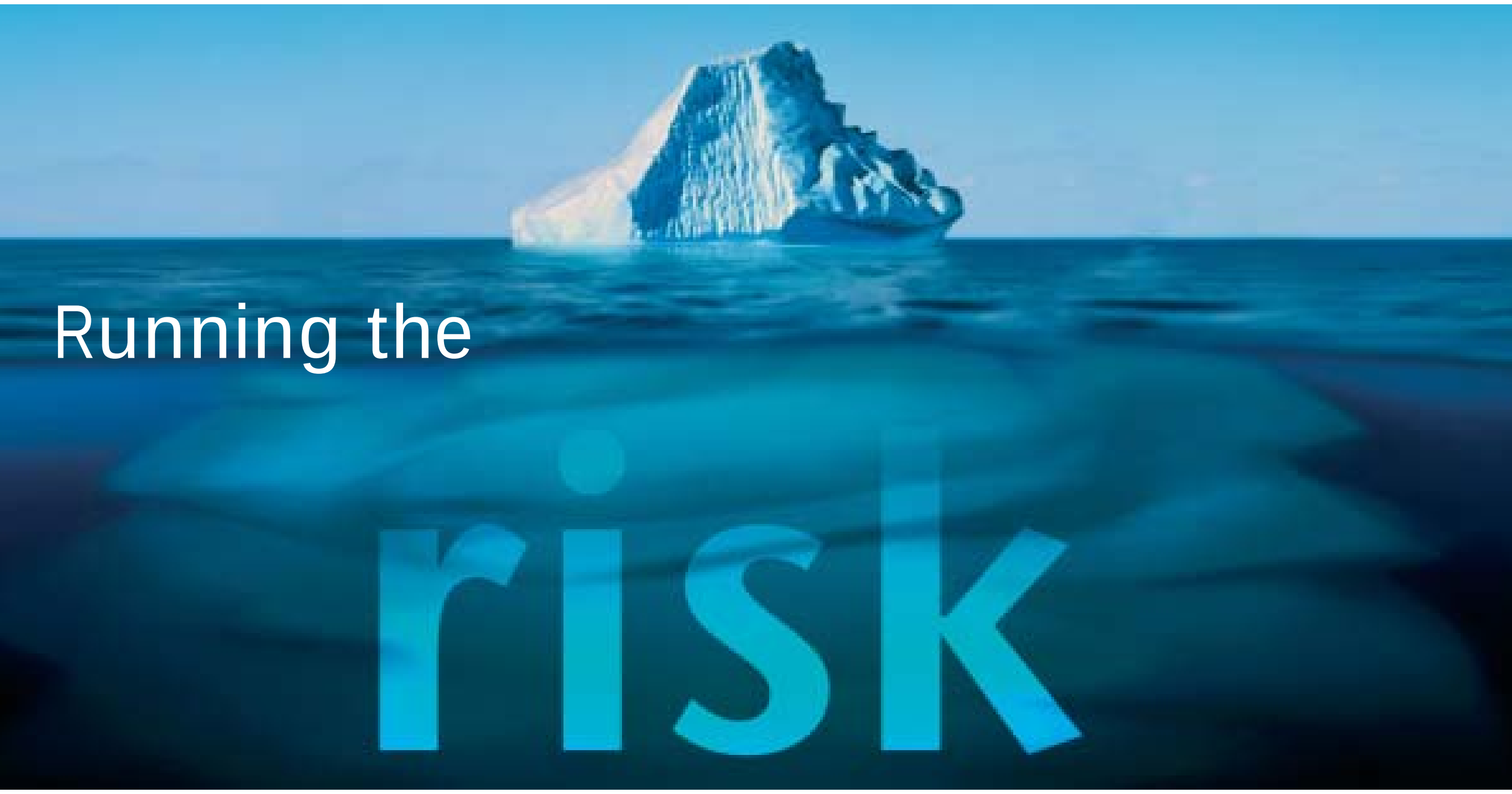
DEDICATED TO MAKING A DIFFERENCE



Risk and sustainable development: a business perspective

World Business Council for
Sustainable Development

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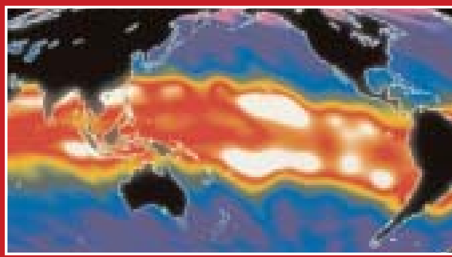

