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GUIDE 2019

EMERGING RISKS

NEW WORLD. NEW SOLUTIONS.
A GUIDE FOR AIRMIC MEMBERS

IN ASSOCIATION WITH:

MARSH

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Marsh is the world's leading insurance broker and risk adviser. With over 35,000 colleagues operating in more than 130 countries, Marsh serves commercial and individual clients with data driven risk solutions and advisory services. Marsh is a wholly owned subsidiary of Marsh & McLennan Companies (NYSE: MMC), the leading global professional services firm in the areas of risk, strategy and people. With annual revenue over US$15 billion and 75,000 colleagues worldwide, MMC helps clients navigate an increasingly dynamic and complex environment through four market-leading firms: Marsh, Guy Carpenter, Mercer, and Oliver Wyman.

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The leading UK association for everyone who has a responsibility for risk management and insurance for their organisation, Airmic has over 450 corporate members and more than 1,300 individual members. Individual members include company secretaries, finance directors, internal auditors, as well as risk and insurance professionals from all sectors. Airmic supports members through: training and research; sharing information; a diverse programme of events; encouraging good practice; and lobbying on subjects that directly affect our members. Above all, we provide a platform for professionals to stay in touch, to communicate with each other and to share ideas and information.

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The world is increasingly volatile, uncertain, complex and ambiguous. While, at face value, practices for managing risk might seem unaffected by this context, the underlying business dynamics of today are so different from those of the past, they trigger the need for recalibrating risk management and rebalancing effort between managing traditional risks and emerging risks.

This guide has a focus on emerging risks with an objective of providing support to the risk professional. The guide addresses the changing external and internal business context and the impact this has on business transformation and the speed of decision making and agility. Interviews with Airmic members provide practical insight through the lens of emerging risks generally and through the touchpoints of political risks and environmental risks specifically.

Airmic is delighted to publish this guide in partnership with Marsh.

Julia Graham
Deputy CEO and Technical Director, Airmic

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MANAGING RISK IN A TRANSFORMING WORLD IS MORE ABOUT COMPANY MANAGEMENT THAN OLD-SCHOOL RISK REGISTERS AND HEAT MAPS.

INTRODUCTION

Risk has typically been viewed as something negative to be minimised or avoided. Since the financial crisis, organisations have focused their risk management efforts on strengthening risk frameworks and processes, tightening risk assessments, reinforcing oversight arrangements, and improving monitoring and reporting processes with an emphasis on compliance and prudence.

Times have changed.

In the last year, the economic growth rates of the major economies have all been positive, but there has been quite a divergence of performance between countries. Recent outlooks for the global economy from the forecasters are quite bearish, with significant scope for politically oriented shocks, especially in advanced economies, where risks associated with national political ambitions, societal frustration and upheaval, disruption and opportunities created by technology, and environmental emergencies dominate the risk landscape.

This makes the assessment of a clear, long-term vision for sustainable business growth more difficult and an understanding of the risks associated with delivering that harder to achieve.

No organisation, whatever the sector or location, can avoid this, and all need to be on the front foot. Risk professionals cannot, and should not, try to predict the future, but the tools and techniques most used for managing traditional risks may not be effective for managing the risks emerging and evolving. These risks typically emit low signals on the risk radar, and for which data can be sparse and unreliable. These risks are often hard to detect, difficult to assess and easy to ignore in favour of the more obvious, immediate and easier-to-explain traditional risks on which many business leaders prefer to concentrate.

This guide examines the context of why emerging risks are important and why they are different. Illustrated by political and environmental risks, it explores the need to shake up risk assessment and enhance risk management practices.

Turning the spotlight on the risk profession, the guide considers the implications for risk professionals with ambitions to gravitate from a back-office analytics and controls orientation to the centre stage of supporting commercial and other management decision-making in a risk-intelligent organisation.

