

Aligning risk and the
pursuit of shareholder value
Risk transformation



Know the worth of risk.

<http://www.deloitte.com/au/risk-transformation>

Transformative change as organisations strive to enhance the effectiveness of their risk management functions.

Organisations are revisiting their business models with a view to improving operational effectiveness, becoming more customer centric and searching for potential synergies to reduce wastage, improve efficiencies and increase returns. Against this backdrop, many organisations are assessing their risk management capabilities and challenging CROs to step back and critically review the value and cost base of their risk management functions.

However, experience shows that an ad hoc or piecemeal response to the management of risk and compliance and shareholder demands may not be equal to the challenges that many organisations face in areas such as capital allocation, costs, economic conditions, and enterprise risk management. Cost pressures drive the need to optimise head count and rationalise infrastructure spending whilst also seeking to improve operational efficiency. Shareholders and external bodies, including regulators and financiers continue to scrutinise the conduct of business and raise the bar for monitoring, reporting, and mitigating of risks.

These challenges impact senior executives and the boards of organisations and demand shifts in management focus, from having adequate capital to capital efficiency, from capital intensive business models to more efficient and agile models, and from risk management as a corporate function to risk management as a discipline embedded across the enterprise and viewed as a strategic enabler to agile decision making. In a corresponding (and necessary) technological shift, management should move from bolted-on risk and compliance “solutions” that add costs and headcount to an integrated view of risks across strategic, financial, operational and legal/regulatory risks. The variety of risks and potential shocks to a business demands data management and analytical capabilities equal to the goals of embedding risk management into business processes, increasing and sustaining shareholder returns and complying with complex regulations.

As senior executives and boards survey the progress they have made to date and the challenges before them, the following questions frequently arise:

- How, specifically are economic developments impacting shareholder returns, and how are they likely to do so in the future?
- How can we provide the right information at the right time to the right people across the organisation to enable them to make responsive, risk aware decisions?
- How effective is our organisation in terms of risk management and governance, and where do we need to improve?
- What do we need to do to maintain stakeholder confidence and achieve strategic goals while controlling costs?
- How do we pursue, sustain, and communicate an organisation’s risk profile that is responsive to both external stakeholders, including regulatory and investor expectations?
- How do we drive risk management into the daily activities of our people?

Questions like these are impossible to answer without an organisation wide or holistic point of view. This Deloitte paper presents such a point of view. It also highlights cornerstone issues that executives and boards must address in this transformative environment. We begin with an overview of forces now impacting the key drivers of shareholder value.

The business case for risk transformation

The business case for Risk Transformation addresses the following key drivers:

- **Scarce capital, liquidity, and funding:**

Organisations must remain competitive while maintaining the right levels of capital to support growth and uncertainty in the various markets in which organisations operate in. These needs are compelling and require organisations to rethink and reconfigure business models, governance processes, and risk management capabilities.

- **Rising cost and performance pressures:**

Many organisations are experiencing diminishing margins while costs continue to be an area of focus. To sustain strong earnings, organisations need to constantly rethink their business models, and in some cases pursue new strategies. Such responses can, however, introduce new, potentially dangerous concentrations and combinations of risk, and add new costs.

