Risk Transformation
Aligning risk and the pursuit of shareholder value
These challenges demand a shift in management focus, from risk management as a corporate function to risk management as a discipline which is embedded across the enterprise and viewed as a strategic asset.

Companies of most every type face continuing pressure and rising expectations for earnings growth, cost reduction, and capital efficiency. As a result, business models are evolving to improve operational effectiveness, become more customer-centric, achieve sustained earnings growth, and maintain competitive advantage. At the same time, global supply chains, increased outsourcing, and proliferating technologies have generated new risks. In addition, evolving regulations and increased public scrutiny and regulatory activity have spawned new challenges.

Many leadership teams have reviewed their organization’s risk management and governance frameworks and mechanisms with an eye toward aligning them with operating models to reduce costs, maintain compliance, and improve results. In the process, many have learned that ad hoc or piecemeal responses may not be equal to the challenges they face. Worldwide economic recovery remains weak, negatively impacting specific markets, industries, and regions. Cost pressures drive the need to optimize head count and rationalize infrastructure spending while improving operating efficiency. Regulatory focus on the conduct of business and on risk monitoring, reporting, and mitigation drives the need for better risk-related practices at the management and board levels, and throughout the organization.

While financial institutions may have borne the brunt of the most recent regulatory storm, virtually all companies operating on a significant scale face similar challenges, albeit in different ways and at a different scale.

These challenges demand a shift in management focus, from risk management as a corporate function to risk management as a discipline which is embedded across the enterprise and viewed as a strategic asset. In a corresponding (and necessary) technological shift, management might consider moving from bolted-on, point-specific compliance “solutions” that add costs and headcount to responses that integrate financial, operating, risk, and regulatory data streams. This also calls for data management and analytical capabilities equal to the goals of achieving and maintaining operational excellence, complying with regulations and legal requirements, embedding risk management into business processes, and increasing shareholder value.

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 regulatory and 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 organization to enable them to make responsive, risk-aware decisions?
- How effective is our organization in terms of risk management and governance, and where do we need to improve?
- What do we need to do to maintain regulatory compliance and confidence, and achieve strategic goals while controlling costs?
- How do we drive risk management standards into the daily activities of the business units and promulgate those standards in our supply chain, and in our sales channels and other partners?

Questions like these may be impossible to answer without an organizing point of view. This paper presents such a point of view and the business case for change. It also highlights cornerstone issues that executives and boards should consider addressing in this transformative environment.

The business – and regulatory – case for change
The business case for changes to risk governance and risk management approaches include:

- **Rising cost and performance pressures:** Many organizations are experiencing diminishing margins even as they continue to focus on costs. To sustain strong earnings, companies must often adjust 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.

- **Capital and funding issues:** Organizations must remain competitive while maintaining the right levels of capital — and access to capital — to support growth and prepare them for uncertainty. These needs are compelling companies to rethink and reconfigure business models, funding strategies, and risk management capabilities.

- **Legacy infrastructures:** Legacy systems and hardware platforms can present high barriers to effective, efficient business, compliance, and risk management. A well-planned, well-executed enterprise risk data architecture can help overcome these barriers by making it possible to build the right data repositories and to avoid ad hoc solutions. An integrated enterprise-specific solution 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. Often these requirements generate redundancy, overlap, and increased compliance costs, burdens, and risk. Addressing these requirements calls for coordination between the various assurance activities within the organization.

Expanding on the latter point, regulatory requirements may be industry-specific or cut across industries. For example, over the next several years, revenue recognition standards for telecommunications companies will likely change. New requirements will call for allocating revenue to different elements of a contract with a customer and, potentially, the timing of realized and reported revenue. The new revenue recognition standards are expected to go into effect for reporting periods beginning after December 15, 2016, according to the Financial Standards Accounting Board (FASB). The general requirements and their likely impacts are clear, and they hold marketing, operational, reporting, and compliance implications and risks.