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INTELLIGENCE IS THE ABILITY TO ADAPT TO CHANGE

STEPHEN HAWKING

GETTING TO GRIPS WITH EMERGING RISKS

Complacency is a killer of strategy

The 2018 UK Corporate Governance Code specifically embraces emerging risks. "The board should carry out a robust assessment of the company's emerging and principal risks. The board should confirm in the annual report that it has completed this assessment, including a description of its principal risks, what procedures are in place to identify emerging risks, and an explanation of how these are being managed or mitigated." The Code requires that the board should monitor the company's risk management and internal control systems, and "at least annually, carry out a review of their effectiveness and report on that review in the annual report". (*The UK Corporate Governance Code 2018 – Section 4*)

However, the Code continues to focus more on audit and less on positive risk-taking. There is a danger that boards will spend too much of their limited time on more traditional risks at the expense of emerging risks, which may be filed in the 'too hard' or 'less important' folder. Clearly, companies cannot squeeze everything onto the board agenda, but there needs to be a balance that allows for informed discussions, decision-making and communication about the risks that really matter.

There is no single or 'correct' definition of an emerging risk, but organisations need to clearly define what they mean, ensure this is understood as part of their risk language, and communicate this internally and externally.

In simple terms, emerging risks are risks that are *new* or *changing in significance*. Their possible trajectories exhibit high levels of uncertainty. Similarly, they often lead to multiple knock-on consequences.

New means that the risk did not previously exist. New risks often arise from scientific developments and transformational technologies, societal and attitudinal shifts, or the introduction of unfamiliar or revised processes.

Changing means that the profile or shape of a 'known' risk is being aggravated by changing external conditions (such as higher taxes on sugar in food and drink products, tightening environmental regulation or a trade war) or has become more consequential due to internal factors (more aggressive strategic ambitions, lower institutional resilience due to cost-cutting measures or challenges in embedding new values and behaviours to reflect repurposing initiatives). »

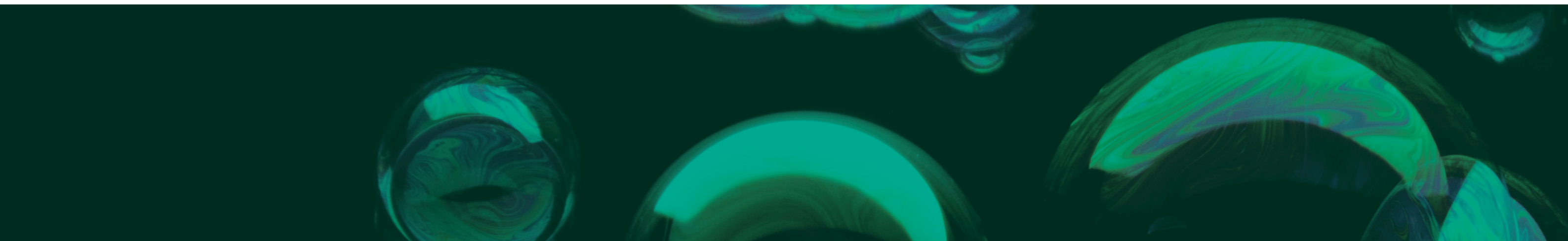
> "Not everybody welcomes conversations about emerging risks at a leadership level. But to have courage to do so, you need confidence, and confidence is enhanced by having a grasp of what you're taking about. The board needs to be able to say: "Hey, we might not have got this right" and work together to reach solutions.

BUSINESS RISK
RISK ROUNDTABLE: WHAT THE EXPERTS SAY
PUBLISHED IN THE SUNDAY TIMES BY RACONTEUR IN ASSOCIATION WITH AIRMIC, APRIL 2019

Organisations tend to focus on threats associated with the business environment, where materiality is clearest due to shifts in customer demand and the competitive landscape, and where they have more control over their choice of direction. But to understand how to best respond, it is vital to explore key risks in a structured way and understand their different characteristics.

Figure 1 sets out key sources of political risk for organisations in the world today. Some relate to domestic politics, others to international economic relations, geopolitical tension and societal frustration. Each source, individually or in combination with others, is giving rise to numerous new complications and surprises that are threatening investment willingness, the attractiveness of core markets, competitive positioning, supply chain reliability, business continuity, operational safety and corporate reputation. Of course, company exposures will vary according to their business profile, but in today's febrile environment, very few can claim to be unaffected or to be fully on top of their exposures.