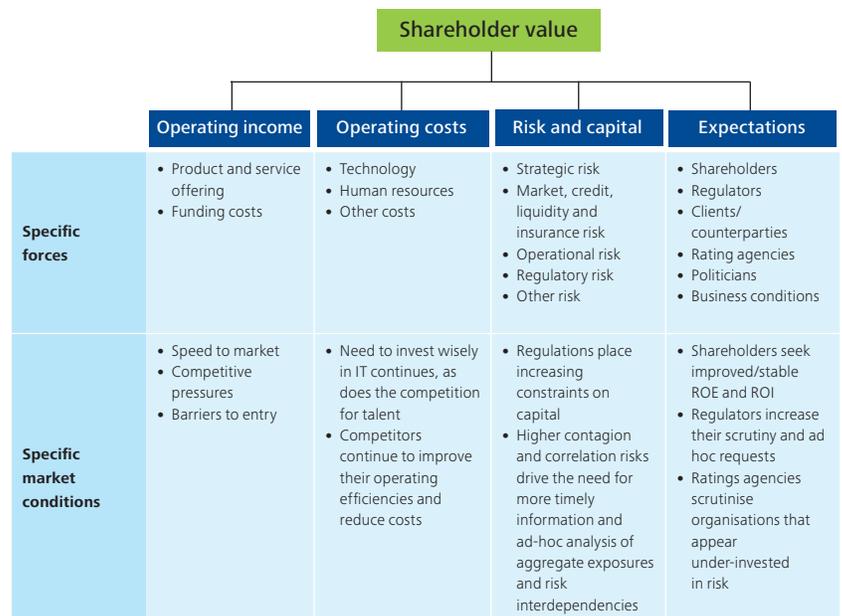
- **Legacy infrastructures:** Legacy systems and hardware platforms present high barriers to effective, efficient compliance, risk management, and business management. A well implemented/ executed enterprise risk data architecture can help overcome these barriers by making it possible to build the right data repositories and to avoid bolted-on or ad hoc solutions. An integrated enterprise solution specific to the organisation can improve data quality, accessibility, and analysis, setting the stage for improved risk management and business management.

- **Increasing regulatory requirements:** The level and scale of regulatory requirements are increasing across a number of industry sectors. Too often these requirements involve redundancy, overlap, and increased compliance costs, burdens, and risk. Addressing these requirements calls for the coordination between the various assurance activities within an organisation.

Impacts on Drivers of Shareholder Value

Shareholder value is driven mainly by sustained positive returns on capital employed, and factors such as operating costs and taxes. As Figure 1 illustrates, those drivers are impacted by specific forces and market conditions affecting an organisation

Exhibit 1. Forces impacting shareholder value



Focusing on shareholder value highlights the need to meet external requirements, while simultaneously improving business management and risk management. This approach transforms the need to meet external requirements, including regulatory expectations in areas such as capital planning and management, stress testing, business conduct, organisational culture, risk data management, and risk management into opportunities to improve these capabilities from an operational standpoint and further integrate risk management practices in business unit processes and activities in order to deploy capital more effectively for higher shareholder returns.

Case in point #1 – Rail Infrastructure Company

Situation/challenge

The operator was privatised in 2010 by a State Government. Subsequent to this privatisation a new competitor entered the market who decided to take a more aggressive stance in risk sharing across the industries supply chain. This new competitive landscape had the potential to significantly impact revenue relating to a number of key clients for this company. Within a 14 month period following privatisation, 60% of the market share of this company was up for tender. This company fundamentally revisited the way it analyzed, assessed and incorporated risk into the pricing and operation of long term contracts, and was a key factor in all the major tenders it submitted.

To achieve this, Deloitte worked with this company to:

- Consider how to use risk as a competitive advantage and to enhance customer/market perception
- Enhance the linkage between risk, operations and strategy
- Develop a risk quantification process and tools using internal data to provide risk insights that can be considered in a commercial manner. These insights were used in contract negotiations and the basis of a new pricing strategy
- Enhance management understanding of the worth of risk to customers thereby enabling them to enter into contract negotiations and tender conversations in a more risk aware manner.

Lessons learnt

- Understanding the root causes and the worth of risk events can assist management to focus its mitigation efforts towards risks which cost the most
- Quantifying the financial impact of risks using existing data produce a robust analytical base in risk aware decision making e.g. developing business cases and reasonable risk premiums during contract negotiations
- Helping management to consider risk/return trade-offs for managing certain risks.

Needs vary by organisation, and specific responses will be particular to the organisation. In general, however, certain approaches will be more likely than others to generate effective responses to external stakeholder expectations and improvements to business results. These approaches embed risk management into business units and functions at the level of people's daily responsibilities. When that occurs, risk management is no longer considered just the responsibility of the "risk management function" but an integral part of the job of the employees in the business.