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Foreword

by Alistair Johnston of KPMG, convener of the WBCSD Risk Champions Group

The Risk Champions Group comprises leaders from large global organizations including specialists in risk, sustainability and organizational issues. KPMG and the WBCSD have convened this group and this paper is the product of its considerations.

If risk is a measure of sustainability, the world faces some massive challenges in the 21st century.

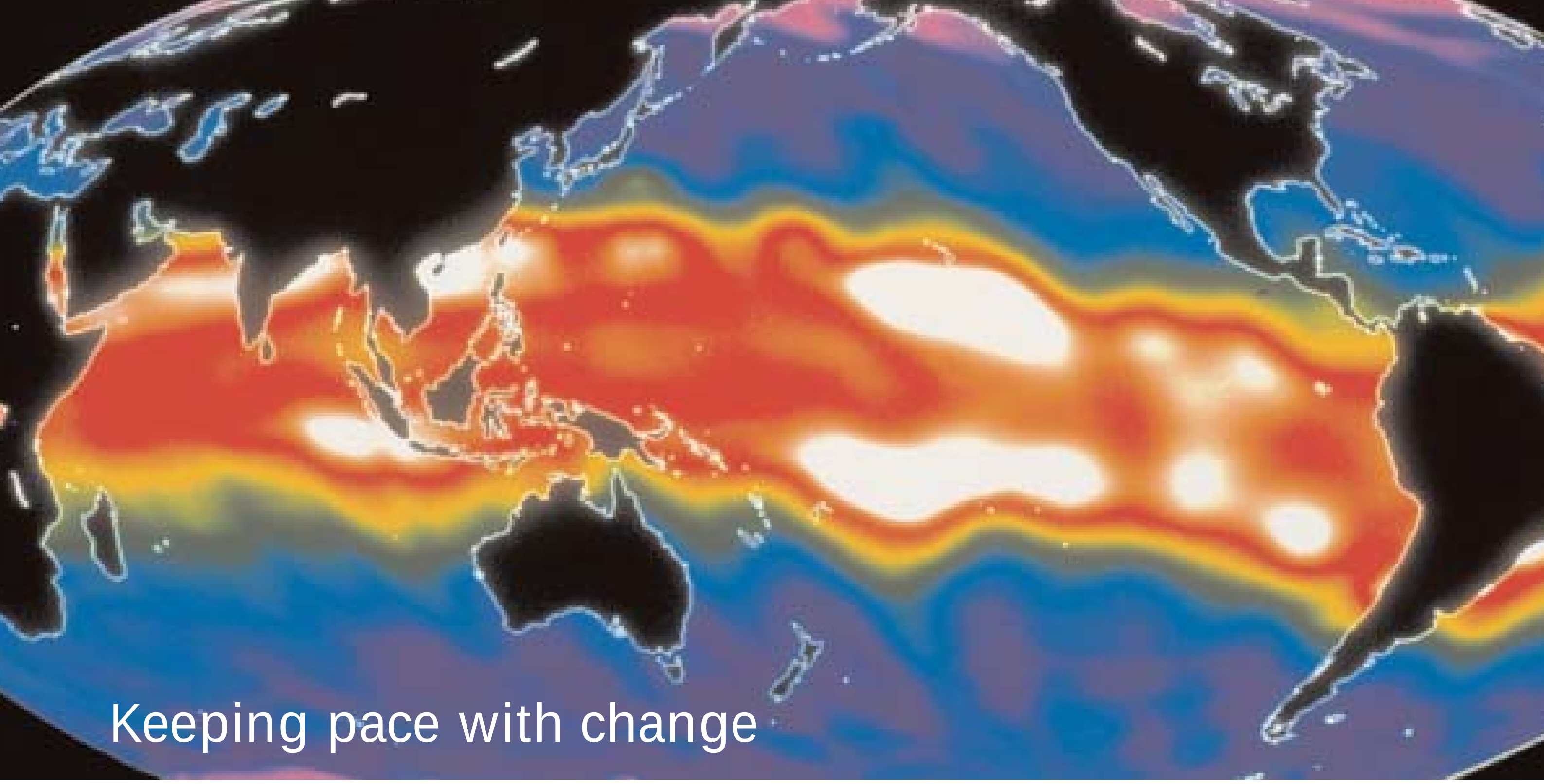
Where our grandparents' generation may have worried about the security of their village or their employment prospects, we face 'mega risks' on a global scale ranging from climate change to international terrorism. Large-scale catastrophe has always been a fact of life, of course, but our thinking about the risks that confront us as individuals has changed immeasurably.

