



cutting through complexity

Expectations of Risk Management Outpacing Capabilities – It's Time For Action

Top Eight Risk Management
Imperatives for the C-suite in 2013

KPMG INTERNATIONAL

In co-operation with the EIU

Economist Intelligence Unit

**The
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The path forward



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Introduction

Expectations of Risk Management Outpacing Capabilities – It's Time For Action

Top Eight Risk Management Imperatives for the C-suite in 2013

With economic activity still constrained by fiscal difficulties in most major economies, in 2013 global economic growth is expected to be only slightly better than in 2012, and well below levels witnessed prior to the recession. The outlook is rosier for the emerging world: the Economist Intelligence Unit forecasts non-OECD (Organization for Economic Cooperation and Development) growth at 5.7 percent, three times faster than OECD growth of 1.4 percent. Yet emerging markets too face challenges as policymakers attempt to promote more self-sustaining growth dynamics in the face of stagnant demand in more mature markets, which still account for over 60 percent of the global economy measured in US dollars, according to the EIU.

Developed world economies face more complex regulatory and compliance environments in the aftermath of the financial crisis, while capitalizing on opportunities in the emerging world requires companies to understand new markets and navigate attendant risks. Consequently, risk management remains at the top of the global corporate agenda.

A dynamic is evolving: A surge in complexity and uncertainty surrounding organizations as they search for innovative ways to expand into new markets, faceoff against increasing

competition and pushing the envelope on technology. Yet these challenges are building faster than most organizations' abilities to manage with agility, knowledge and a resilient risk-aware culture. Thus, the gap is widening and we are at a turning point – warranting an even stronger capability to master and optimize risk. Stakeholder expectations on an organization's risk management sophistication continue to grow, yet capabilities are not keeping pace.

In December 2012, the EIU conducted a global survey, sponsored by KPMG International, of more than 1,000 C-suite executives to explore how effectively companies are integrating a holistic governance, risk and compliance (GRC) framework throughout the enterprise. The principal findings of the survey, which create the basis of this report, are as follows:

1. Risk management is viewed as making a key contribution to the business; however, organizations need to improve how they measure risk management's return on investment, and how they communicate its processes, value and effectiveness to key stakeholders
2. Executives continue to struggle with assessing enterprise-wide risk exposures



3. The C-suite sees risk management as critically important but few organizations are articulating their risk appetite
4. Regulatory pressure and changes in the regulatory environment is the issue posing the greatest threat to respondents; global economic and political instability is seen as the greatest risk scenario threat
5. Respondents believe business units are more adept than risk management departments, compliance and internal audit in assessing and managing risk
6. Lack of human resources/expertise impedes convergence of risk and control functions
7. Weak incentive structures impede risk-based decision-making
8. Spending to enhance risk management will continue to increase over the next three years

The survey included responses from 1,092 C-suite executives from around the world. Of them, 28 percent are CEOs, 18 percent CFOs, and 7 percent board members with the remaining C-suite executives comprising operations, risk, legal, technology, compliance and internal audit executives. Survey responses came from North America (25 percent),

Western Europe (23 percent) and Asia-Pacific (23 percent), and the remainder from the rest of the world including Latin America (15 percent) and the Middle East (13 percent). More than half (54 percent) of respondents' companies have annual global revenues of US\$500 million or more, with 37 percent reporting revenues of US\$1 billion or more, and 14 percent over US\$10 billion. The survey primarily focuses on five industry clusters accounting for more than three-quarters of all respondents: financial services (17 percent); technology, media & telecommunications (16 percent); diversified industrials (15 percent); healthcare (15 percent); and energy & natural resources (14 percent).

The survey questions centered around priority areas for assessing the evolution of GRC: (a) operationalizing/embedding the risk management program and linking it to organizational strategy, (b) ensuring accuracy of the risk profile, (c) clarity of roles and responsibilities through the "three lines of defense" structure, (d) converging the risk and control functions across the organization, (e) enhancing the aggregation and analysis of data to create an enterprise-wide view of risk, (f) increasing transparency with enhanced reporting and communication tools, and (g) adapting to an evolving regulatory environment.

Return on investment

1. Risk management is viewed as making a key contribution to the business; however, organizations need to improve how they measure risk management's return on investment, and how they communicate its processes, value and effectiveness to key stakeholders

Almost half (47 percent) of C-suite executives indicated that risk management is essential for adding value to the overall business, with another 34 percent citing occasional improvements to the business resulting from risk management (see chart 1).

However, varying methods of measuring return on investment from risk management are deployed, with 28 percent of

organizations having no measure (see chart 2). Additionally, less than half (44 percent) believe the organization is effective at developing stakeholders' understanding of the risk program (see chart 3). Thus, there appears to be an opportunity for organizations to capture greater shareholder value from their risk management efforts through more effective measurement and communication.

Assess risk exposures

2. Executives continue to struggle with assessing enterprise-wide risk exposures

Since the onset of the financial crisis, most industries have made some improvements to their systems for aggregating risk data. Today, nearly half (48 percent) of executives say their risk management function performs a bottoms-up risk assessment process at least annually, another third (34 percent) say that all risk and control functions are aligned to ensure a complete risk profile; and 38 percent say the business uses a risk and control self-assessment process.

Still, one in five (20 percent) report that they have no risk aggregation process. And although most respondents rate the maturity of their risk management programs fairly high relative to peers, risk quantification/aggregation is rated significantly lower than other aspects of risk management. Only 38 percent say that their organization is more advanced than peers in this respect compared with 48 percent for risk assessment, and 45 percent for risk governance.

