faces an increasingly uncertain economic and geo-political

How risk officers and their boards see the world of risk differently

Top corporate executives and managers appear to be far more optimistic than risk professionals about their companies' prospects. Asked in our survey how well their companies anticipate risk, for example, 72% of management and board members said "very well" or "well" compared with just 57% of risk officers. In addition, while 61% of senior management believes risk-taking is well aligned with their strategic planning function, only 49% of risk officers concur. The gap is even wider when it comes to alignment with external stakeholders, where 41% of executives believe their risk profiles are aligned versus just 29% of risk officers.

Some might say that represents a significant disconnect between top leaders and those carrying out day-to-day analysis. But many risk officers suggest it's just the nature of the beast.

"As risk folks, we are paranoids by profession, and so we are going to view the glass as half empty," says John Nichols, the Chief Risk Officer of Fannie Mae. "Management and boards are paid to be more optimistic. They want to believe that execution will be flawless. The chief risk officer's job is to blend the paranoia and optimism together."

"If you start talking about things that may impede on their positive view," says Mr. Nichols, "it takes a pretty special board to stay focused on the conversation, because it is not necessarily a message they want to hear."

For chief risk officers, says Mr. Nichols, the challenge is to "present information in a way that board members, who often have a natural bias to discount negative information, will pay attention to." It is crucial to make arguments that are credible and to the point, he adds.

environment, creating a holistic risk management system becomes a more critical initiative.

But our survey suggests that some companies may not be striking the right balance of risk appetite and risk management. Focused on rapid expansion and aggressive growth but lacking a strong risk management program, these companies can leave themselves vulnerable to mistakes. They may make decisions, like committing to an outsourcing partner, without really having a solid handle on the capabilities of their contractors, suppliers, and vendors. While companies often need to move quickly, sometimes "they can move too fast," notes PwC's Brian Schwartz, citing the myth of third-party risk management. Some companies, he notes, "put too much reliance on a third party where it's assumed they have adequate controls in place." Yet the cost of a security breach could exceed the entire value of the company. "Managing risks takes time. It takes resources, and while it costs money, it can ultimately save companies significant expense over the long term," he says.

"We understand that both companies and economies run through cycles, and you better be prepared to live through a down cycle and weather the storm."

—Ryan Zanin, Chief Risk Officer, GE Capital

What this means for your business

Five steps to risk management program leadership

Risk is inevitable in any business, but suffering negative impacts from risk is not—if the business has done the work to prepare itself. The key is a deliberate approach that leverages risk management programs to better anticipate and prepare for risk events, provide the analysis to identify acceptable risks, and ultimately generate higher returns and improve performance across the enterprise.

"A strong risk management program gives organizations the tools to make more informed business decisions," says PwC Partner and Risk Assurance Leader Dean Simone. "It allows boards to more effectively carry out their oversight responsibilities, gives management the ability to measure the impact of emerging risks, and helps companies aggregate risks against a clearly defined risk appetite framework." Creating effective risk management requires investment, but the potential payoff in sustainable profits and competitive advantage can be enormous, Mr. Simone notes.

Strategies will naturally vary for every company, but our conversations with chief risk officers from leading risk management programs reveal some critical action points.

1. Create a risk appetite framework, and take an aggregated view of risk

Developing a risk appetite framework that has buy-in from senior management and the board sets the all-important tone from the top. Effective communication helps drive the message down the ladder, fostering broad buy-in to the defined risk tolerances and risk limits and personal responsibility for their implementation in the day-to-day business. Having a clearly defined risk appetite framework allows companies to quickly assess strategic decisions in the context of risk, and make better-informed business decisions knowing they are taking on acceptable and agreed-upon levels of risk.

Companies also need the ability to scan the business landscape across multiple lenses of risk—for instance, regulatory compliance, technology, operations, culture, brand, and product portfolio risk. Testing that holistic assessment against the company's risk appetite brings multiple benefits, including the confidence to know which risks are worth taking and which should be avoided.

- Have you clearly defined your risk appetite, obtained buy-in from your board and leadership, and then pushed it down into the business? Have the business units bought in? Are they using the risk appetite framework to evaluate business decisions?
- Are you periodically aggregating risk across the enterprise against the established risk appetite framework to understand your changing company risk profile?

2. Monitor key business risks through dashboards and a common GRC technology platform

Transforming data into meaningful insight helps executives monitor the key risks in their business against their risk appetite statement, and identify trends in real or near-real time. To get started, make sure all risk and compliance functions in the company are leveraging a common governance, risk, and compliance (GRC) technology platform, which fosters consistent monitoring and reporting across the enterprise.