This shift in mindset is mirrored within the global business community. If you looked at a typical corporate risk profile of even five years ago, it would more than likely be focused on issues like health and safety and the exposure of physical assets to 'traditional' risks such as fire and flood. Now, the profile has been expanded to include everything from political and social instability to brand protection and sabotage.

The challenge that presents itself to companies, governments and institutions of all kinds is not only to identify the risks that face them, but also to devise practical ways of managing them. It is a huge task that calls for clear thinking, innovation and engagement with all of society's stakeholders. Why? Because corporate risk management has become inextricably linked with wider issues of sustainable development.

In producing this report, the WBCSD has not sought to provide any definitive answers: these will depend on the unique needs, objectives and ambitions of individual organizations. Our aim is instead to contribute to the debate about the changing nature of risk by looking at how the global risk environment has evolved. In doing so, we provide some examples of risk concepts that we believe represent best practice, together with our views on the steps that organizations might take in developing effective approaches to risk management.

We hope that readers will find this report a useful adjunct to their own risk management thinking and activities. If you have any feedback you would like to give us, please contact the WBCSD's Risk Champions Group through James Griffiths, whose details are provided at the back of this report.



Executive summary

As individuals, we all have different attitudes to the risks of everyday life. Those attitudes have changed significantly over the generations as society has become more inter-connected. Globalization has prompted a shift in our concerns about risk from ‘local’ to ‘global’; indeed, as we enter the 21st century, we are faced with mega risks of a kind that society has never previously had to deal with.

The way corporations view risk has changed in the same way. There is a new recognition among companies that the achievement of their objectives depends on being able to deal with risks of a more ‘systemic’ nature. These are risks that cannot be tackled in isolation from each other, and which need to be addressed through an alliance of business and society working in unison. Achieving sustainable development falls squarely into this category.

While corporate actions in meeting societal needs for goods and services undoubtedly contribute to risk, the adoption of sustainable development strategies by businesses can actively contribute to avoiding risk or minimizing adverse impacts.

The challenge for the corporate sector is to understand how different sources and magnitude of risk are likely to affect them over the long term. In order to gain that understanding, companies need to take a genuinely holistic approach that includes a consideration of sustainability as well as commercial, political and societal risks. They also need to find ways of assessing, managing and sharing risk in collaboration with stakeholders, business partners and other responsible bodies.

Looking to the future

The new mega risks we face present unprecedented challenges to businesses and governments alike. Energy use and its potential impact on climate change, for example, is something that requires co-ordinated action on a global scale. Meanwhile, the world's population continues to grow, raising issues about the shape of future markets and the viability of social support systems and the consequent affects for society and business.

Getting the response to risk wrong may result in serious difficulties for business that quickly spiral out of control. Corporate reputations can be destroyed in a matter of days, especially in cases where companies depend on intangible rather than physical assets. Globalization compounds these risks still further since the world has become a place where there is 'nowhere to hide'.

