

Risky Business

Managing risks before disaster strikes

Executive summary

Whether it's a drought, an earthquake or a storm the size of Hurricane Sandy, natural disasters expose businesses to losses that can persist long after the event has passed. A strong risk management strategy can help prevent damage, control costs, and in some cases, even create new value.

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The worst drought in 50 years has been catastrophic for farmers and ranchers across the U.S. this past year. By September 12, 2012 the U.S. Department of Agriculture (USDA) had designated more than 2,000 counties disaster areas.

Fortunately, 80% of major field crops in this country are covered by federal crop insurance, thanks to the USDA Risk Management Agency, which provides a broad safety net for American farmers and ranchers. But when risk management is in the hands of private enterprise, far too often the impact of natural disasters can be more devastating.

Following the massive earthquake and tsunami in Japan in March of 2011, for example, the Fukushima nuclear power plant suffered explosions, meltdowns and releases of radioactive material. The plant's owner and operator, the Tokyo Electric Power Co., had underestimated tsunami risks to the reactors and failed to implement a satisfactory risk management plan. Compounding the situation, the Japanese government, which took over the plant after the catastrophe, withheld critical information about the extent of the damage and restricted the response to a small, closed decision-making staff.

The chain of events in Japan negatively impacted agriculture, water, energy and the fishing industry. Experts predict that it could take decades to decontaminate land in the vicinity of the Fukushima plant.

As this real-life example illustrates, natural catastrophes and the impact they can have aren't always predictable and are rarely preventable. And in the global marketplace, where companies are vulnerable to an interconnected web of risk, the need for corporate risk management strategies and plans has never been greater.

As a result, senior executives are growing increasingly aware of the importance of responsive, effective risk management teams that can consider a broad swath of potentially risky areas: weather, energy, water and agriculture; geopolitics, international finances and economies; and intellectual property, cyber security and corporate image, to name the key ones.

Assessing potential risk

The first step in developing effective plans, experts advise, is for companies to assess potential risks to their facilities and operations.

"Everything begins with a realistic assessment of both your direct physical risks — hurricanes, floods, earthquakes — and your indirect risk to disrupted supply chains," says Branko Terzic, executive director of the Deloitte Center for Energy Solutions. A former CEO of Yankee Energy System Inc. and Yankee Gas Services Company in New England, and former commissioner on the Federal Energy Regulatory Commission, Terzic feels things are heading in the right direction: "We're seeing more and more companies looking at best practices."

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Executive Director
Deloitte Center for Energy Solutions

Many companies that have taken this route have come up with reassuring answers. In Bank of America Merrill Lynch's CFO Outlook Spring 2011 survey, senior executives of U.S. companies were asked, "How prepared is your company and do you have a systematic approach to identify, assess and plan for risks it may face?"

- 92% of companies surveyed said they are prepared for future risks. The report attributes this general state of preparedness to a heightened risk awareness among U.S. CFOs and the programs put in place to safeguard their businesses in the wake of the recession.
- 71% of companies reported having a systematic approach to managing risk. Nine out of 10 said they want to strengthen their enterprise risk management. Just 3 in 10 companies said they have no systematic approach.

Implementing an action plan

In an earlier study entitled *Strategic Risk Assessment*, Dr. Mark L. Frigo, director of the Center for Strategy, Execution and Valuation, and director of the Strategic Risk Management Lab at DePaul University, and fellow professor Richard Anderson outlined additional steps for conducting an effective assessment. They include understanding the strategy of the organization, gathering and communicating data gathered on short- and long-term risks, and developing and implementing a risk management action plan.

In the past, risk management was primarily concerned with protecting the bottom line through insurance against natural disasters. In some companies, it still is. Over time, however, that approach evolved into plans to anticipate and control damage and loss. More recently, companies have been embracing enterprise risk management (ERM), a strategic discipline that supports an organization's goals by addressing the full spectrum of its risks and managing the combined impact of those risks.

Robert Cartwright, Jr., the loss prevention manager at Bridgestone Corp., who serves on the board of the Risk and Insurance Management Society (RIMS), helps advise the society's 10,000-some members on developing and implementing ERM programs.

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“Risk used to be the unanswered question in the back of the room when something happened,” he says. “Enterprise risk management is risk examined from the viewpoint of the entire enterprise, not just one person or office. It looks at risks across the organization, and determines and asks what is our risk tolerance. The company then determines the top five risks, what resources do we need to address those risks, and what are the contingency plans to back them up.”

He adds, “When you get all of the folks who are involved—especially the decision-makers, those who are in the C-suite—you create a plan that looks at all elements of risk across the organization, so it's no longer just one pocket somewhere in the corner. Now everyone in the enterprise is involved in risk management and they can all see the problem at the same time.”

Leadership, in other words, plays a critical role in effective risk management. C-suite-level involvement in ERM has led to the creation of the position of corporate risk officer (CRO). According to Cartwright, the CRO is like a clairvoyant who, in interacting with all departments of an organization, can see further into risks and potential risks, and from multiple angles.

According to Cartwright, having CROs in place enabled companies like Corporate One and Paychecks to weather the 2008 financial crisis. In turn, the process of enterprise risk management has led in recent years to an integration of risk into strategic planning at many companies.

Strategic risk management

Questions about how natural resources, or any other elements, might impact an organization's business must be considered at the strategic level, according to risk management experts. To fail to do so, they say, is to court disaster.