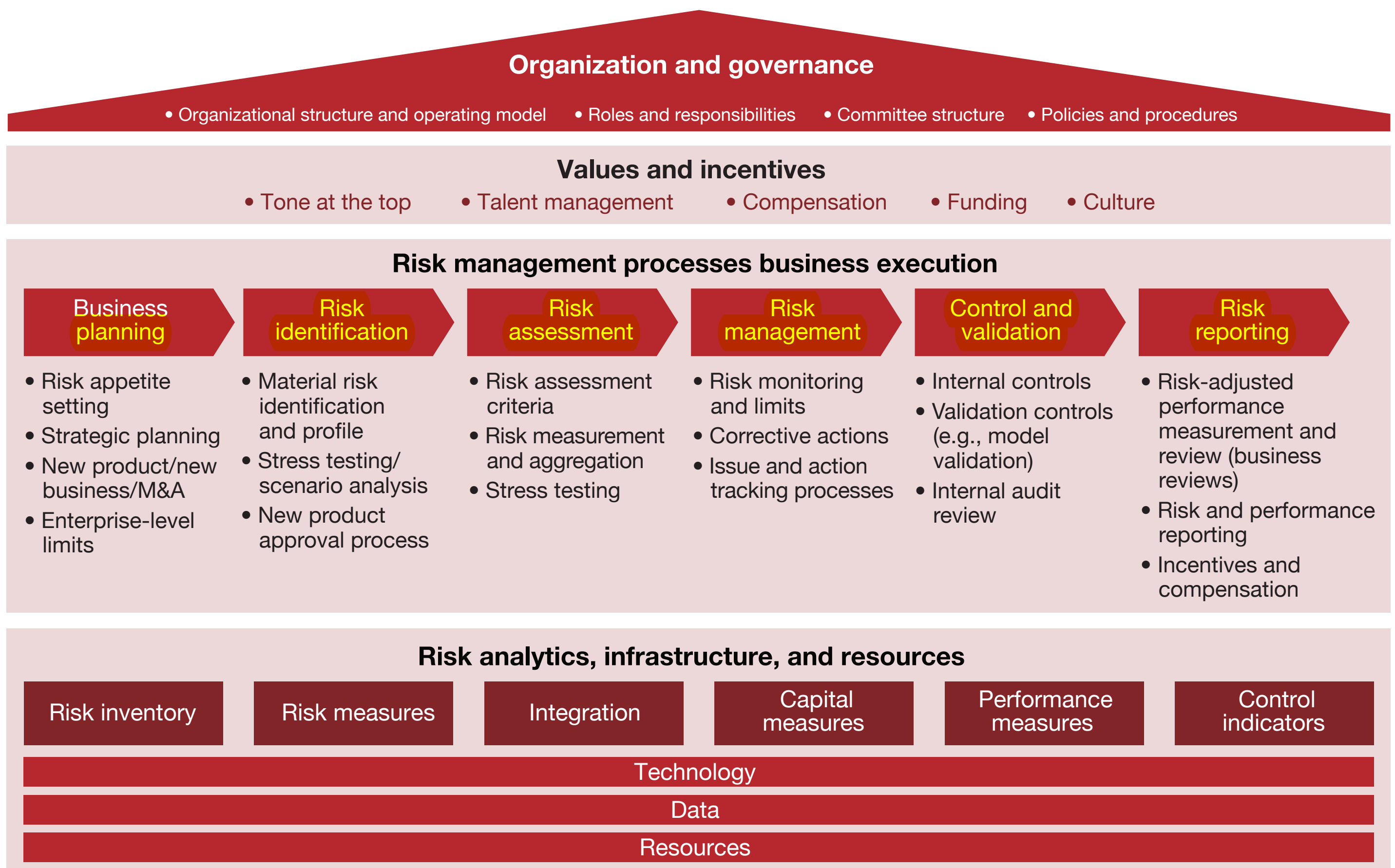
- Which processes inside your company would benefit from the greater transparency that data analytics and dashboarding can provide?
- Are you using a common GRC tool or multiple tools?

3. Build a program around expanding and emerging business risk, such as third-party risk and the digital frontier

Absent proof, there's no guarantee that third-party service providers have built reasonable controls, offer good security, and are compliant with regulatory requirements. Companies doing business with third parties need to make sure their service providers have the right conditions in place to reduce risks without slowing down the business. Service providers, meanwhile, need to build transparency into their processes and business continuity plans. At the same time, complex, evolving technologies are disrupting business models everywhere. Companies must prioritize the building of risk management programs that can handle the associated challenges, including cybersecurity issues, privacy, and system integration initiatives.

- When was the last time you performed a risk assessment on your vendors and outsourcing providers?
- Have you fully considered the potential risks associated with cloud computing, Big Data, the Internet of Things, and other digital initiatives?

Figure 10: Comprehensive framework for assessing ERM



4. Continuously strengthen your second and third lines of defense

Risk management, compliance, and internal audit are management's backup in the defense against risk. Risk and compliance functions sitting in your second line of defense should focus on pushing out to the business a well thought-out approach for identifying, assessing, and monitoring key business risks. The second line should not take on responsibilities related to managing risks since those belong in the first line, where these risks exist. The second line should continually strengthen the overall risk management program so it stays aligned to the evolving enterprise. Meanwhile, a strong internal audit function is best able to add value to the overall risk management framework through its objective point of view, its ability to work with the second line of defense, and its ability to understand and align with the priorities of the business.

- Are your three lines of defense clearly delineated, fully integrated, and aligned within the overall risk management framework?
- Is the maturity level of your risk management program fully aligned to the risk profile of the enterprise?

5. Partner with a risk management provider to close the gap on internal competencies

It's not always possible for companies to independently manage and/or strengthen all aspects of their risk management program. Partnerships can provide expertise and shore up areas where capability gaps create risk. Says Under Armour's Jonathan Schwartz, "Our company is growing very quickly, at 25-plus percent annually. It means we have to have really good outside partners to help us manage our risk profile globally and ensure our risk management processes are as innovative and strategic as our business." With the enterprise risk profile constantly shifting, companies need help to make certain their risk management programs keep pace.

- Have you performed a talent assessment across your company's risk management structure to determine your competency gaps?
- Have you engaged a risk management service provider to independently assess your risk management program's current state against your current risk profile and leading industry practices?

It all boils down to a single essential question:

In today's uncertain environment, have you put in place the powerful tools and resilient processes you'll need to anticipate and manage risk, leverage it to build competitive advantage, and move your business toward a stronger bottom line?

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To have a deeper conversation about how this subject may affect your business, please contact:

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