Political upheavals, terrorism, cross-border litigation, environmental pressures and health pandemics are just some of the other mega risks that face the corporate sector. Dealing with them requires far-sightedness and innovation. It also calls for an appreciation that, while many risks have local origins, their impact may rapidly become global.

Developing an effective response

The traditional approach to risk has been fragmented, largely reactive and focused on the short term. Because risk is multi-dimensional, managers tend to associate it with loss, rather than weighing up the downsides against the upsides.

Recognizing that responding to the new risk environment requires more than just risk assessment alone, forward-looking organizations have developed 'enterprise' approaches to risk. As the name suggests, this involves bringing previously disparate roles and activities into a unified framework. The result is a structured yet practical risk management approach which is aligned with the business and therefore makes the organization better able to co-ordinate its risk management activities.

Companies that truly embed this approach within their organizational behavior come closest to achieving the 'holy grail' of risk management: that is, embracing risk management as a business enabler rather than as a compliance-driven 'necessary evil' . They assign roles and responsibilities for risk management throughout the organization, creating company-wide awareness of and accountability for risk management.

The result is an approach to risk which moves well beyond the mere use of controls to limit risk exposure. Instead, it creates risk optimization and even risk leadership – the process by which an organization is able to seize opportunities within defined risk parameters and capitalize on the rewards that follow. Such a strategic approach is essential to managing mega risk and achieving sustainable development.

Adopting a new approach

The challenges inherent in developing new approaches to risk are increasingly interchangeable with the sustainability agenda. Consequently, the issues that have to be faced are as applicable to governments and individuals as they are to companies.

From the CEO's point of view, however, the first task is to develop a wider appreciation of risk within his or her organization; mega risks need to be identified and understood, and people have to be encouraged to 'think the unthinkable'. The next step is to ensure a focus on the long term, underpinned by meaningful consideration of the risks that need to be addressed to secure corporate sustainability.

Companies should make sure that their 'appetite' for risk is clearly defined and communicated throughout the organization. This gives employees the confidence to take decisions within a known framework in which flair and appropriate risk-taking are encouraged. At the same time, risk management needs to be seen as a decision-making tool that facilitates rather than stifles the entrepreneurial approach – risks present opportunities, not just problems.

Finally, there needs to be a recognition that the most effective risk management is likely to require engagement with all the organization's stakeholders. The performance of customers and suppliers is inextricably linked with the performance of the company itself. Anticipating, accommodating and exploiting the way in which all stakeholders are affected by risk is central to the organization's long-term prosperity and survival.

The world has changed

have we?

Risk is a fact of our everyday existence. We all have aspirations and objectives, and we continuously evaluate, consciously or unconsciously, the risks inherent in achieving those objectives.

Each of us has differing attitudes to the risks we encounter. Some of us are more conservative in the goals we set ourselves and therefore the level of risk we are willing to accept; others are more aggressive in their approach. The same is true for societal groups, including governments and corporations.

Although we generally do not record, or formally communicate to others, the risks we face as individuals, it's essential to do this when risk is encountered at an organizational level in order to form a collective view and to formulate appropriate responses.

Given that the risks we are exposed to will change over time; the identification and evaluation of risk cannot be approached on an ad hoc, occasional basis. Yet the frequency with which we review our risks, whether these are at an individual, societal or corporate level, will not in itself ensure that we identify those risks that are critical to our goals and, occasionally, our very existence.

What's required is a change in perception of the nature of risk.

A global recognition of risk

We can think of many ways in which our own perception of the risks that are important to us as individuals is very different from that of previous generations.

If we were to go back, say, 25 years, our thinking about risk would typically have been 'local' in its orientation – the security of our town or community, or the job prospects offered by local industry. Now, many people see rather different threats to their welfare, a number of which would probably be of a much more 'global' nature – instability in the Middle East, the impact of climate change, or the potential dangers of GM foods.

