



TOWERS PERRIN RISK AND OPPORTUNITY

Risk is an essential part of any business. Properly managed, it drives growth and opportunity. But today the stakes are higher than ever. Executives struggle with business pressures that may be partly or completely beyond their immediate control, such as distressed financial markets; mergers, acquisitions and restructurings; disruptive technology change; geopolitical instabilities; and the rising price of energy.

To learn more about how corporate leaders view risks and opportunities in the context of business growth and financial performance, Towers Perrin partnered with the Economist Intelligence Unit on a research study that involved a cross-industry group of 1,452 senior executives of midsize and large companies in all regions of the world.

WHITE PAPER

Of all business forces, executives expressed the least amount of confidence in their ability to successfully manage people/workforce risks and opportunities.

The Towers Perrin Risk/Opportunity Study took a comprehensive look at business risk and opportunity across the full spectrum of business forces, from strategic to financial to operational to people/workforce factors (see sidebar below).

Conducted in the third quarter of 2007, the study produced revealing insights into the thinking of senior executives just prior to the credit crisis and the emergence of other economic pressures. At that time, for example, respondents were optimistic and confident, seeing significantly more opportunity than risk across all the areas tested.

While this optimism may have been misplaced, the findings indicate that executives increasingly see risk as something that can be managed to add value and not merely a threat to operations and physical assets.

Perhaps surprisingly, executives believe workforce skills and experience present the number one opportunity for their companies. It’s through their employees that companies feel they are best able to differentiate themselves from their competitors. However, of all business forces, executives expressed the least amount of confidence in their ability to successfully manage people/workforce risks and opportunities.

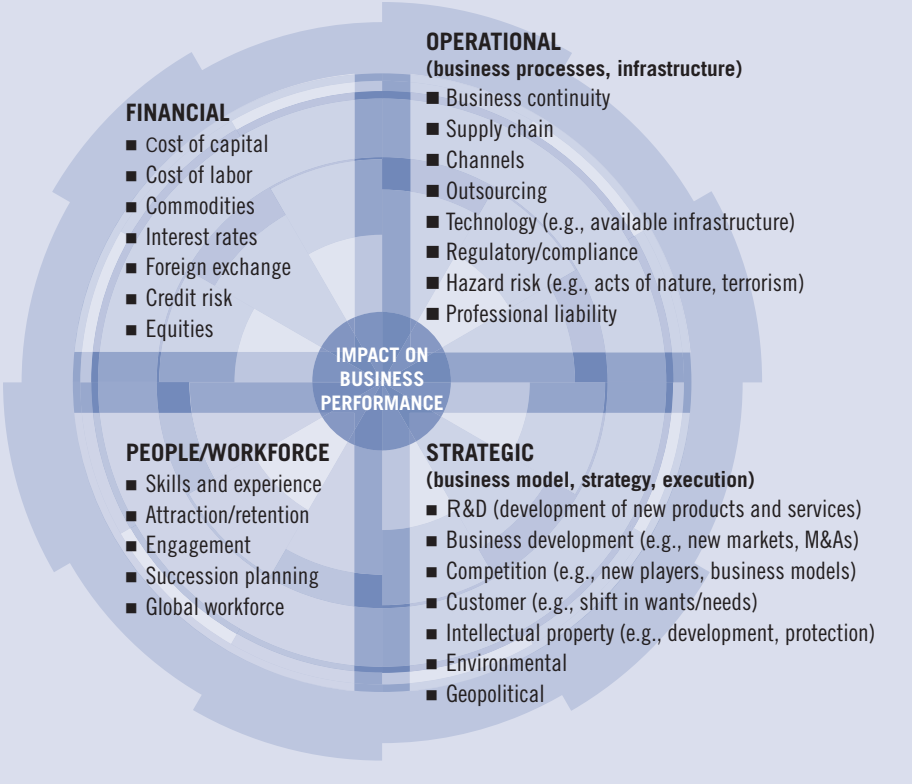
Of the many conclusions that can be drawn from the survey, the most critical may be the need for organizations and their leaders to avoid the trap of not paying enough attention to risks when times are good, and not paying enough attention to opportunities when times are bad. Effective management of opportunity and risk demands a dynamic, long-term and tailored approach that always seeks to “get the balance right.”

This paper presents the key findings that point to this and other conclusions that may hold practical lessons for business executives.

A Word About Business Forces

Our study divided business forces (both internal and external to the company) into four categories: financial, people/workforce, operational and strategic. These, in turn, capture 27 different subgroups of business issues. Participating executives were asked to rate each of the subissues separately, as both a risk and an opportunity for their business. It was in this context that survey respondents provided their candid comments and assessments.