Figure 2 illustrates that intensifying climate risks have some similar sources and some different ones. The more obvious (but not always predictable) sources relate to physical impacts on assets and supply chains over different time horizons, but others stem from rising regulatory, legal and governance challenges, the increasing potential for obsolescent products and services, and the consequences of strengthening societal activism. Individual company exposures vary across the nine sources, but incidents and developments in these areas may increasingly threaten raw material costs, long-term asset viability, market share, business continuity and corporate reputation, among other things.



Decisions taken by a company to achieve capital efficiencies can change the profile and shape of risks. Manufacturing plants consolidated into fewer, larger locations to leverage production cost savings, and a reduction of suppliers within supply chains to leverage discounting, can collectively impact the business model. Changes may intensify location and supplier risk severity profiles and amplify risk aggregation through the connected effects of change. This will in turn impact business continuity and crisis management plans, which should be adjusted after running new scenarios, integrating holistic threat monitoring and event triggers, and modifying the level of readiness and agility required to respond.

The Future Shocks section to the 2019 World Economic Forum (WEF) Global Risks Report outlines the potential misuse of weather manipulation tools which could stoke geopolitical tensions. They see the intensification of climate-related impacts as a growing incentive to turn to such technological fixes that could be used to manipulate rainfall or similar. Additionally, to any environmental consequences the use of such technology could lead to, WEF raises the concern that it could also be viewed as a hostile act if nations use it unilaterally, illustrating a scenario of risk connectivity between geopolitical and environmental risks.

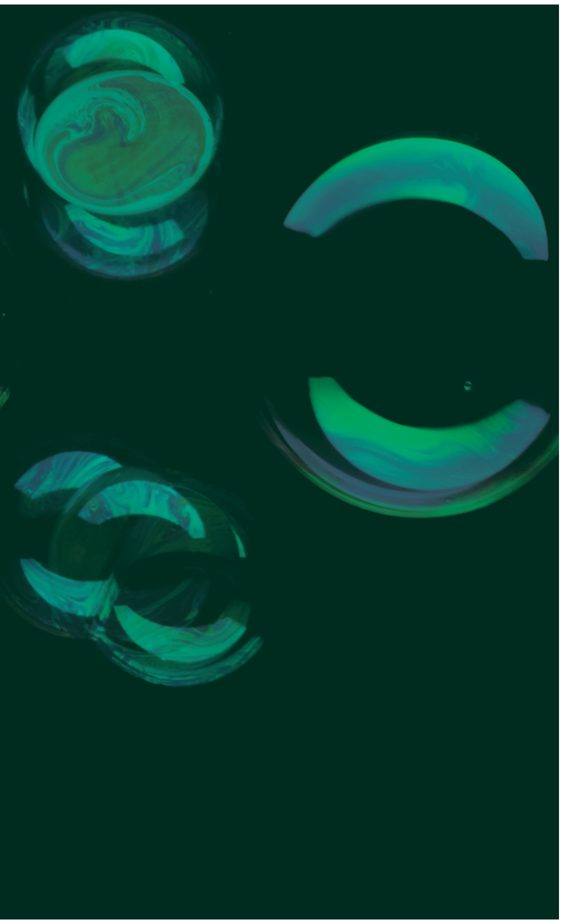
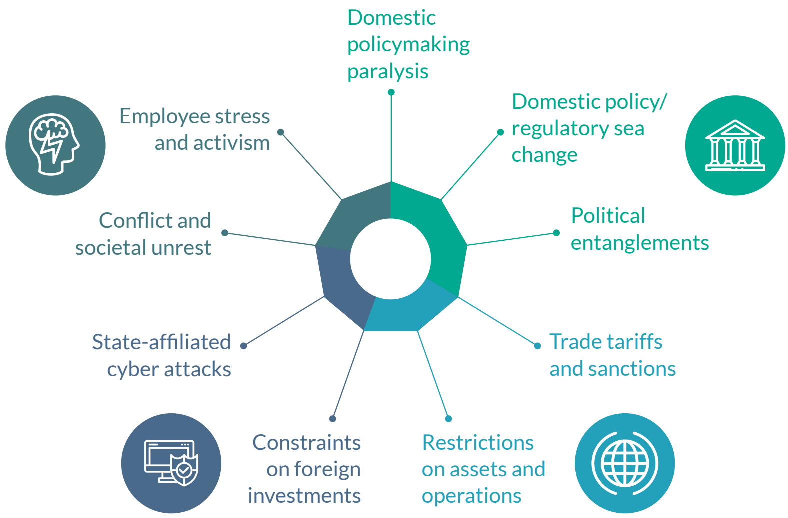