Technology is an important enabler of successful risk management integration across the organization. In fact, about three-quarters of executives surveyed view technology as a key risk management tool – indicating that it is either very important (51 percent) or critical (23 percent) to their risk management efforts. Respondents see technical challenges as a smaller obstacle to risk management data collection and analysis as compared to difficulties in understanding complex risk exposures. When asked to name the top three challenges, the largest proportion of executives (47 percent) cite difficulty of understanding the entire risk exposure on a global enterprise basis, and nearly as many (44 percent) see the same problem at the business unit level. Diversity of IT platforms is the only technical barrier included in the top three obstacles by more than one-third (41 percent) of respondents.



Articulate risk appetite

3. The C-suite sees risk management as critically important but few organizations are articulating their risk appetite

Nearly all C-suite executives recognize risk management as an important ingredient in their organization's overall business success. An overwhelming majority (86 percent) of survey respondents said that risk management considerations are to some degree factored into strategic planning decisions (see chart 4). More sophisticated organizations regularly include risk considerations in making strategic decisions – consistently applying a risk lens equivalent to the growth lens.

Yet only one in five (19 percent) respondents say their organization has fully developed and implemented a risk

appetite statement while nearly one-quarter (22 percent) say an appetite statement is in development. About 40 percent say that a statement has been created but so far not communicated across the organization, and 19 percent say the organization has not addressed this issue at all (see chart 5). While some progress has been made, organizations will need to increase their efforts in developing creative tools for decision-making (e.g., building risk appetite measures and statements).

Greatest threats

4. Regulatory pressure and changes in the regulatory environment is the issue posing the greatest threat to respondents; global economic and political instability is seen as the greatest risk scenario threat

Regulatory pressure/changes in the regulatory environment ranked highest with 46 percent of respondents indicating it is the risk issue posing the greatest threat; followed by reputational risk (41 percent), credit/market/liquidity risk (34 percent), and geopolitical risk (32 percent) (see chart 6). Global economic crisis/geopolitical instability was cited as the top risk scenario confronting every industry, with the exception of healthcare – which ranked this scenario as second, behind a sharp slowdown in healthcare spending. Arguably, healthcare is an industry with guaranteed growth opportunities around the world, as governments tackle the challenges of aging and rising chronic diseases; and emerging middle classes demand more

private health services. The challenge for providers is navigating varying and in some cases shifting regulations and pressure by governments to contain spending.

Financial services and energy & natural resources are two other industries for which regulatory pressures are of particular concern to risk managers. In the wake of the global economic meltdown, regulators were given a new mandate – to consider how the actions of companies are affecting markets worldwide. And C-suite executives today are acutely aware that instability in one part of the world can have a profound impact on their businesses both at home and abroad.

Regulatory/government pressure is the single greatest risk that poses a threat to my industry

Financial Services	59%
Healthcare	50%
Energy & Natural Resources	53%
Diversified Industrials	23%
Technology, Media and Telecommunications	33%
Other industries	46%

Global economic crisis/geopolitical instability is the risk scenario that poses the greatest threat to my industry

Financial Services	66%
Healthcare	36%
Energy & Natural Resources	69%
Diversified Industrials	81%
Technology, Media and Telecommunications	49%
Other industries	69%

Source: Expectations of Risk Management Outpacing Capabilities - It's Time For Action, KPMG International, 2013.

Three lines of defense

5. Respondents believe business units are more adept than risk management departments, compliance and internal audit in assessing and managing risk

Survey respondents give their organizations high ratings for their ability to identify, assess and manage both current and emerging risks in the context of the 'three lines of defense' of enterprise risk management. The first line of defense (business units) is considered strongest, with 79 percent and 75 percent, respectively, saying that their organization is effective in identifying/assessing risk and managing risk at this level. The proportions drop off to 74 percent and 73 percent, respectively, for the second line (risk management function and compliance)

and around two-thirds for the third line (internal audit). These findings are contrary to GRC wisdom – which suggests that the second (risk management function and compliance) and third (internal audit) lines should be equally adept at identifying, assessing and managing risk. Opportunities exist to cross-train between the lines of defense regarding risk management processes and methods to support the identification, prioritization, measurement and reporting of risks.





Barriers to convergence

6. Lack of human resources/expertise impedes convergence of risk and control functions

Over 50 percent of respondents indicated the strongest reason for converging risk and control functions is to reduce exposure of the organization to risk; the second being to improve performance (37 percent) (see chart 7).

The task of converging risk and control functions faces a number of barriers and respondents were asked to select the top three. Lack of human resources/expertise is the

top-ranked barrier for 42 percent of respondents, followed by complexity of the convergence process (36 percent), and the existence of more important priorities (33 percent). All of the other barriers are given less significance, and are cited by less than one-third of respondents (see chart 8). Notably, lack of financial resources is the least significant barrier with 19 percent.

Weak incentive structures

7. Weak incentive structures impede risk-based decision-making

While most respondents say that their companies have relatively mature risk management programs compared to peers, the link between risk management and employee compensation is weak. In fact, survey respondents readily admit that they do a less-than-stellar job motivating business line managers to adopt effective risk-based decision making. The absence of a compensation structure that rewards a focus on risk management also is seen as an important weakness by

33 percent of respondents. About 40 percent of respondents say their organization has informal links between risk management and compensation for business-line employees, and 38 percent say there are formal links. But fewer than half of executives in each of these categories rate these links as "strong"; and nearly one-quarter (22 percent) of all respondents say there is no link.