Four Categories of Business Forces Present Risks and Opportunities



Companies that feel they can manage risk well are likely to feel that they can safely take on more.

CONFIDENCE VERSUS OPTIMISM: STRIKING THE RIGHT BALANCE

Senior managers were optimistic and confident at the time of our study. Growth was their overriding business goal, and they cited “growth/expansion” as *the* strategy element that most affected their assessment of the business forces we tested. Respondents demonstrated their confidence in two ways.

First, they were far more likely to see opportunity than to see risk in the various business forces (*Exhibit 1*). Business opportunities tend to be more visible in a stable or growing business environment.

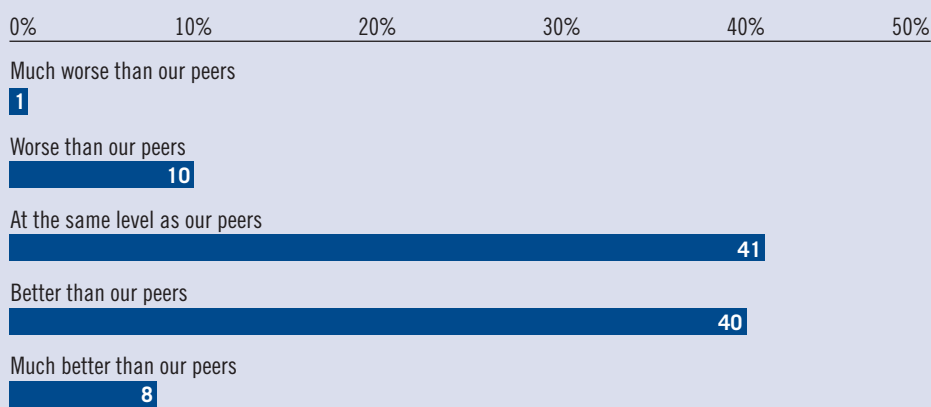
Second, findings suggest a degree of overconfidence in their ability to manage business risk. In what has been called the Lake Wobegon effect — where people tend to overestimate their intelligence, looks and abilities — 48% of companies considered themselves *better* or *much better* than peers at managing risks and opportunities, while only 11% said that they were *worse* or *much worse* than their peers (*Exhibit 2*). Among the various senior-level groups in our survey, CEOs and board members tended to take a comparatively more favorable view of their own companies.

Respondents who gave higher ratings to their company’s risk management capabilities also indicated they were willing to tolerate more risk. In other words, companies that feel they can manage risk well are likely to feel that they can safely take on more.

EXHIBIT 1 Percent Seeing Significant or Very Significant Risk/Opportunity

Business Force Category	Potential Risk	Potential Opportunity	Difference
Financial	60%	71%	11% pts.
People/Workforce	64%	78%	14% pts.
Operational	59%	74%	15% pts.
Strategic	57%	78%	21% pts.

EXHIBIT 2 Overall Assessment of Risk and Opportunity Management



Towers Perrin’s Point of View: Success in business requires risk taking. So, on one hand, executives’ tendency toward confidence is a good thing because it prompts a business growth strategy. This enthusiasm should be tempered by a considered, fact-based approach to dealing with risks and opportunities. As suggested by the subprime mortgage crisis, management with an inflated notion of its ability to manage risk may become more risk tolerant than a realistic risk management approach merits.

CEOs' top risks are financial in nature (cost of labor and credit risk), while CFOs' top risks are strategic (customer demand and business development).

EXECUTIVES' PERSPECTIVES ARE DIFFERENT — AND VALUABLE

Executives' perspectives on business risks and opportunities did not vary dramatically by company size or by geography. The top risks and opportunities on a global, cross-industry basis are shown in *Exhibit 3*. Operational (business continuity) and strategic (customer demand, business development and competition) elements represent four of the top five risks and opportunities. Skills and experience round out the opportunity list; technology completes the risk factors.

Where differences did exist in how the various business forces were viewed, those differences were shaped primarily by three factors:

- the industry in which respondents compete
- how their companies compete
- the respondents' job title.