This said, maintaining historical returns under today's uncertain conditions is challenging. Thus, management should take a holistic approach to these challenges, which may represent a break with the past. In most organisations, siloed responses to external changes, economic indicators, shareholder demands, and risk have generated a lack of alignment, with results that can resemble aspects of the structure depicted in Exhibit 2. In such organisations, although they are centred on risk, business models and operating models are not aligned, nor are the business units and functional areas. Risk management lacks coordination, and business units and functions may see risk as the responsibility of the risk management function rather than intrinsic to their jobs.

Misalignment and gaps develop over time, sometimes over decades, as the organisation diversifies its businesses, introduces new products and services, and responds to new laws and regulations. Some business units come to see the risk management function as being responsible for managing risk while the risks actually reside in the businesses. The resulting lack of alignment may leave organisations unintentionally exposed to risk and unable to efficiently coordinate responses. Lack of alignment also results in fragmented technology systems and data repositories, inhibiting the organisation's ability to cost effectively manage enterprise risk and respond to regulatory demands.

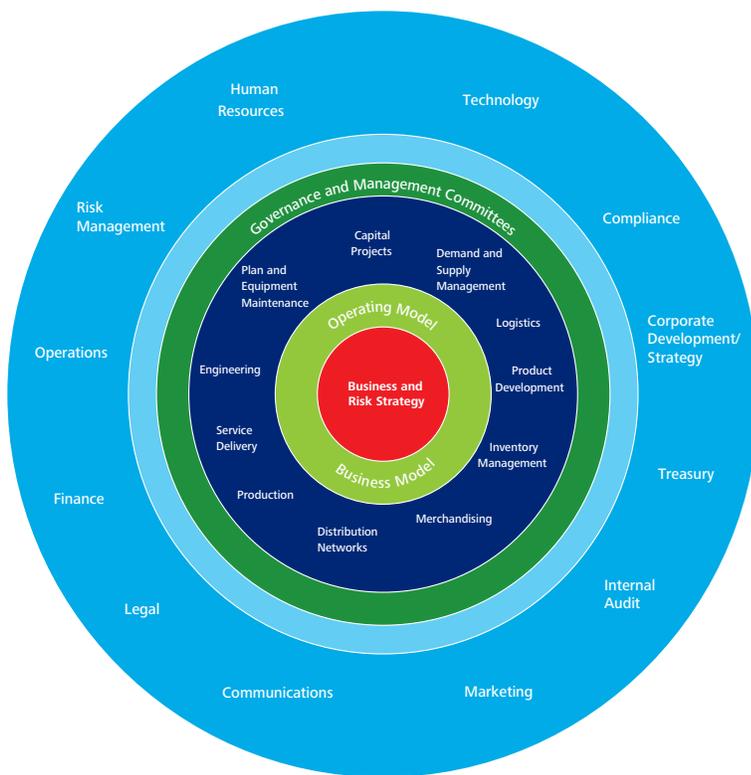
Exhibit 2. Lack of alignment in an organisation



Current and emerging trends will further impact this reality. Particularly, new regulations are driving structural changes making Risk Transformation imperative

- Illustrative functional areas
- Illustrative lines of business

Exhibit 3. Alignment in an organisation



Alignment enables enhanced visibility of aggregate risk positions and more effective decision making resulting in a more nimble organisation

An aligned organisation (as illustrated in Exhibit 3) integrates business and risk strategies and explicitly task risk owners with both organisational objectives and risk management responsibility. Risk owners manage the full range of risks they face and are supported by a suitable risk management infrastructure. The businesses and functions – and executives and the board – fulfill their risk-related responsibilities in ways that align stakeholder expectations. This aligned organisation minimises silos and fragmentation among business and risk strategies, business and operational models, and businesses and functions. It is supported by a common operational and risk data architecture,

which enables the institution to access specific data when needed and to drive down costs by embedding risk management and IT support into the broader strategic technology architecture.

This illustration of alignment is *not* presented as a model or framework, but simply to portray the integrated state of an organisation aligned around business and risk strategy. The result is greater synchronisation between strategy and execution in operations and risk management.

How is such a state achieved?