“The disconnect between strategy and risk management is a big barrier,” says DePaul's Frigo, whose group has studied thousands of companies. “It prevents organizations from doing a better job incorporating the natural resource dimension in managing the business this year and five years out.”

One company that has implemented a successful strategic risk management process is The LEGO Group, the play materials company based in Denmark. In 2007, management came up with a list of 90 risks, a list it then shared with the board of directors. Since then, it has used simulations, strategic scenarios, AROP (active risk and opportunity planning) software and Excel spreadsheets to refine the process.



“Strategic risk management is not that complicated,” LEGO corporate risk manager Hans Lessoe told an audience attending a RIMS conference in Canada earlier this year. “It’s about identifying and assessing and handling and reporting. And then it’s about common sense. The only problem I have with common sense is that it’s by far the least common of the senses.”

After experiencing a declining market share and a sales dip a decade ago — and despite a stagnant toy market in general — LEGO tripled its revenue in the past eight years.

The upside of risk

Strategy, risk management, performance and sustainability are clearly linked, studies show. Researchers at the Strategic Risk Management Lab at DePaul found that companies with risk management plans that are both integrated with strategy and focused on protecting and creating value tend to be resilient to uncertainty and risk. In fact, a focus on creating value in the face of disaster can put an entirely different spin on how companies view risk.

Dr. Frigo calls this aspect of strategic risk management “a vigilance to forces of change,” a tagline that came out of a study of 100 high-performance companies conducted by he and his colleagues at DePaul. The phrase reflects a view of risk not just as downside but also as potential upside.

An example of a company that has looked beyond the downside in taking a strategic risk is Delta Airlines and its decision to buy an oil refinery as a hedge against disruption of supply and price spikes.

Last April, the company acquired the Trainer refinery from ConocoPhillips for \$150 million, after receiving \$30 million from the state of Pennsylvania — where the shuttered refinery is located — to support job creation.

The airline said it would exchange gasoline, diesel and other petroleum products produced at Trainer for jet fuel from other sources. Richard H. Anderson, Delta’s CEO, estimates that once the refinery is refurbished and operating, it will reduce the company’s annual fuel bill by \$300 million.

“Some 30% of Delta’s operating costs are fuel,” calculates Carol Fox, director of strategic and enterprise risk practice at RIMS. “Rather than dealing with that volatility, they took control of it. If they can produce more fuel than they need, then obviously it becomes a revenue stream for them as well.”

“Upside thinking” can be applied to small, relatively minor risk scenarios as well as to Armageddon-scale catastrophes. For decades, the University of California at Davis suffered from an embarrassment of natural resources. Between 1934 and 1953, a member of a local ranching family bequeathed to the university land that eventually totaled 136 acres of olive orchards. The problem with the generous gift was that by late summer every year, the grounds would be black and slippery with unpicked, rotting fruit and oil, resulting in falls, lawsuits and escalating maintenance costs.

Rather than cut down the 2,000 trees — a solution that would not have gone over well on a Southern California campus — an enterprising groundsman suggested picking the olives, processing the oil and bottling it for sale. Today, under the auspices of the UC Davis Olive Center, the fruit is harvested, processed and bottled for sale as table olives, olive oil and olive body products bearing the UC Davis label.

“Risk presents an uncertain future outcome that can either improve or worsen your position,” observes Fox at RIMS. “As organizations begin looking at risk that way instead of only thinking about how many controls do we need to put in place to avoid this risk — when they begin looking at this risk as what are the things that could happen that could actually improve our position — then that risk becomes value-creating, if you will.”

Best practices in action

Recent natural disasters — Hurricane Sandy; earthquakes in China and Japan; floods in Thailand, India and the Philippines; drought and crop failures in Australia and the Midwest; and the recession and economic instability throughout Europe and the United States — have cost companies billions of dollars in closed facilities and lost products, services, customers and sales.

Perhaps as a result, 91% of companies plan to reorganize and reprioritize their risk management approaches in the next three years, according to the 2012 Excellence in Risk Management survey, commissioned by Deloitte and Forbes Insights. Another 2012 study, conducted by Ernst & Young, found that companies with mature risk management practices outperformed their peers and generated the highest growth in revenue.

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At the Strategic Risk Management Lab at DePaul University, working with a study of hundreds of companies, Dr. Frigo's group identified a handful of what it sees as "leading practices" that are moving organizations in the right direction. These practices include:

- Risk management is treated as a continual process integrated in strategy development and strategy execution. The process regularly assesses risk and reassesses strategies and plans of action.

- Risk management is developed as a value-added discipline that has a clear strategy for how it will create and protect value for its constituents. This means including risk management as part of the corporate and business-unit strategies.
 - Strategic risk management is a core competency of successful organizations. Acknowledgement of this concept enables companies to develop the capabilities and internal culture for managing risk and uncertainty.
 - Leadership of an organization supports the development of risk management as a valuable discipline in the organization. Executive leadership in this area is a necessity if a company is to thrive in today's uncertain environment.
 - Risk management does not over-rely on traditional risk management tools that are often focused only on downside risk and do not consider strategic risks. Companies with strategic ERM programs use a variety of management tools that fit the organization and its business. They also look for opportunity within risk and uncertainty.
- "Ultimately," Dr. Frigo observes, "risk management is simply management done well. And ultimately, a company with better risk management is more successful and more valuable."