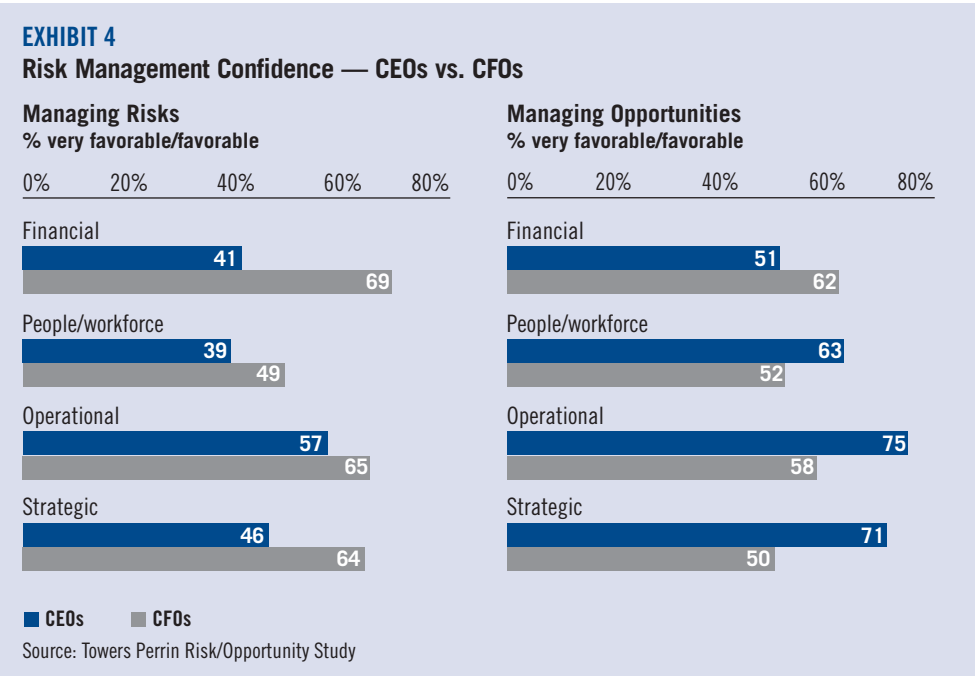


Data show that perspectives in the banking industry, predictably, are shaped by credit risk and interest rates, while insurance companies are more focused on competition and business development. For senior leaders at manufacturing companies, risk management is more likely to center on their supply chain and cost of commodities.

How companies compete for business also plays an important part in shaping perspectives. In banking, competitive advantage is based most commonly on customer service and brand recognition. Insurance companies are more likely to find competitive advantage in operational excellence and customer service. For health care companies, it's most commonly product innovation and operational excellence. Regardless of industry, companies

competing on a platform of customer service and operational excellence tended to consider the cost of labor a higher risk, while companies competing on brand recognition tended to consider channels a higher risk.

CEO and CFO perspectives tended to vary. Each function sees greater risks in those business forces that are primarily the responsibility of the other. For example, CEOs' top risks are financial in nature (cost of labor and credit risk), while CFOs' top risks are strategic (customer demand and business development). Also, CEOs are considerably more confident about taking advantage of business opportunities than managing risks, while CFOs are much more confident about managing risks than taking advantage of opportunities (*Exhibit 4*).



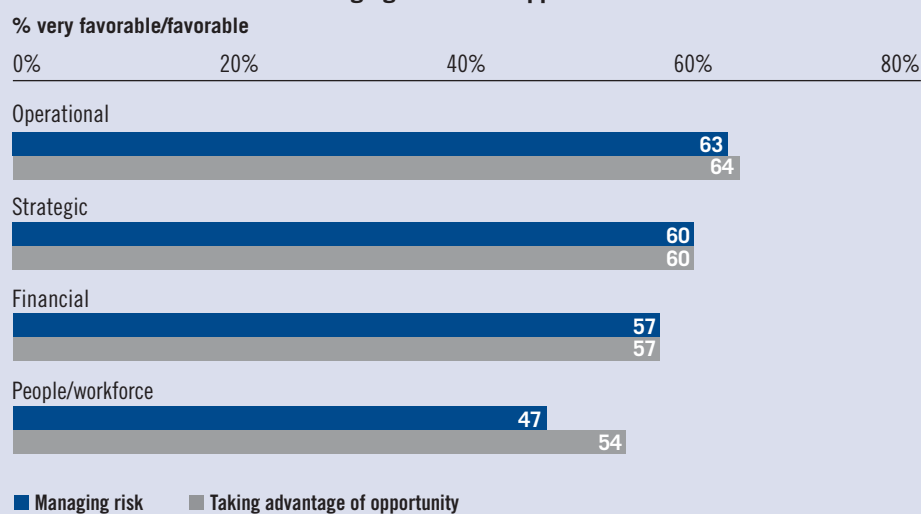
Management of risks and opportunities should be tailored to the company's industry position and business strategy, and communicate a well-defined "risk appetite" that is understood throughout the organization.