FIGURE 1

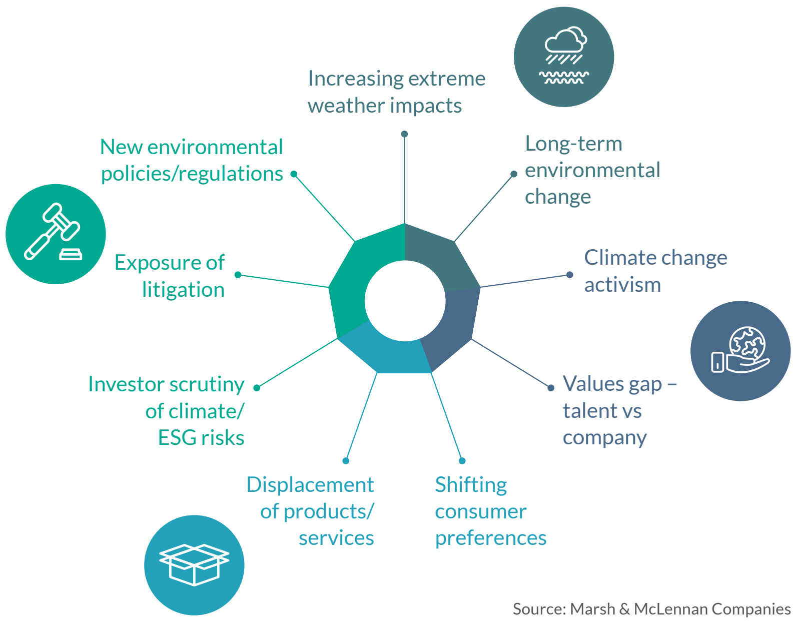
KEY SOURCES OF POLITICAL RISKS TODAY



Source: Marsh & McLennan Companies

FIGURE 2

KEY SOURCES OF ENVIRONMENTAL (CLIMATE) RISKS TODAY



Source: Marsh & McLennan Companies

RECALIBRATING MANAGING RISK

In practice, although a robust discussion of principal risks would also likely capture emerging risks, few organisations currently have a formal process for identifying emerging risks or can specify how they apply this in practice. While the approach for emerging risks should be analytical, it should also be creative and pragmatic reflecting the complexity of uncertainties to secure buy-in and actionable results. Often there are no 'right' answers.

Assessing emerging risks

Emerging risk assessment should focus on plausibility and impact. Probability is notoriously challenging to assess for emerging risks and creating angst over this can act as a distraction. Formal assessments and heat maps should be exchanged for structured, creative discussions across business units and functions that bring different perspectives to bear on the topic and seek to strip away unhelpful biases. This will help organisations to better appreciate potential risk trajectories, where the organisation might be touched, and the knock-on consequences.