Investment in risk management

8. Spending to enhance risk management will continue to increase over the next three years

In today's increasingly complex business environment, most companies are investing in risk management. Two thirds (65 percent) of respondents globally indicate that the share of revenues invested in risk management is higher today than

three years ago, and a similar number of respondents (66 percent) expect an increase over the next three years (see charts 9 and 10).





Conclusion

Managing risk amid stagnating global economies and heightened regulatory pressure has created formidable challenges for the C-suite. Despite the improvements to risk management driven by executives to date, stakeholder expectations continue to rise requiring a greater level of sophistication. To meet this challenge, organizations need to enhance risk management capabilities to address the imperatives discussed. This will require increased

involvement and leadership of executives in order to respond to the demands of the market regarding governance, risk, and compliance. The complete survey and analysis (Expectations of Risk Management Outpacing Capabilities – It's Time For Action) will elaborate on the Executive Summary in much greater detail offering perspectives on how to evolve governance, risk and compliance in the months and years ahead.

Appendix

(Source: Expectations of Risk Management Outpacing Capabilities – It's Time For Action, 2013)

Chart 1: Which of the following best reflects your view of risk management's contribution to your organization?

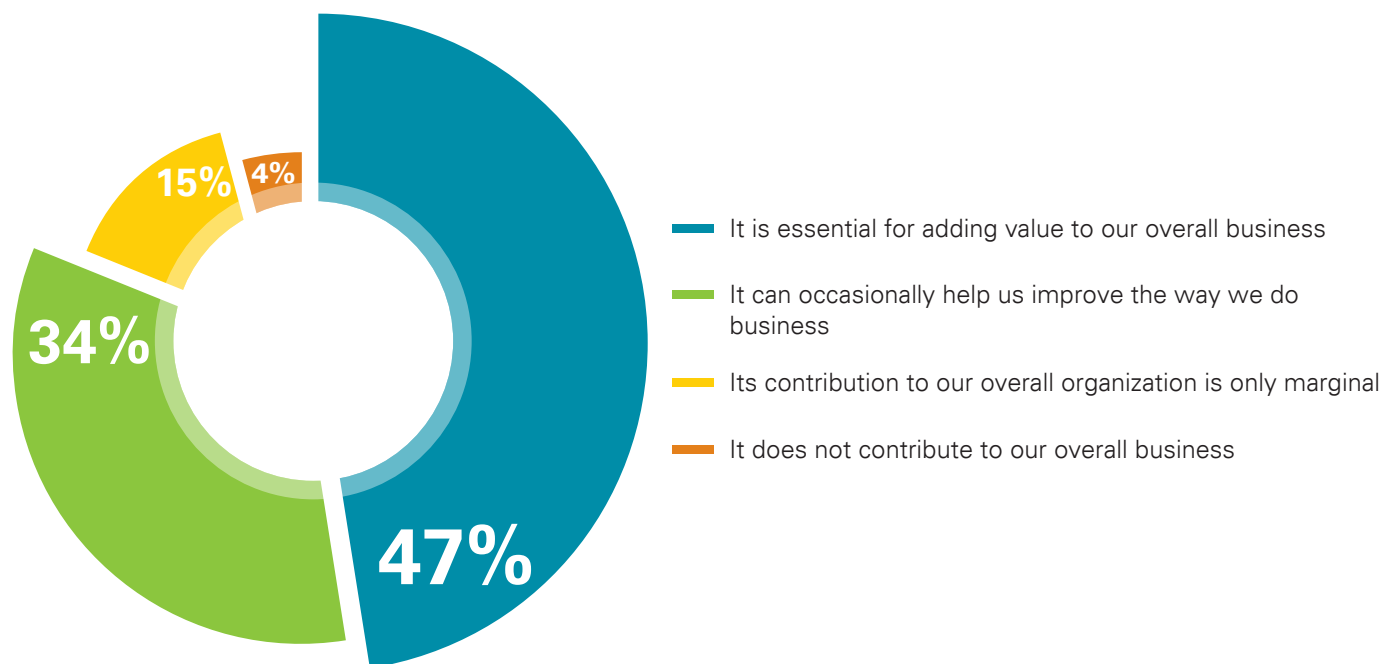


Chart 2: How do you measure the return on investment (ROI) in your risk management program?