It is often said that we are all now members of a 'global village'. Consequently, there is an increasing awareness of broader issues and risks, while factors such as increased mobility and the decreasing size of the family in developed western economies mean that we are less likely to focus on local issues in the way that our parents did. There has been a similar shift from local to global in the role and focus of national governments. In many countries, interest in politics at a national level is in continual decline as the interaction of governments on the global stage grabs the headlines.

Another challenge for governments, with a consequent impact on companies, is an attitude in society that increasingly inclines toward a 'zero tolerance' of risk, taking the precautionary principle to its extremes. An example of this seeming overreaction took place in London in 2003. A motor on an underground train came loose and fell on the track, resulting in one of the busiest lines being out of action for three months with huge consequent disruption to London's businesses, commuters and visitors. The reaction was significantly out of proportion to the original incident. This type of reaction is often combined with a search for "someone to blame" if things go wrong.

Risk profile of your company

Against this background of change, how has the risk profile of your own organization altered in recent years? For many companies, a typical risk profile five years ago would have encompassed the risks in the left hand box below. Some of these areas are still important, but the risk profile has expanded to include additional issues.

Changes in the 'risk profile' of the individual have been accompanied by a new focus among companies, which recognizes that the achievement of their goals and objectives depends on responding to areas of risk that are of a more 'global' or 'systemic' nature.
Has our own appreciation of risk developed to take account of these changes? It may be that we are still shocked or surprised by risks or events that could have been foreseen had we only sought to understand the potential impact of global changes better.

For example, the events of September 11, 2001 and the scale of their impact on the world have led many organizations to think differently about the risks that they face and how sociopolitical change, often over a prolonged period of time, might affect the future of their business. This requires a different approach to how risk is viewed and managed by most organizations – an approach that is at odds with the focus on short-term performance that pervades the global capital markets.

Traditional and emerging mega risks

Mega risks, whether traditional or emerging, are large-scale risks or mega-trends that can impact, for example, societies, human health, the environment and the business sector. The sources of these risks may be natural events, social and technological developments, or political actions. Mega risks tend to have a number of characteristics that set them apart from some of the risks we have outlined above.

Experience tells us that the mega risks (some of which are detailed in the next chapter) are generally too large to be managed or mitigated by any single stakeholder. There is also unlikely to be a ready 'market' solution. Hence no one really 'owns' the problem – exacerbated by the fact that they are also often regarded as things that need to be dealt

Risks five years ago

- Health and safety risks
- Protection of physical assets (fire and flood)
- Regulatory compliance, covering financial and reporting obligations
- The Y2K bug
- Product liability

Risks today

- Health and safety risks
- Protection of physical assets (fire and flood)
- Regulatory compliance, covering financial and reporting obligations
- Product liability
- Brand and reputation protection

with by other people. Indeed, these risks are usually too complex to be managed by societal stakeholders without the involvement of the corporate world and vice versa.

Mega risks also tend to have a far greater degree of uncertainty as to the ultimate outcome, they tend to be long term and often result in an unexpected catastrophic event.

Mega risks can only be addressed by similarly systemic approaches – and not simply by the 'risk owner' or by just one group of stakeholders. The issue is primarily about interdependency, rather than significance and complexity.

Such is the growing interdependency of our world that these forms of risk can no longer be tackled in isolation from each other. The disruption of critical infrastructures, at any one point by any of these elements, could have wide-ranging effects throughout our industrial systems, thereby putting society and enterprise – and the achievement of sustainable development – at risk.

Working together

Addressing mega risks represents probably the biggest shift in thinking required by corporate organizations. It is prompting the reconciliation of past antagonisms between civic society and corporate stakeholders, and the formation of new coalitions and partnerships.

Encouragingly, many corporations are recognizing the impact that these mega risks will have on the future of their business and reaching the conclusion that they need actively to engage in their mitigation. An example of this is the Kyoto Protocol, which is an attempt to address the risk of climate change through engagement of developed, and developing countries, corporations and ultimately consumers.

In addition, we have seen a number of pharmaceutical companies distributing HIV drugs free or at a reduced cost. This is a response to the exploding public health risk of HIV/AIDS, the disparity of profits and the needs of the poor. It also reflects the risk to a company's reputation of being seen not to be doing anything.