Meanwhile, Securities and Exchange Commission (SEC) rules that took effect in 2010 require companies issuing proxy statements to disclose their risk-related practices — rules that potentially affect all U.S. publicly held companies. To date the disclosures have focused on the board’s role in risk oversight and governance, board committee risk oversight responsibilities, and alignment of risk oversight and management with the company’s business strategy — among other topics. In addition, regulatory scrutiny of U.S. companies doing business internationally continues under the Foreign Corrupt Practices Act. Such scrutiny, when coupled with global supply chains and the imperative of speed to market, can generate new regulatory, compliance, and legal risks for a wide range of companies.

In general, regulators have made greater involvement by the board in the oversight, governance, and disclosure of risks, and increased visibility into risks for investors and other stakeholders, high priorities. This reinforces the business case for change, which promulgates sound risk governance and management by integrating risk management into all organizational activities.

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2 Dowling up the future: Meeting the challenges of the proposed revenue recognition requirements for the telecommunications industry <http://www.deloitte.com/assets/Docom-UnitedStates/Local%20Assets/Documents/AERS/us_aers_revenue_recognition_telecommunications_051613.pdf>

Case in point #1 – Rail Infrastructure Company

Situation and challenges

The operator was privatized in 2010 by a state government, after which a new competitor entered the market and adopted a more aggressive posture in risk sharing across the industry’s supply chain. The altered competitive landscape could have significantly impacted revenue relating to key clients of the newly privatized company. Within 14 months following privatization, 60 percent of the market share of this company was in jeopardy.

In response the company revisited the way it analyzed, assessed, and incorporated risk into the pricing and operation of long-term contracts, and reconsidered risk as a key factor in all major contracts.

The company worked to:

- Consider ways of using risk management as a competitive advantage and of enhancing customer and market perceptions
- Improve the linkages between strategy, operations, and risk management
- Develop a risk quantification process and tools, using internal data to provide risk insights to be used in contract negotiations and as the basis of a new pricing strategy
- Enhance management’s understanding of the value of risk mitigation to customers, thereby enabling them to enter into contract negotiations in a more risk-aware manner

Business value

For the company, the lessons learned included the following:

- Understanding the root causes and potential impacts of risk events can help management focus mitigation efforts on company — and customers — risks with the most potential impact on value
- Quantifying the financial impact of risks using existing data can produce a robust analytical basis for risk-aware decision making, in this case by facilitating development of business cases and reasonable risk premiums to use in contract negotiations
- Considering risk/return tradeoffs can assist management and business units in managing certain risks for the company and its customers
Impacts on drivers of shareholder value
Shareholder value is driven mainly by a sustained positive spread between the risk adjusted return on capital and the cost of capital, and factors such as operating costs and taxes. As Figure 1 illustrates, those drivers are impacted by specific forces and market conditions affecting the business.

Focusing on shareholder value highlights the need to meet external requirements, such as market demands, competitive conditions, and regulatory demands, while improving business management and risk management. This transforms the need to meet external requirements into an opportunity to improve capabilities from an operational standpoint and further integrate risk management practices into business unit processes and activities. This in turn assists management in deploying capital more effectively for higher shareholder returns.

Needs vary by organization, and specific responses will be particular to the organization. In general, however, certain approaches will be more likely than others to generate effective responses to external stakeholder expectations and improve 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.

Given the complexity and interrelatedness of the challenges, a holistic approach stands the greatest chance of achieving effective risk management; however, an approach such as this may represent a break with the past. In many organizations, siloed and often ad hoc responses to marketplace changes, economic conditions, shareholder demands, and risks have generated lack of alignment. The results can resemble aspects of the structure depicted in Figure 2. Although they are centered on risk, business models and operating models in such organizations 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.

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Misalignment and gaps develop over time, sometimes over decades, as the organization 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 many organizations unintentionally exposed to risk and unable to efficiently coordinate responses. Lack of alignment also often results in fragmented technology systems and data repositories, inhibiting the organization’s ability to cost effectively manage enterprise risk and respond to regulatory demands.