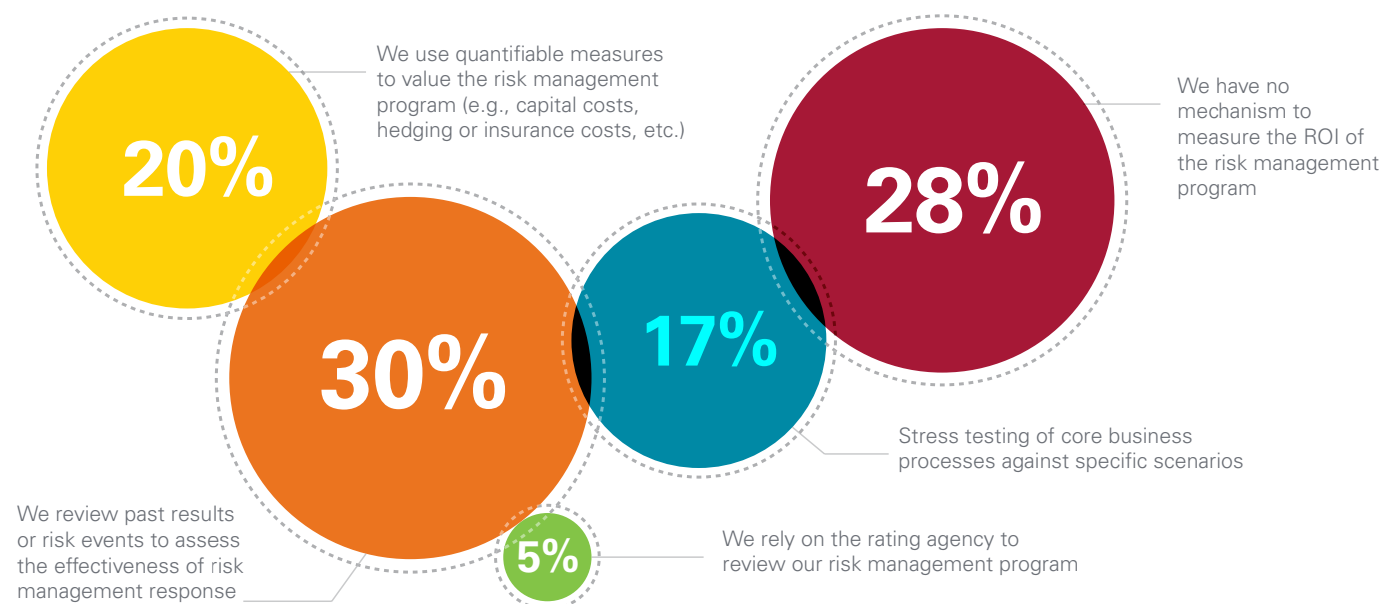


Chart 3: How effectively is your organization able to develop stakeholders' understanding of your risk program?

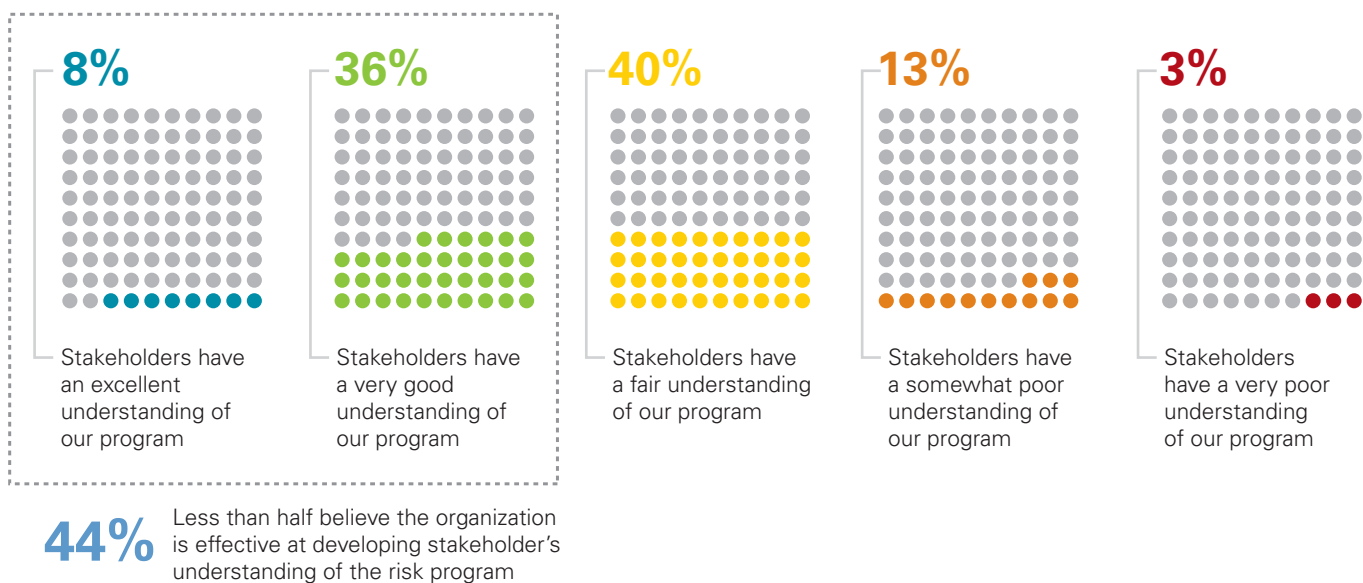


Chart 4: How often are risk management considerations factored into your organization's strategic planning decisions?