Clearly, the investment made by corporations in responding to mega risks and issues of global sustainability is not based on altruism alone. For instance, the publicity attracted by renewable energy initiatives by global corporates such as BP and Shell far outweighs the actual contributions that these initiatives make to short-term performance. Obviously, this publicity is advantageous from a corporate image and reputational perspective, but the underlying fact is that the core operations of these corporations continue to depend on the exploitation of finite natural resources.

Developing a response

Responding to risks that affect our objectives and welfare in the long term is difficult and challenging. As individuals, many of us rise to this challenge every day through the recycling of household waste in response to our fears for the future. We accept that our individual – and even our collective – actions will probably do little to limit the impact during our own lifetimes, but we recognize our duty to future generations.

In the same way, more and more companies are acknowledging that both corporate and global sustainability can only really be achieved through a new approach to risk.

Industry sectors have started to address these issues in partnership with non-business stakeholders. Achieving consensus on solutions to sustainable development is an effective risk-sharing strategy that can deliver on economic, social and environmental fronts. The WBCSD's cement, mining and forest products sector projects, for example, provide platforms for understanding and risk sharing by negotiating performance standards which is a crucial step towards well-functioning markets.

Key messages

- Companies need to understand how different sources and magnitude of risk could impact their long-term survival.
- Companies should take a holistic approach to risk and sustainability.
- Because risks are so complex and inter-related, companies will need to collaborate with partners and other responsible bodies in order to effect change.
- Companies should engage with stakeholders to assess, manage and share risk.

Risks today cont...

Asset vulnerability due to greater emphasis on intangibles
Changing markets
Political, social and economic instability
Terrorism and sabotage
Human capital
Vulnerability of infrastructure
IT and communication risks
The development and application of new technology, including its acceptability to the market and society in general

A forward-looking view

In the 21st century, our world is confronted by a huge variety of mega risks, many of which are unprecedented in their potential scale and cost. International terrorism, new infectious diseases and natural disasters all have the scope to impact us in a way that was never previously possible.

For most risks, the market determines the trade-offs to be made. Governments only intervene to provide regulation in the event of market failure – for example, where externalities are not included in pricing.

For mega risks the market is not able to respond or, if it can, only in a limited way. Society in these circumstances attempts initially to react through the introduction of regulation or by invoking the precautionary principle. But society and the market will be faced with highly complex planning and coordination issues in achieving any progress.

Understanding the impact

The potential scale, repercussions and duration of mega risks make it difficult, if not impossible, to quantify their impact. However, a few sample statistics may help in providing a clearer picture of the magnitude of the issues societal and corporate stakeholders are seeking to manage:

- For the 1990-99 period, the US Federal Emergency Management Agency (FEMA) spent USD 25.4 billions for disasters and emergencies, compared with USD 3.9 billions for the 1980-89 period: technical or natural catastrophes which man has influenced are increasing both in terms of their frequency and the amount of damage caused.

- UK agricultural departments forecast GBP 4.3 billions of expenses for 1996-2001 in response to the BSE crisis: lack of knowledge and short-sighted decision making led to enormous costs and loss of confidence.

- The insured property loss following the terrorist attacks on the World Trade Center and the Pentagon add up to some USD 19 billions: the financial loss resulting from this man-induced event exceeds the highest damage ever caused by a natural catastrophe.

It is not just the nature of mega risks that seems to be changing: the context within which they appear has altered, as has society's capacity to manage them. The forces shaping these changes are many and varied.

Some examples of mega risks are explored in more detail below.

Energy and climate

World energy production rose from 6,600 to 9,352 million tons of oil equivalent – a 42 percent increase – between 1980 and 2000, mostly accounted for by growth in the use of fossil fuels. Even factoring in ecologically driven development, future energy consumption will continue to mushroom, with demand projected to grow by a further 66% from 2000 to 2030. Growth will be particularly pronounced in the large emerging economies. Yet, the mix of energy sources is projected to remain nearly unchanged.