An aligned organization (as illustrated in Figure 3) should integrate business and risk strategies and explicitly task risk owners with both organizational objectives and risk management responsibilities. Risk owners should manage the full range of risks they face and be supported by a suitable risk management infrastructure. The businesses and functions — and executives and the board — should fulfill their risk-related responsibilities in ways that align regulatory and other stakeholder expectations. This aligned organization should minimize silos as well as fragmentation among business and risk strategies, business and operational models, and businesses and functions. It should be supported by a common operational and risk data architecture. This should enable the organization to access specific data when needed and to drive down costs by embedding risk management and related IT support into the broader strategic technology architecture.

Figure 2. Lack of alignment in an organization

Current and emerging trends will further impact this reality. Particularly, new regulations are driving structural changes making Risk Transformation imperative.
Case in point #2 – Life Sciences Company

**Situation and challenges**

Company forecasts indicated that over the next ten years a key franchise was facing declining revenue, highlighting the need to explore inorganic growth opportunities. The company had limited resources to develop new products but did have an opportunity to in-license assets to supplement the declining franchise’s revenue stream.

The company needed to compare in-licensing opportunities across different drug classes and therapeutic areas (TAs) in terms of opportunities and risks, on the basis of timely information on the drugs and the behaviors of patients, physicians, and payers.

The company worked to:

- Assess industry analysts perceptions of TAs and products within each TA
- Gather real-time data from patients, physicians, and payers
- Provide insights into the following key business questions:
  - What are the epidemiological and market forecasts for the TAs under consideration?
  - What does the latest utilization data say about physician prescribing trends?
  - What insights into the target patient population can enable better positioning of a particular product?
  - What are the current reimbursement trends for a given drug class or TA?

**Business value**

As a result of this work, the company:

- Facilitated proper, risk-aware valuation of each prospective product
- Prevented the in-licensing of products with limited commercial viability
- Developed accurate revenue forecasts and accurate assessments of the risks to those forecasts

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This illustration of alignment is not presented as a model or framework, but simply to portray the integrated state of an organization aligned around business and risk strategy. The result is greater coordination 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 can be 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 organization. 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 and regulatory environment as an opportunity to strengthen not only the management and governance of risk and but also management of capital, operations, and supporting IT infrastructure. For instance, the changing environment impacts business models, pushing management to choose which businesses to pursue, what scale to achieve, and how to manage risks in the businesses. We believe 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 organization, risk management and governance recognizes business unit and overall ROI objectives and the operational requirements and risk profiles required to achieve those objectives. This recognition sets the stage for alignment of operational and risk management and risk governance policies, practices, roles, and responsibilities. The risk management function then supports each business in operating within the risk profile each requires to meet 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 defense” 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 recognizes and supports business unit risk management.
• Third, it aligns the three lines of defense, which have often lacked coordination, leading to unpleasant, often very public “surprises” for organizations.

Rather than over-reliance on the risk management function, Risk Transformation implements enterprise risk management capabilities in concert with business objectives and regulatory requirements 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 organizational activities. With that information in the right hands and with an effective analytical infrastructure and decision-making protocols, managers can better optimize their use of 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 organization, risk management practices tend to be siloed and separated from the ways in which the business operates and performance is managed. (See Figure 4.) As a practical matter, in such situations accountability for risk often resides primarily within the risk management function. This leaves the businesses, functions, and risk management largely separated and to an extent “doing their own thing” with regard to risk analysis, monitoring, and mitigation.

During transformation, accountability for risk management shifts — to the appropriate extent — 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, improving decision making in the businesses and functions and at the organizational level.

Figure 4. Pre-transformation relationship between risk management and organization

<table>
<thead>
<tr>
<th>Key business activities</th>
<th>Corporate functions</th>
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<tbody>
<tr>
<td>Engineering</td>
<td>Finance</td>
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<tr>
<td>Plant and equipment management</td>
<td>Corporate/development strategy</td>
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<tr>
<td>Capital projects</td>
<td>Human resources</td>
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<tr>
<td>Supply chain management</td>
<td>Technology</td>
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<tr>
<td>Product development</td>
<td>Communications</td>
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<tr>
<td>Inventory management</td>
<td>Compliance</td>
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<tr>
<td>Merchandising</td>
<td>Internal audit</td>
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<tr>
<td>Logistics</td>
<td>Treasury</td>
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<tr>
<td>Distribution networks</td>
<td>Risk management</td>
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<tr>
<td>Production</td>
<td>Operations</td>
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<tr>
<td>Service delivery</td>
<td>Marketing</td>
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<td></td>
<td>Legal</td>
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In the target state, risk is identified at its source and managed within these business activities. (See Figure 5.) Risk management shifts from being a functional responsibility (of the risk management function) to an ingrained management discipline. Accountability becomes clearer. People throughout the organization 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 revenue, costs, margin, and growth.