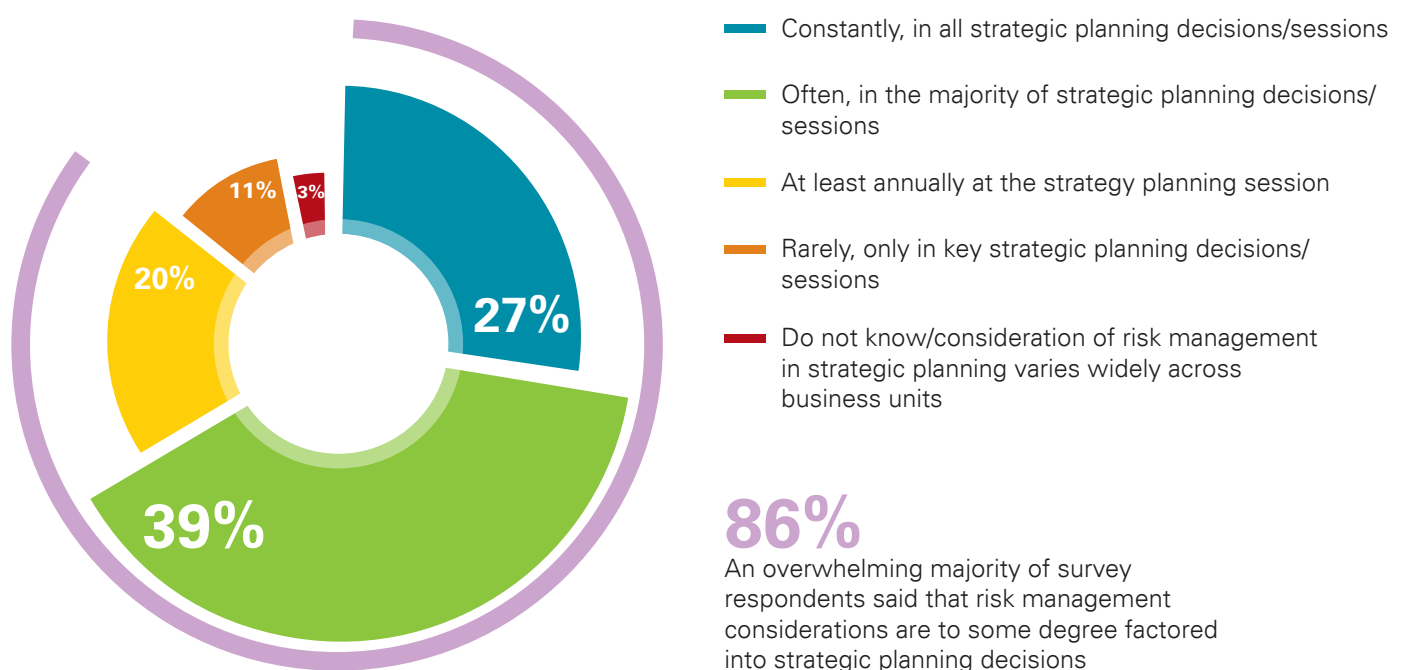


Chart 5: To what extent has your organization developed a formal risk appetite statement?

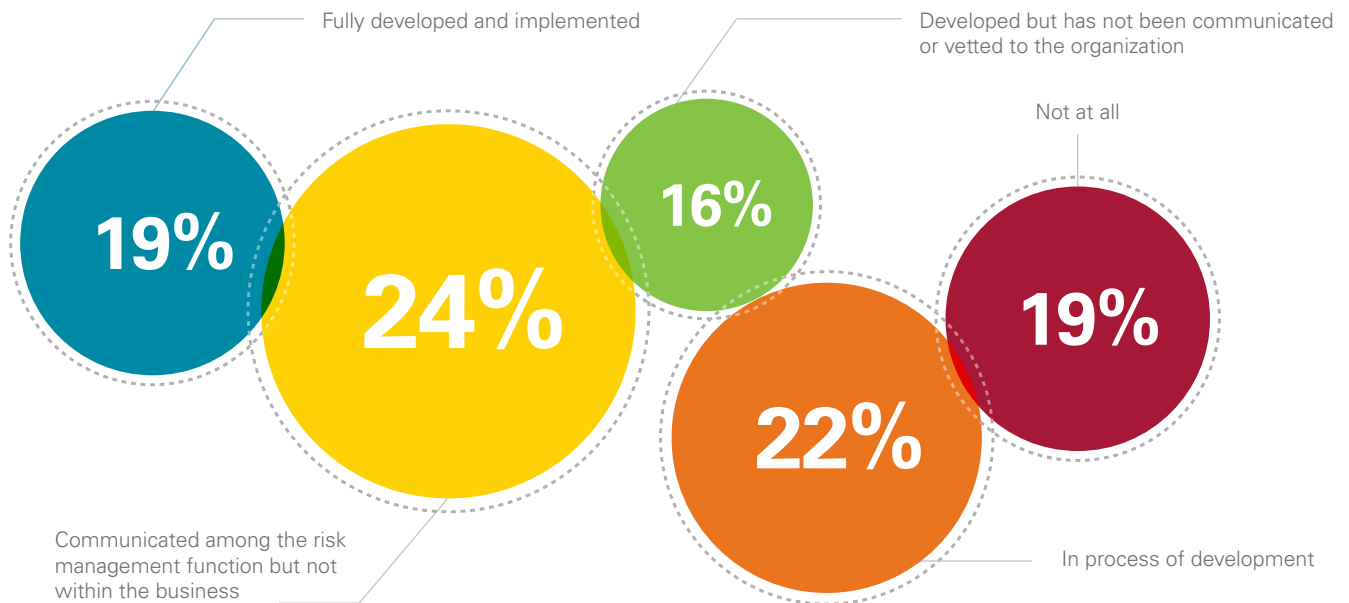


Chart 6: Which of the following issues pose the greatest threat to your industry?