The environmental impacts of rising energy production and consumption are introducing considerable uncertainty to industries, for example, oil and gas, reinsurance and agriculture. In response, proactive businesses are conducting inventories of their operations to reduce energy intensity and greenhouse gas emissions.

Some major multinational companies have made voluntary commitments to reduce their emissions and have provided support to markets for trading carbon emission allowances and reduction credits. These commitments are driving new markets in alternative energies, energy conservation services and energy efficient technologies.

Energy efficiency is on the agenda of environmentalists, as well as government representatives and business. The former group sees energy efficiency as an effective way to reduce greenhouse gases: the latter as a way to strengthen energy security and independence from OPEC countries.

A likely scenario for the next decade is that business will operate within two sets of emission schemes: a mandatory approach in some industrial countries that will implement the Kyoto Protocol – regardless of whether or not it enters into force – and voluntary or national schemes in other countries.

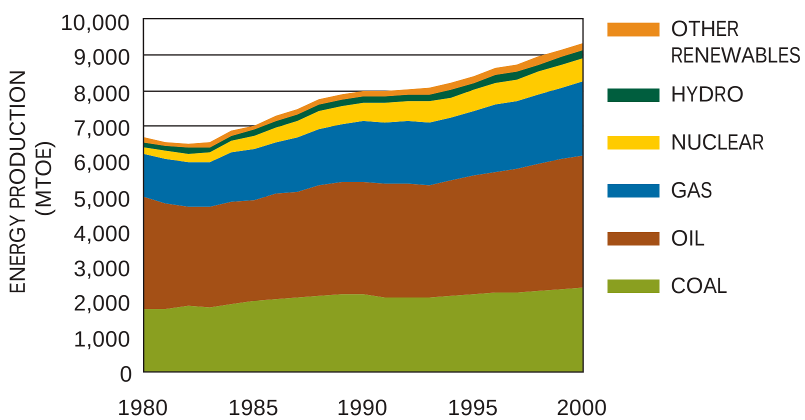
Demography

We live in a world of continued population growth, even as fertility rates decline worldwide. In 25 years' time, the population is estimated to reach about eight billion – a third larger than today.

Population dynamics are at the root of almost every trend shaping tomorrow's business climate since population growth affects the environment and the

Energy use is increasing rapidly

World Annual Energy Production by Source



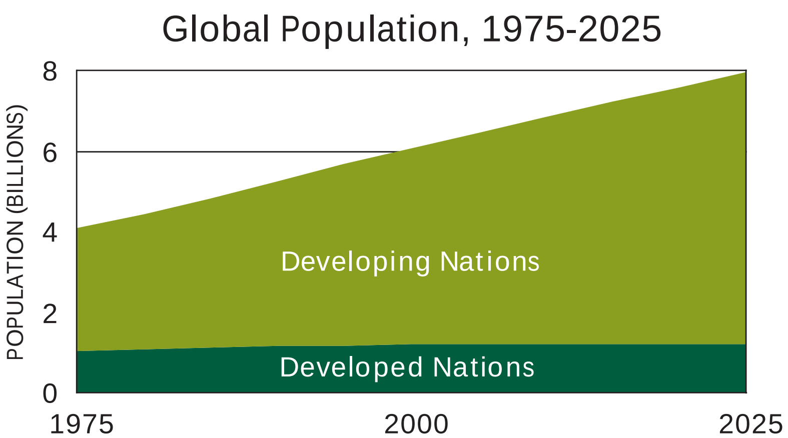
Source IEA, 1999 and 2000

health, nutrition, education and wealth of practically all the world's citizens. In the next 20 years, populations will shrink or barely grow in the high-income countries – defined as those with a Gross National Income (GNI) per capita of > $9,266. Most of the world's citizens will be born in low – (GNI per capita of < $755) and medium income economies (GNI per capita $756 - 9,265).

Maximizing the potential of low and medium income labor, and of consumer markets, will require the development of a skilled work force, and products and services tailored to people's basic needs – and to those of an expanding middle class in particular. Developing countries will need to nurture their domestic industries to serve their own population and today's multinational companies will need to develop appropriate strategic, technical, operational and marketing competencies, with risk management embedded in each area, to operate in these new markets.