Scenarios

Airmic members report that risk conversations often take place in silos and that the integration of output and actions could be improved. Scenarios are a good way of making emerging risks tangible, with a view to delineating or calculating the immediate and longer-term impacts on strategic, tactical and operational targets. They can, moreover, capture attention, initiating discussion about mitigation measures. Facilitators should be unafraid to have the assumptions of the business challenged, creating space to 'think the unthinkable' and 'speak the

FIGURE 3

MAXIMISING VALUE FROM SCENARIOS – THREE PILLARS

STRATEGY

- Appreciation of internal stakeholders and agendas served
- Coverage of different types of emerging risks and impacts
- Inclusion of repeatable and bespoke scenarios

SELECTION

- Working group generation of a long list
- Steering group alignment on a short list
- Senior management approval of programme

SPECIFICATION

- Business unit and function input to scenario narratives
- Parametization to challenge historic data and risk relationships
- Opportunities for scenario intensification

Source: Material Improbabilities – Richard Smith-Bingham, Marsh & McLennan Companies unspeakable'. This can help surface and resolve conflicts between commercial ambitions and corporate risk appetite.

While many organisations work on scenarios in a relatively informal manner (via brainstorming sessions at offsites, for example), those with more advanced capabilities may have a more structured programme (see Figure 3) that selects key concerns for deeper analysis, ongoing monitoring and regular reporting.

Bow ties

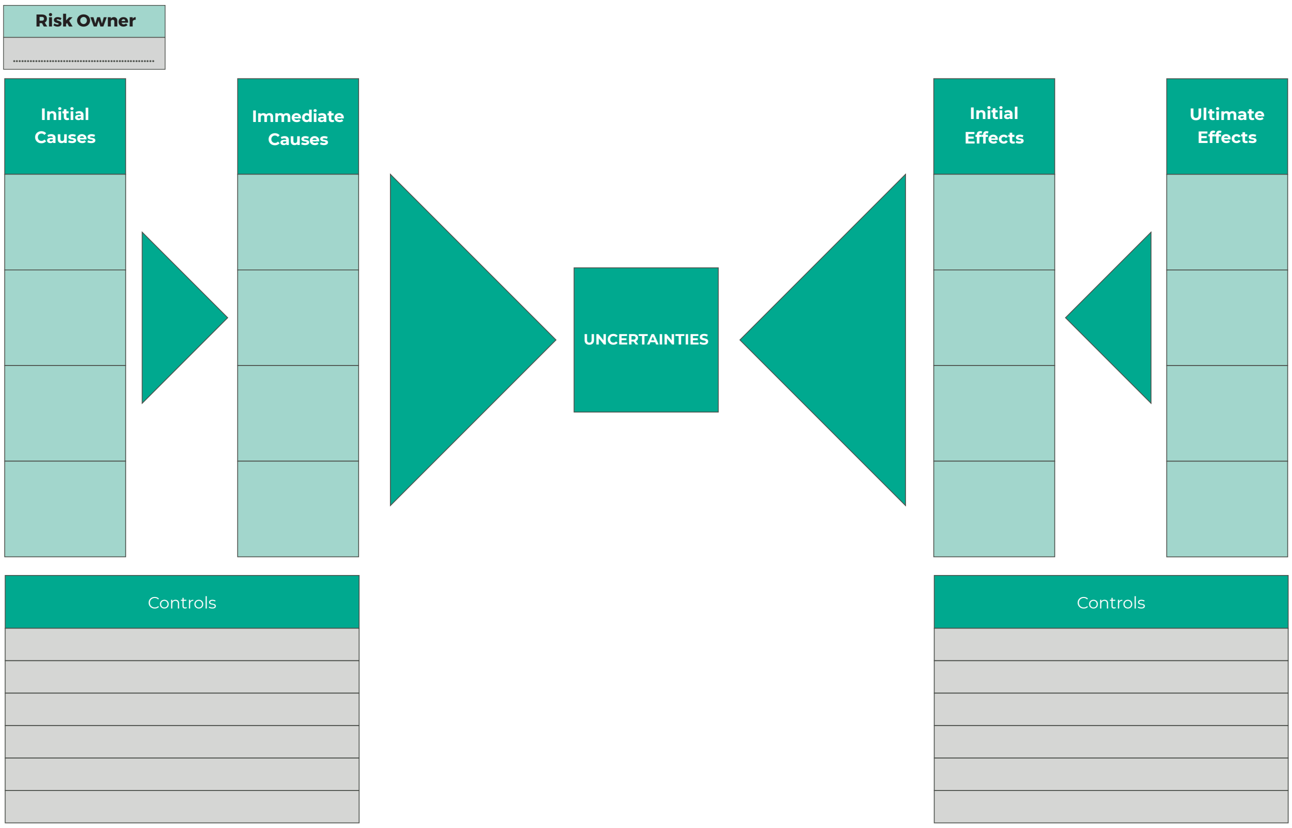
Slow-burning macro or megatrends can change pace and direction, and erupt into crises with little warning and with far-reaching consequences. The bow tie is a risk assessment method that can be used to demonstrate causal relationships and provide a visual summary of risk scenarios. They can be used as a map of the initial signals of a megatrend and their immediate causes, with potential near and long term effects. The Bow tie can be overlaid with control measures and integrated with semi-quantitative analysis techniques such as Layers of Protection Analysis, which is typically used in process industries where risk controls are developed as layers of defence that are related to, but operate independently from, one another. First developed five decades ago in the oil industry, bow ties are now used in many other sectors, including aviation, mining, maritime, chemical and health care.