Risk transformation: A path to alignment

Deloitte believes the desired state is best achieved through a process of Risk Transformation. Risk Transformation integrates risk management into the conduct of business, taking risk management to higher levels of excellence by driving practices throughout the organisation. This means embedding risk management in the daily activities of employees so as to align the conduct of business and of risk management with the businesses strategies.

Risk Transformation takes the need to respond to the changing business environment as an opportunity to strengthen not only the management and governance of risk and but also management of capital, operations and the supporting IT infrastructure. For instance, the changing business environment impacts business models, pushing management to choose which businesses to pursue, what scale to achieve, and how to manage risks and capital in the businesses. Those choices are best made from a holistic point of view with due consideration given to the enabling data and analytical resources.

In an aligned organisation, risk management and governance acknowledge business unit and overall ROI objectives *and* the risk profile required to achieve those objectives. This aligns operational and risk management and risk governance policies, practices, roles, and responsibilities. The risk management function then

supports each business in operating within agreed risk limits and actively take on and proactively manage the risks needed to meet investor return objectives.

This alignment between the businesses and the risk management function is neither formulaic nor easily achieved, but a continual, dynamic work in progress. The resulting approach to risk builds on the traditional “three lines of defence” risk governance model – the business units, risk management functions, and the audit function – in three ways:

- First, this approach involves a proactive rather than a defensive posture toward risk management.
- Second, it more fully recognises and supports business unit risk taking management.
- Third, it aligns the three lines of defence, which have often lacked coordination, leading to unpleasant, often very public “surprises” for organisations.

Rather than over-reliance on the risk management function, Risk Transformation implements enterprise risk management capabilities in concert with business objectives and supports the people responsible for achieving those objectives.

The past several years have shown that clarifying risks (and rewards) calls for reliable data on the full range of risks and rewards posed by all organisational activities. With that information in the right hands and with an effective analytical infrastructure and decision-making protocols, managers can better optimise their use of capital and other resources. This comes about through a synergistic approach to business strategy execution, operational efficiency, risk management, and regulatory compliance. This approach enables the business to leverage risk and regulatory compliance projects strategically to meet business needs.

Transformational moves

In a misaligned organisation, risk management practices tend to be siloed and separated from the ways in which the business operates and performance is managed. (See Exhibit 4.)

Exhibit 4. Pre-transformation Relationship between Risk Management and organisation

Key Business Activities	Corporate functions
Engineering	Finance
Plant and Equipment Maintenance	Corporate Development/Strategy
Capital Projects	Human Resources
Demand and Supply Management	Technology
Product Development	Communications
Inventory Management	Compliance
Merchandising	Internal Audit
Logistics	Treasury
Distribution Networks	Risk Management
Production	Operations
Service Delivery	Marketing
	Legal

In the target state, risk is identified at its source and managed within these business activities. (See Exhibit 5.) To the appropriate extent, accountability for risk management shifts to the businesses and functions while responsibility for risk is shared among the businesses, functions, and risk management. This enhances the

businesses' and functions' visibility into risk and the visibility of aggregate risk positions, improving decision making in the businesses and functions and at the organisational level.

Exhibit 5. Post-transformation Relationship between Risk Management and the organisation



Risk management shifts from being a functional responsibility (of the risk management function) to an ingrained management discipline. Accountability becomes clearer. People throughout the organisation manage risk as part of their jobs. They are evaluated and rewarded on their management of risk as well as on their operational performance. They have goals for risk management as well as for returns, costs, and growth.

Risk Transformation expands the traditional view of risk. It equips people across the organisation to better recognise threats and opportunities associated with social media, cloud computing, outsourcing strategies, market initiatives, and other developments. Risk Transformation enables the holistic view of risk embodied in Deloitte's concept of the Risk Intelligent Enterprise¹. It provides a context for implementing risk management and regulatory compliance solutions in an integrated but flexible manner.

¹ Putting risk in the comfort zone: Nine principles for building the Risk Intelligent Enterprise™, Deloitte, 2012
< http://www.deloitte.com/view/en_us/us/6b929c9096ffd110VgnVCM100000ba42f00aRCRD.htm>

Four Cornerstones of Risk Transformation

To translate the overall goal of achieving alignment as described here into actionable terms, Deloitte has identified four organisational components – or cornerstones – of Risk Transformation. These cornerstones highlight cross-functional, risk-related elements and activities that help determine an organisation’s approach to risk.