Towers Perrin's Point of View: There is no "one size fits all" approach to risk management, as evidenced by the variation in perspectives on risks and opportunities across industries. Even within the same industry, perceptions of risk and opportunity varied significantly by the way in which each company competes. Management of risks and opportunities should be tailored to the company's industry position and business strategy, and communicate a well-defined "risk appetite" that is understood throughout the organization.

The diversity of perspectives between CEO and CFO can be healthy if it is exploited to ensure that the organization has a properly balanced view of risks and opportunities.

EXHIBIT 5

Self-Perceived Success in Managing Risks and Opportunities



Source: Towers Perrin Risk/Opportunity Study

PEOPLE/WORKFORCE DILEMMA: THE MOST CRITICAL ISSUE IS THE LEAST WELL MANAGED

Across industries and geographies, people issues surfaced as the biggest risk and the biggest opportunity (see Exhibit 1, page 3).

It's through their people that companies feel they are best able to differentiate themselves from their competitors. Looking to the future, respondents' two biggest concerns were:

- Will we have the talent we need?
- Where will we get it?

The substantial business opportunities associated with having an engaged workforce with the right mix of skills and experience is both recognized and appreciated by senior managers. *Skills and experience of workforce* is the number one opportunity on a global basis and among the top three opportunities in almost all industries analyzed. It is rated a significant opportunity by 90% of respondents.

Ironically, despite their appreciation for its significance and its impact on business performance, executives have less confidence in their ability to successfully manage people/workforce risks and opportunities than they have for managing any of the other three business-force categories. As a group, the executives in our survey believe they are doing a relatively poor job, and this showed in our study results. Less than

half (47%) of survey respondents consider their organization's management of people/workforce risks as *favorable* or *very favorable*, a full 10 points below its closest competing force (*Exhibit 5*).

Towers Perrin's Point of View: Talent management strategy and tactics — including how and where the workforce is sourced, having the right mix of skills and experience, and successfully attracting/retaining/engaging workers — are key to successful management of *all* business risks and opportunities, not just those dealing specifically with HR issues. Much can be achieved through technology, outsourcing and business partners. But having engaged, empowered and capable people who understand how their work impacts business risks and opportunities is critical.

ERM is a structured approach for achieving the optimal balance between risk and opportunity, and is appropriate for all industries, not just insurance and other financial services.

These findings coincide with Towers Perrin’s Global Workforce Study of almost 90,000 workers, which found that there is a definitive connection between the intensity of employees’ engagement on the job and the financial performance of the company. That study also found that employees’ perceptions of senior management’s concern for their well-being was a major factor in driving employee engagement levels.

Without doubt, processes, programs and technology are important. But they are insufficient to guarantee that an organization adequately seizes opportunity and mitigates risk at the right time, in the right way and with the right speed. In the end, opportunity and risk management is about ensuring that everyone in the organization understands his or her role in the larger mission and vision, and building an engaged, skilled workforce that operates within a culture of communication, empowerment and accountability.

ENTERPRISE RISK MANAGEMENT EXCELLENCE TEMPERS EXECUTIVES’ OVERCONFIDENCE

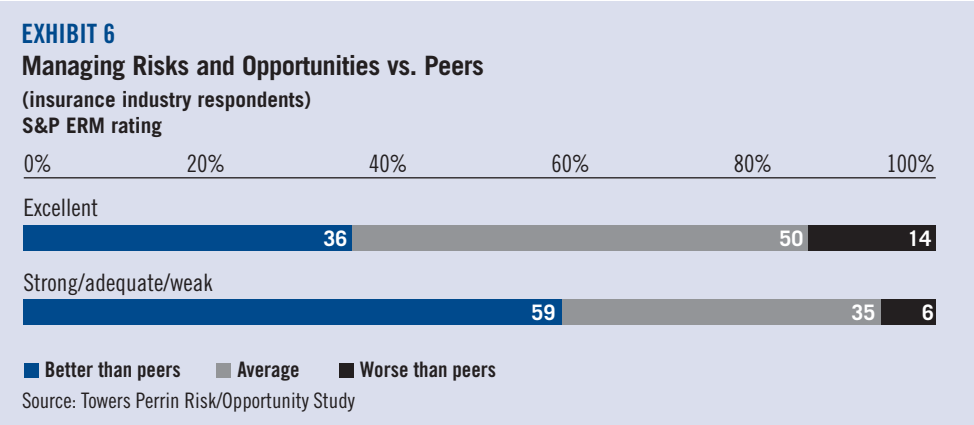
Following the completion of our survey work, we sought to link enterprise risk management (ERM) adoption and maturity with perspectives on risks and opportunities. We focused on the insurance industry — where 69 of the 200 insurance companies in our survey represented companies for which there were Standard & Poor’s (S&P) ERM ratings available. Using this information, we ran a simple cross tabulation of the survey data, comparing S&P ratings with respondents’ self-acknowledged risk management confidence.