Challenging traditional risk management practices

There is a host of risks that are visible and predictable, and that businesses subconsciously choose to ignore. »

FIGURE 4

EMERGING RISKS BOW TIE



Big problems, such as impacts from the rise of protectionism and climate change, are often neglected until it is too late. Michele Wucker (author of *The Gray Rhino* and founder and CEO of Gray Rhino & Company) urges us to “replace the myth of the ‘black swan’ that rare, unforeseeable, unavoidable catastrophe – with the reality of the ‘grey rhino’, the preventable danger that we choose to ignore”. In its annual financial stability report published in March 2019, China’s central bank sounded the alarm that ‘grey rhino’ risks continue to threaten the economy. The trade tensions between China and the US will continue to send shock waves out to us all, and there is no excuse for businesses to say they did not see this coming.

It is crucial to understand the interconnections between risks that can be influenced by the same external and internal factors, and that can also influence one another. Based on discussions with Airmic members, there is a tendency for organisations to manage risk in business silos and for senior leaders to play down emerging risks until they are on the risk register. Most resource assigned to managing risk continues to be focused on near-time, downside risks, rather than risks further out on the horizon which may present opportunities for future value creation. Coupled with the absence of useful data sets from which to draw conclusions, this often means that the consideration of emerging risks is relegated to the back seat.

As the complexity of the world increases and the pace of change heats up, managing emerging risk cannot be a strategic afterthought. A time lag can open up when the external and internal context of an organisation moves faster than the organisation, creating a gap between the reality and the perception of risk. An assessment of these risks should be part of the strategic planning process and

“The search for emerging threats requires looking beyond the issues that can immediately and easily be anchored to business performance. Unpack hot risk topics and trends to see how different – often non-market – forces might surge or collide in problematic ways. Tease out pockets of volatility or uncertainty in the firm’s commercial ecosystem. Apply a fresh lens to the firm’s strategic and institutional vulnerabilities.”

RICHARD SMITH-BINGHAM, DIRECTOR, GLOBAL RISK CENTRE, MARSH & MCLENNAN COMPANIES contribute to the strategy context-setting process. The frequency of risk assessment and analysis should be a function of how fast risks are emerging and the level of their materiality rather than determined by traditional institutional administrative cycles.

Strategic, finance and operations response options

It is important to identify, develop or leverage the right basket of measures to mitigate key risks, noting that new risks can often be addressed by commonplace tools and fast action after the fact may be a more valid response for some risks than up-front actions. No company, however, wants to be in a position of not having moved earlier, when there was more room for manoeuvre.

Figure 5 sets out some core response options, and it is incumbent on organisations to examine which can address a combination of strategic emerging threats in order to get best value from that effort. It is also valuable to consider the cost-benefit timeline of the measures under strongest consideration. Note that high levels of uncertainty make the threshold for mandating action somewhat higher for emerging risks than for familiar risks, especially with regard to pre-emptive responses.

These measures are broadly applicable as response options for the different political and climate-related risks highlighted earlier.