If management firmly establishes these cornerstones, risk management and compliance efforts can be implemented in an efficient, coordinated manner within each business and across the organisation:

- **Strategy:** Strategy puts the organisational vision and mission into action. The executive team should consider the risks *of* the strategy and *to* the strategy. Enterprise risk management and governance infrastructures should support execution of the business model and capital allocation. Capital is allocated based on strategically selected risk-reward trade-offs, risk capacity and appetite, and desired risk profile.
- **Governance and culture:** Governance is intended to ensure that strategies are executed properly and in alignment with risk and business strategy. Culture embodies the shared values, principles, and beliefs that guide the organisation. Governance and culture set expectations regarding risk taking and risk management, enabling people to discern acceptable and unacceptable risks even when not explicitly addressed by policies and procedures. In considering governance and culture, the executive team might assess the organisation’s level of risk intelligence, its risk management and governance frameworks, and its risk governance operating model.
- **Business and operating model:** The business model defines economic relationships between the organisation and its customers, suppliers, investors, and other stakeholders. The operating model structures the ways in which the business conducts its activities with its stakeholders. Within both models, risk should be

managed with clear accountabilities, authority, and decision rules at all levels, and well-defined handoffs between business risk and control functions. Both models require standardised structures, processes, and controls for shared and outsourced services as well as for business units and support functions.

- **Data, analytics, and technology:** Management should determine the key data required to address risk management needs and oversee development of a data management and sourcing strategy to address those needs. Management should also facilitate integration of finance and risk data to enable common and reconciled risk and compliance reporting. The business units need near real-time processing and reporting of aggregated risk data to monitor volatile market risks. An enterprise risk data and architecture strategy can deliver the right risk-related data to the right points and enable the organisation to respond to new business opportunities and to risk and regulatory demands consistently and efficiently rather than through ad hoc or bolted-on solutions. A streamlined set of business intelligence solutions can support risk and regulatory needs while analytics enable scenario analyses of stresses on global positions.

In incorporating and addressing these cornerstones, senior executives create a unifying context for risk management and risk governance, operational enhancements, and regulatory compliance activities. Note, however, that an organisation need not work on every cornerstone to the same extent or at the same time. Depending on needs, priorities, and resources, management can select a single cornerstone or an element of a cornerstone to address, rather than launching change along all four.