Risk Transformation expands the traditional view of risk. It equips people across the organization to better recognize threats and opportunities associated with marketing and operational initiatives, outsourcing and channel-partner arrangements, and developments such as social media, cloud computing, and cyber threats. Risk Transformation enables the holistic view of risk embodied in Deloitte’s concept of the Risk Intelligent Enterprise. It provides a context for implementing risk management and regulatory compliance solutions in an integrated but flexible manner.

Figure 5. Post-transformation relationship between risk management and the organization

<table>
<thead>
<tr>
<th>Key business activities</th>
<th>Shared responsibility for risk</th>
<th>Corporate functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Engineering</td>
<td>Risk</td>
<td>Finance</td>
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<tr>
<td>Plant and equipment management</td>
<td></td>
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4 Putting risk in the comfort zone: Nine principles for building the Risk Intelligent Enterprise, TM Deloitte, 2012
Four cornerstones of Risk Transformation

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

• **Strategy:** Strategy puts the organizational vision and mission into action. The executive team should consider the risks of the strategy and risks to the strategy. Enterprise risk management and governance infrastructures should support execution of the business model and capital allocation. Capital and other resources can then be allocated based on strategically selected risk-reward trade-offs in light of business objectives and risk mitigation and management capabilities.

• **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 organization. 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 organization’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 organization 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 standardized 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 financial, operational, and risk data to enable common and reconciled risk and compliance reporting, while providing the business units with access to timely risk data. An enterprise risk data and architecture strategy can deliver the right risk-related data to the right points and enable the organization to respond to new business opportunities and to risk and regulatory demands consistently and efficiently rather than through ad hoc or bolted-on solutions.

In 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 organization 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 organization. In defining the target state, executives might assess the current state in terms of these cornerstones. (See Figure 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 figure indicates, Risk Transformation helps leaders define subjects for analysis across the organization against a maturity continuum. Five distinct maturity states are defined for each cornerstone, with the “optimized” state corresponding to the practices of a Risk Intelligent Enterprise.

Risk Transformation recognizes that risk management can be organizationally 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, categorizing, and prioritizing 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.

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 organizational 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?

Figure 6. Illustrative maturity continuum

<table>
<thead>
<tr>
<th>Cornerstone</th>
<th>Unaware</th>
<th>Fragmented</th>
<th>Integrated</th>
<th>Comprehensive</th>
<th>Optimized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy</td>
<td></td>
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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 organized way:

• **Start the conversation.** The large organizations, across most industries, are wrestling with risk management, operational, and regulatory demands. Virtually 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 organization faces similar challenges. These challenges are, however, best addressed in a team setting.

• **Assess the current state.** Consider the factors affecting your organization’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 organization? What is the level of maturity—fragmented, integrated, comprehensive, or optimized—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?

Other questions abound, but these are a good start. And the time to start is now.
Begin the journey
Risk Transformation can position leadership teams to address organizational challenges and to meet future expectations in a prudent, profitable manner. It recognizes risk as intrinsic to doing business and therefore integrates risk oversight, governance, and management into the organization’s business activities.

When regulatory and compliance demands — and risks — form part of the business landscape, as they do for virtually all significant companies operating in multiple jurisdictions, addressing those demands and risks should also be integral to the conduct of business. In achieving this state, Risk Transformation not only precludes expensive, ineffective ad hoc or bolted-on solutions; it also positions the organization to respond to new regulatory demands and new risks in an effective, efficient manner.

This transformation is one that only the executive team and board can lead. Given the current and foreseeable environment, it is a transformation well worth leading.
Talk to us
We look forward to hearing from you and learning what you think about the ideas presented in this paper. Please contact us at risk@deloitte.com.