Technology-based opportunities

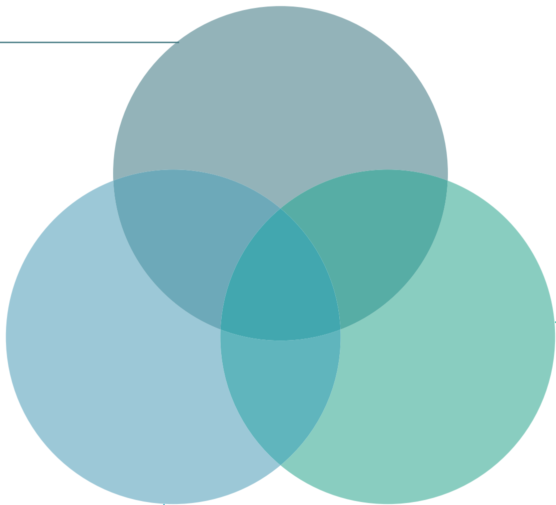
Technology can be used to provide insights into emerging risks through improved data gathering, analysis and reporting. Opportunities for risk identification and assessment include using machine learning to flag abnormal signals posed by novel cyber exploits »

FIGURE 5

RESPONSE OPTIONS FOR EMERGING RISKS

STRATEGY

- Rethink strategic purpose
- Align products and processes with purpose
- Align culture and talent with purpose
- Change investment allocation
- Make divestitures or acquisitions
- Develop joint ventures and alliances
- Build know-how and capability
- Embed flexibility and agility
- Adopt the Airmic Resilience and Transformation Model

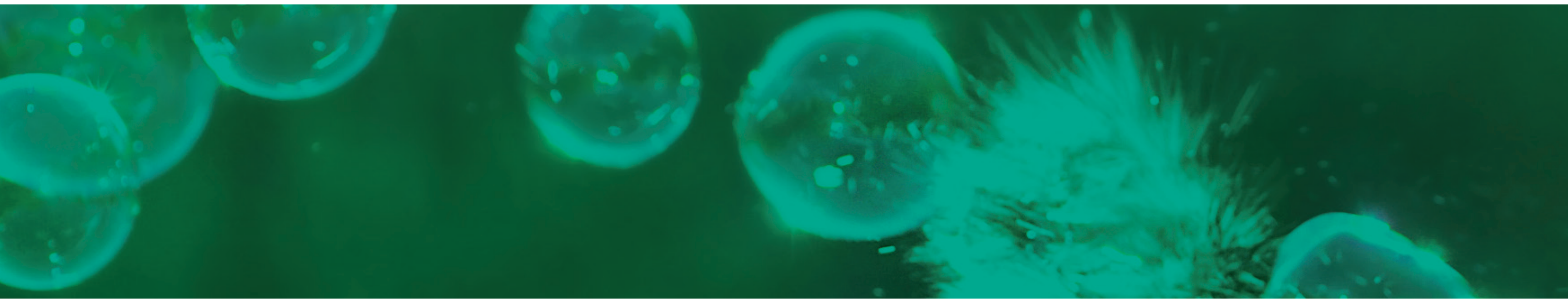


FINANCE

- Flex risk appetite
- Reinforce financial buffers
- Increase risk transfer
- Boost hedging
- Reduce cost

OPERATIONS

- Tighten business controls and limits
- Undertake public affairs and public relations campaigns
- Respond to a shift in the supply chain curve
- Strength environmental, social and governance capabilities
- Adopt new technologies to achieve digital transformation



or using social listening to detect changing sentiment in countries, sectors and customers. Opportunities within risk management include using blockchain-based authentication to combat the increasing challenge of counterfeit goods and using remote technologies to embed control measures and fix problems before they escalate into crises.

Crisis management

How an organisation responds in the immediate aftermath of a crisis can determine the extent of damage and the time needed to recover. This is why the initial response to an event is so important.

The dynamics of crisis management are different and present specific challenges as a crisis may overtake an organisation before the risks have been fully understood and response options properly calibrated. While there are numerous examples of companies that have been slow to react, it is also important not to respond too quickly, or to overreact.