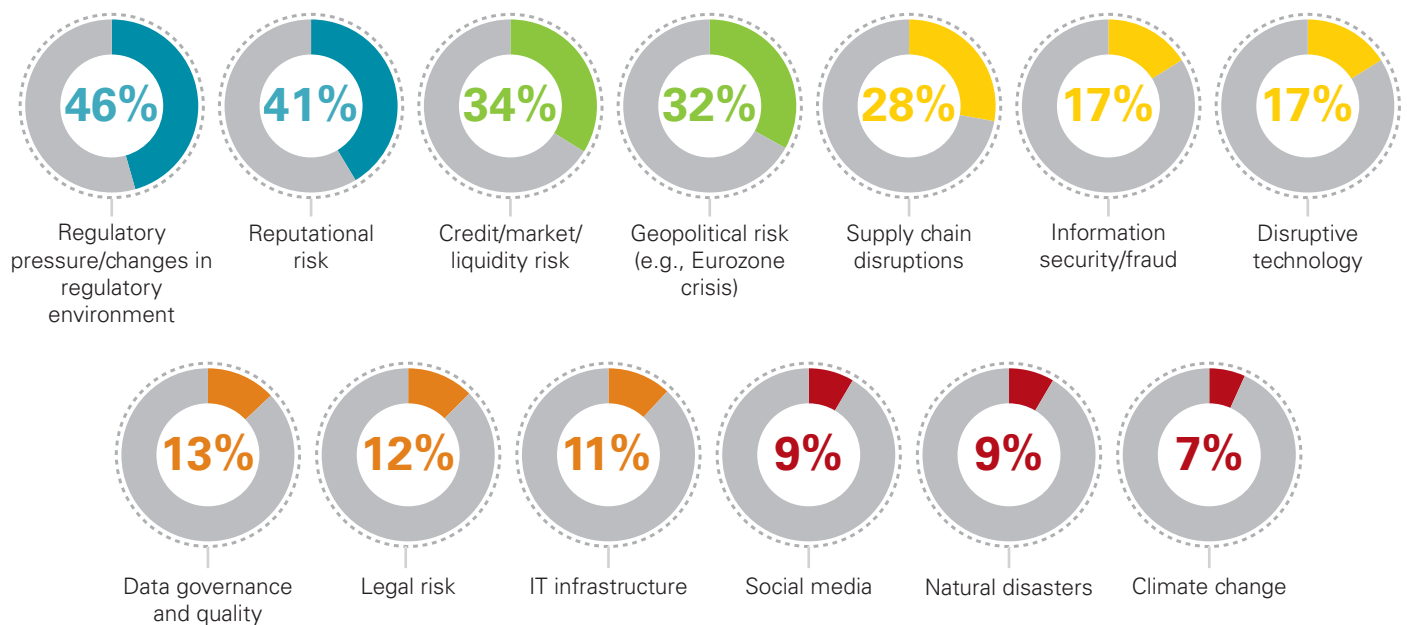


Chart 7: Which of the following factors has the strongest influence over your organization's interest in converging its risk and control functions (i.e., risk management responsibilities across all lines of defense)?