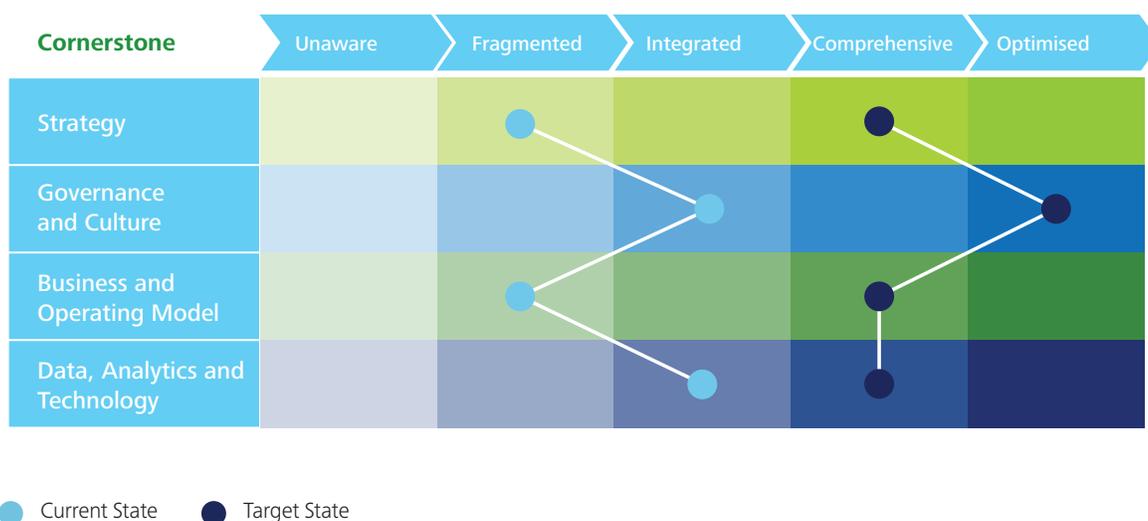
Assessing needs

As noted, the journey of Risk Transformation differs for each organisation. In defining the future state, executives might assess the current state in terms of these cornerstones. (See Exhibit 6.) They can then decide which capabilities related to

strategy; governance and culture, business and operating models, and data, analytics, and technology require what degree of enhancement. As the exhibit indicates, Risk Transformation helps leaders define subjects for analysis across the organisation against a maturity continuum. Five distinct maturity states are defined for each cornerstone, with the “optimised” state corresponding to the practices of a Risk Intelligent Enterprise.

Risk Transformation recognises that risk management can be organisationally aligned even if parts of the whole stand at various maturity levels. The maturity continuum is only one tool by which Risk Transformation assists management in identifying, categorising, and prioritising activities for enhancement. Primarily, the cornerstones – and the concept of Risk Transformation – aim to elevate senior-level discussions regarding risk management, risk governance, and regulatory compliance.

Exhibit 6. Illustrative Maturity Continuum



Given the nature of the changes, here are key points to consider, framed as questions to be answered in senior-level discussions of risk management and regulatory compliance:

- **Strategy:** How clear are our business and risk strategies to internal and external stakeholders? How can we improve that clarity? How can we bring our risk strategy more in line with our business strategy so they support one another? How can we allocate capital more efficiently while managing the risks to which it is exposed? How much capital should we allocate to new business initiatives?
- **Governance and culture:** Do our governance systems and culture support implementation of our strategy? How can we best align our governance goals and our organisational culture with our values and mission? To the extent that we see misalignment, what is the cause? What values are – and are not – expressed in our culture? How can we drive positive values throughout our culture? Are we truly practicing good governance?
- **Business and operating models:** How can we best drive awareness of and accountability for risk throughout the organisation? To what extent have we rationalised, synchronised, and optimised risk management and regulatory compliance mechanisms? How could we enhance these attributes? Is it possible for a unit to engage in risky activity without the board's and management's knowledge?
- **Data, analytics, and technology:** How can we leverage our investments in risk management, internal control, and data management and analysis? How can we better align these across our organisation? How well do our data management and analytical capabilities support our risk management and regulatory reporting efforts? How can we develop an integrated data storage and aggregation infrastructure to support financial, operational, regulatory, and risk reporting?

Other questions abound, but these are a good start. And the time to start is now.

Three steps to consider

Like the issues it seeks to address, Risk Transformation can be all-encompassing and complex. The following three steps can help executives and directors approach the matter in an organised way:

- **Start the conversation.** Virtually every organisation, across many industries, are wrestling with risk management, capital, liquidity, regulatory, and operational demands. Any senior executive or director in a financial, operating, marketing, compliance, risk management, or other role can raise the subject of alignment and transformation, because virtually every area of the organisation faces similar challenges. These challenges are, however, best addressed in a team setting.
- **Assess the current state.** Consider the factors affecting your organisation's strategic execution through measures such as revenue, income, costs, risks, return on capital, and shareholder expectations. What is the current state of alignment in the organisation? What is the level of maturity – fragmented, integrated, comprehensive, or optimised – in specific businesses and functions?
- **Consider the possibilities.** Which opportunities to enhance alignment of risk and operational management seem obvious? How might we respond to external market changes and new risks in a coordinated manner? Where are our highest priorities? How can we more clearly define our desired enterprise risk profile and ways of achieving, maintaining, and communicating it?

Begin the journey

Risk Transformation can position organisations and management teams to address organisational challenges and to meet future expectations in a prudent, profitable manner. It's a transformation that only the executive team and board can lead. Given the current and foreseeable environment, it is a transformation well worth leading.

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