When Airmic conducted research with its members in 2019, they were asked to draft their 'Nightmare Headline' should their organisation appear in the press. A range of typical headlines is reported in Figure 6. Similar headlines could originate from emerging risks. Their range and diversity illustrates the importance of crisis response team design in terms of appropriate seniority, scope of issues they could be called upon to manage and need for team agility. Leadership of a team should be driven by the nature of the crisis, but any team member should have the ability and the authority to take the lead should the speed of the crisis unfolding demand a rapid response. This demonstrates the importance of using scenarios as a method for rehearsing crisis plans and how teams would respond/would work together, and using similar techniques as potential headlines to 'think the unthinkable'.

FIGURE 6
NIGHTMARE HEADLINES

THE AGILE RISK PROFESSIONAL – STEP UP OR STEP OUT

A clear commitment by the leadership of an organisation to the value of analysing emerging risks as part of strategic and operational planning will strengthen commitment and buy-in to the effort.

Against this backdrop, and as business continues to shift and evolve, risk management will need to adapt and play a more significant role in helping the board of directors and executive team develop a more risk-intelligent organisation. Strengthening the number of risk professionals who can step up to the challenge and demonstrate leadership in this area is a priority for Airmic support.

While this doesn't mean tasking risk professionals with predicting the future, it does call for a stronger role in challenging prevailing assumptions and giving shape to key uncertainties in a way that illuminates the impact of plausible scenarios and informs senior management decisions. It involves recognising not just that new risks are appearing on the horizon, but that traditional risks may change and move from the controllable to the uncontrollable, and risks assumed to be acceptable may acquire 'fat tails'.

In this context, risk professionals should not only take a holistic view of their organisation's risks (even if some topics are beyond their direct remit), but also become more strategic and commercial. They need to understand how business drivers are evolving and the dynamics of new technology introductions. They can have a role to ensure that strategy, tactics and operations are fully synchronised and mindful of unanticipated eventualities.

The risk professional will need to translate often patchy data on emerging risks into usable intelligence. 'Information lock' can be a real problem for the quality of board oversight if the data the board is getting is unclear and lacks interpretation. This will contribute to improving the understanding of traditional risks and free up the capacity of the risk function to spend more time addressing risks on a longer-term horizon.

Organisations must move faster, drive innovation, and adapt to and shape its changing environment. More than any other factor, the key to successful agility is for risk professionals to develop substantially new mindsets and for capabilities to move at the same pace.

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Organisations will need to spend more time managing and coordinating across different intra-organisational and inter-organisational boundaries, because in a digital environment, these boundaries become more complex, uncertain and ambiguous. Organisations must become faster at decision-making and build a culture of experimentation, fast adoption and openness with a motivated, engaged and talented workforce.

ROADS TO REVOLUTION – BOARDROOM EDITION, **AIRMIC 2019**

TAKEAWAYS

Avoiding emerging risks blindness

1. Is there a clear definition of emerging risks in your organisation and is this well understood and communicated?

2. Is the assessment of emerging risks part of the overall risk management system for your organisation?

3. Is consideration of emerging risks built sufficiently early and sufficiently well into strategic planning and major investment decisions?

4. Are you comfortable with the oversight arrangements for emerging risks?

5. Is there a consistent risk reporting methodology across your organisation using key metrics that can be aggregated?

6. Is there an arrangement for risk communication and reporting to ensure that your board is sufficiently engaged on emerging risk issues?

7. Is your organisation's decision-making capacity adequate should there be a significant change in the risk context, internally or externally?

8. Is challenge and debate encouraged with respect to risk-weighted decision-making for strategy, tactics and operations?

9. Is there a process for recording, analysing and discussing incidents and near-miss events to encourage a culture of continuous learning?

10. Is there a preparedness by senior postholders and business partners to admit mistakes, biases and gaps in their knowledge?

11. Is the use of risk-based objectives part of the personal evaluation, development and structured learning of all the workforce?

12. Has the crisis management programme been calibrated to reflect the emerging risk universe and the different characteristics of emerging risks response?

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