Our research showed that companies with “Excellent” S&P ERM ratings (the highest rating conferred) tended to be *more risk conservative* and considerably *less confident* of their overall risk management effectiveness when compared to their peers with lower S&P ERM ratings. Roughly one-third (36%) of the

best-rated companies considered their risk management skills better than their peers, while a much larger 59% of lower-rated companies considered their skills above average (*Exhibit 6*).

Towers Perrin’s Point of View: ERM is a structured approach for achieving the optimal balance between risk and opportunity, and is appropriate for all industries, not just insurance and other financial services. Strategic and capital decision making should be rooted in bedrock corporate finance principles, like the cost of capital and risk-adjusted return on capital. ERM should be seen as a framework for making that process consistent across an enterprise and more transparent.

The survivors in today’s global economy are those that have shed extra staff, stripped their operations and supply chains of redundancy, and been driven by competition to return surplus capital to investors. Given this context, it is not hard to find management teams that are vulnerable to the possibility of seismic shocks to their business strategy. ERM enables management to expressly incorporate business-altering scenarios (both negative and positive) into their capital allocation and strategic decision-making processes, and do so with consistent metrics across these myriad scenarios. It is these risk-aware management teams, leveraging their ERM experience in the insurance and banking industries, that are likely to be adequately capitalized and organized to endure or withstand shocks, and more likely to rebound.



The most critical message for organizations and their leaders is to avoid the trap of not paying enough attention to risks when times are good, and not paying enough attention to opportunities when times are bad.

CONCLUSION

The findings and timing of this study — especially in the context of the problems in today’s credit markets and within the broader economy — underscore the challenges business leaders face in managing risk and opportunity. With the benefit of hindsight, it is clear that many organizations underestimated risks or completely missed emerging risks, and that the levels of optimism and confidence the study revealed in the third quarter of 2007, when economic times were relatively good, were not justified.

Perhaps the most critical message for organizations and their leaders is to avoid the trap of not paying enough attention to risks when times are good, and not paying enough attention to opportunities when times are bad. This historical pattern is part of the reason we see periods of “irrational exuberance” on the one hand and a “bunker mentality” on the other. Effective management of opportunity and risk demands a dynamic, long-term and tailored approach that always seeks to “get the balance right.”

Our study also confirmed that there is no single “best” approach to risk management. How companies initially perceive their business risks and how they ultimately choose to manage them will vary by company and by company management. What works for one may not be at all appropriate for another. Risk and opportunity management needs to be tailored to the

About the Study

The Towers Perrin Risk/Opportunity Study is a global, Web-based study fielded by Towers Perrin in association with the Economist Intelligence Unit. A total of 1,452 senior business executives of midsize and large companies across all industries participated in the quantitative portion of the survey. These findings were supplemented by qualitative research interviews among two dozen executives conducted by telephone. Survey questions focused on 27 different business forces that fall into one of four categories: Financial, People/Workforce, Operational and Strategic.

The survey was conducted during the third quarter of 2007, just prior to the subprime lending crisis and related events emerged in the marketplace. Twenty-five percent of survey respondents were board members, CEOs, presidents or managing directors of their company. Another 30% had other C-level titles, while the remaining 45% had SVP, VP or director titles. Geographically, respondents were from Western Europe (32%), Asia/Pacific (28%), North America (26%) and other regions (14%).

company’s industry, its business strategy and its tolerance for risk. And, given the increasingly global economy in which companies compete today, management needs to appreciate how the various business forces work in different parts of the world and then incorporate those differences into an overarching risk management framework for their organization.

Finally, corporate culture is a big part of the approach. Process is important, but without an engaged, skilled workforce and a corporate culture that encourages looking at things holistically, companies are likely to fall short. You need both — processes and culture — for the maximum benefit to shareholders over time.

ABOUT TOWERS PERRIN

Towers Perrin is a global professional services firm that helps organizations improve performance through effective people, risk and financial management. The firm provides innovative solutions in the areas of human capital strategy, program design and management, and in the areas of risk and capital management, reinsurance intermediary services and actuarial consulting.

Towers Perrin has offices and alliance partners in the world’s major markets. More information about Towers Perrin is available at www.towersperrin.com.