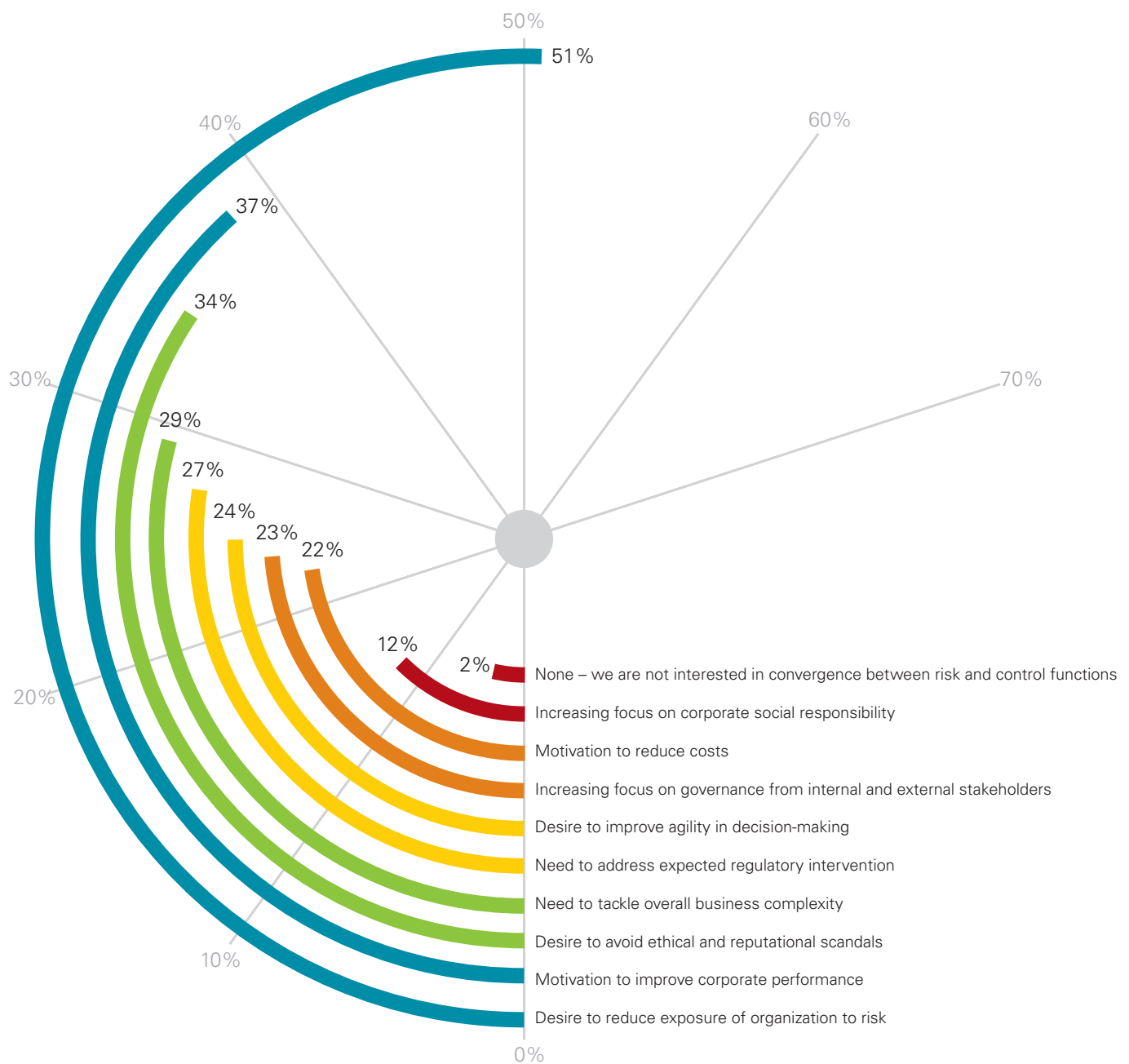


Chart 8: Which of the following do you consider to be the most significant barriers to greater convergence of risk and control functions at your organization?

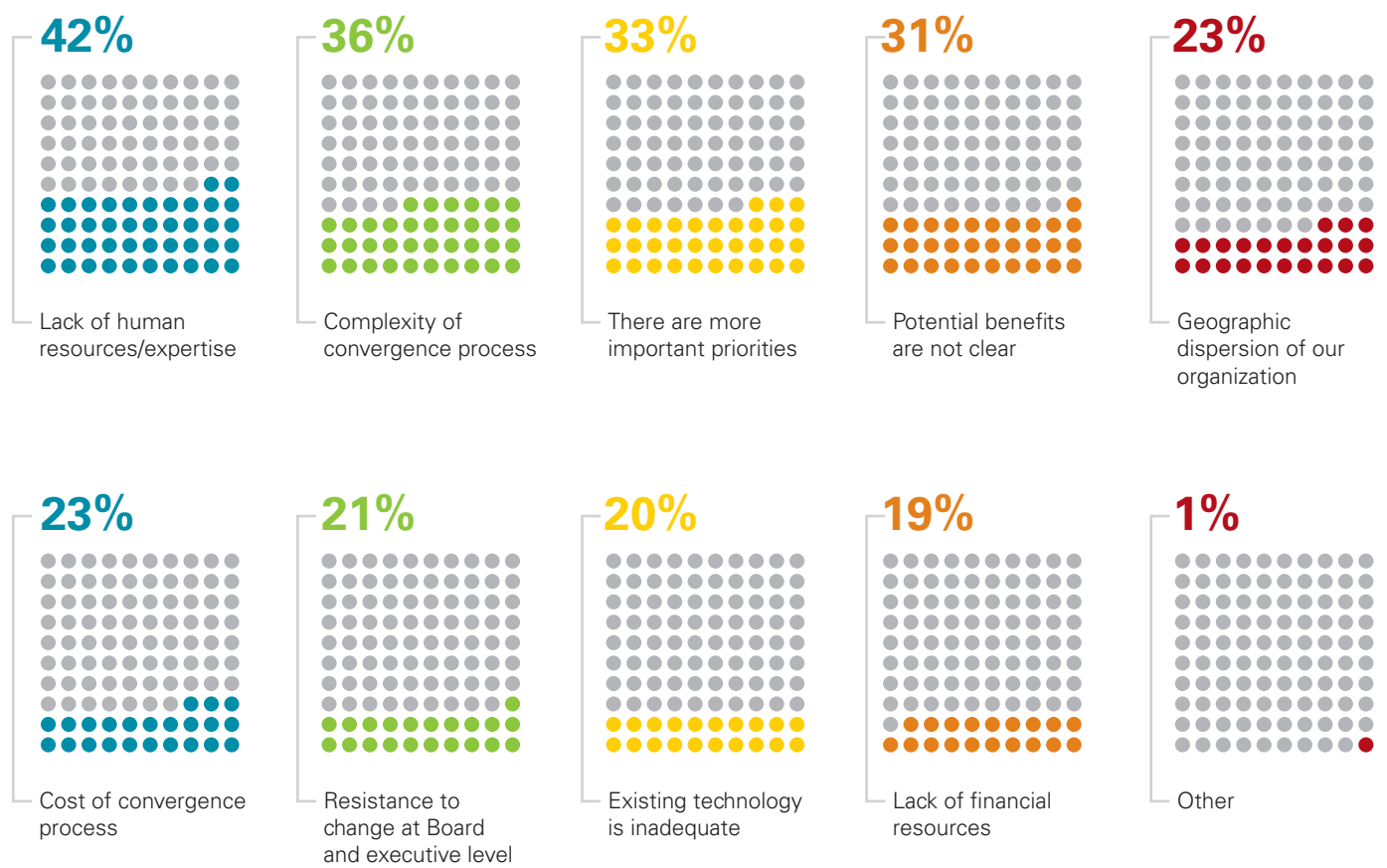


Chart 9: How does the level of investment in risk management (as a percentage of revenues) at your organization today compare to three years ago?

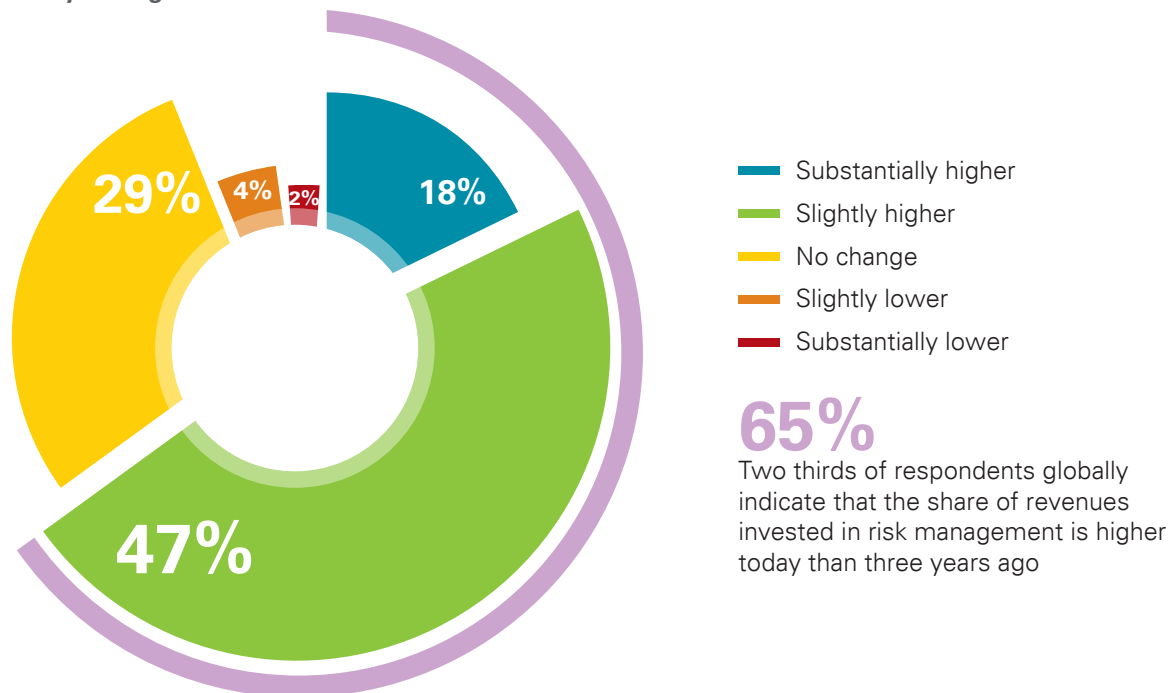
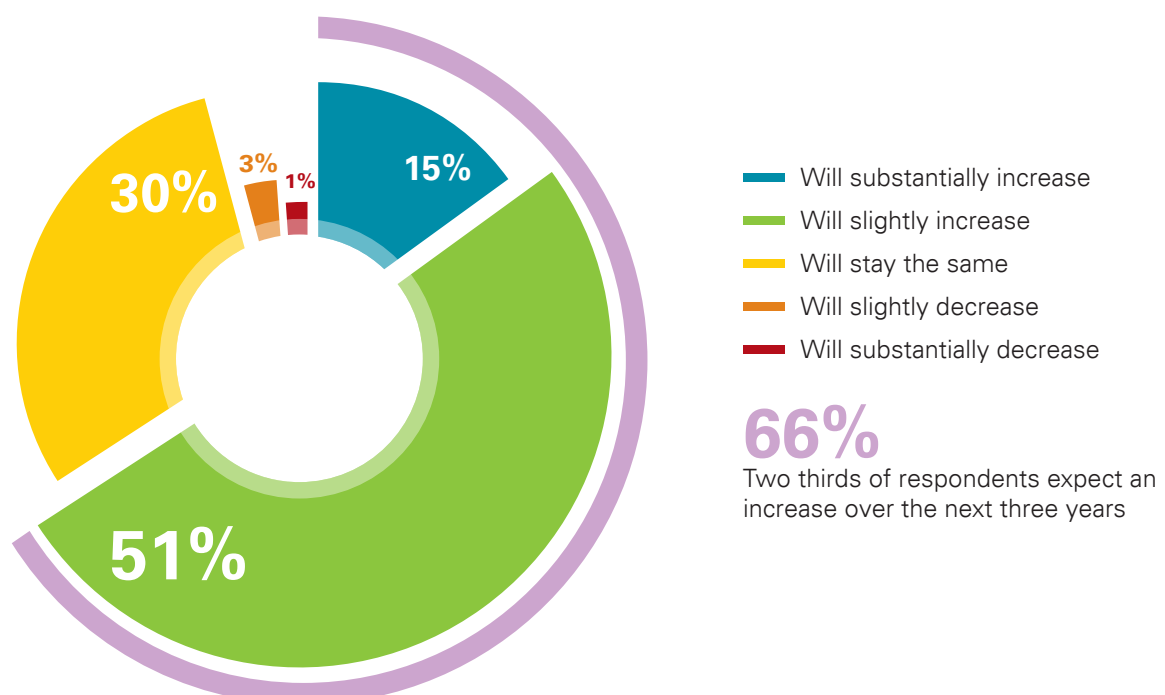


Chart 10: How do you anticipate the level of investment in risk management (as a percentage of revenues) will change at your organization over the next three years?



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