The ageing population of the developing world and the reducing number of working age also leads to a significant stress on the pensions systems in the developed world. Pensions are largely unfunded, resulting in serious issues regarding the sustainability of the developed world's social systems.

The world's population is growing



Source United Nations Population Division, 2000

Intangibles

The market capitalization of a corporation is built on the capacity to generate earnings from two types of assets: physical and intangible.

Physical assets such as land and manufacturing facilities now only make up part of the market capitalization of a corporation. The other part – up to 75 percent – comes from intangibles. These include reputation, brand, trust, credibility and the ability to interact and work in partnership with stakeholders.

We live in an information society where "everyone knows everything about you, all the time". There is no place to hide and, in this global and transparent world, the management of a company's reputation becomes a central element in managing the corporation itself. The risk of damaged reputation is also increasing as this element of visibility increases. All this is placing bigger demands on companies to be transparent.

Yet transparency brings its own risks, as illustrated by the Nike/Kassky case. This revolved around whether statements made by Nike were "commercial speech", and therefore capable of being attacked in the courts; or "free speech", and hence protected under the First Amendment of the US Constitution.

There have been many examples in recent years of corporations' reputations being ruined in a short space of time, resulting in a loss of value and significant knock-on effects for other companies within the industry. One of the more acute examples is that of international accounting firm Andersen, whose reputation, initially damaged by a single incident and then compounded by poor crisis management, led to it being eliminated as a corporation within a matter of months.

A strategic approach to risk management is key to protecting these intangible assets. There are many examples of corporations which have failed to respond to changing societal demands and which have experienced dramatic impacts on their market valuation when being accused of using child labor, human rights abuses, environmental pollution and so on.

Globalization and the local aspect

Globalization in all its dimensions – economic, technological, cultural, environmental – is growing apace and increasing interdependence, making it all the easier for dangerous viruses, pollutants and technical failures to spread. Yet the legal framework in which companies do business remains local (at the national/state level), even though the world has 'gone global' in terms of both economics and communications.

Globalization happens at different rates in different areas of the economy. A fundamental dichotomy at the heart of today's economy is that while finance and technology markets have become global, labor markets as well as affected communities remain largely localized.

The all-important 'license to operate' has come to mean more than meeting minimum international or regional standards. Companies are under pressure to foster goodwill among the societies in which they operate. They are seen as powerful, and having the means to support improvements, and they are expected to contribute accordingly.

Democratic societies tend to offer the conditions for secure business operations, investment and growth. In these societies, stakeholders and shareholders are holding corporations to a single high international standard. Business partnerships with dictatorial governments are scrutinized by an international network of NGOs, which makes the operation of ethical companies in non-democratic countries difficult and jeopardizes companies' license to operate at home and abroad. Companies face the difficult decision of whether to operate in non-democratic environments – and perhaps to support democratic change through their own practices – while risking potential damage to their regional or international reputation.

This risk is magnified by the global communications boom, which provides the means to inform purchasers about the ecological or social impacts of products. Emerging communications technologies also help balance power between people, corporations and nations by enabling businesses, governments and civil society to scrutinize each other and share information.

Political risk and terrorism

Political risk is by no means a new threat, but changing political realities have amplified its magnitude and thereby its capability to disrupt critical systems.

The relative security provided by the Cold War's balance of power has been swept away and American hegemony, rather than bringing global security as many had hoped, has become the target of terrorist groups across the globe. These groups are often decentralized, united more in ideology than in structure, making them more unpredictable and therefore potentially very dangerous.

The threat of terrorism is almost as potent as the attack itself, and the climate of fear following the events of September 11, 2001 has made the prevention of attacks on the citizens and interests of the US and her allies an overriding concern. Resentment has heightened, particularly in the Arab world, where the interventionist policy of the US, and its support of certain Middle Eastern governments, continues to inflame opposition.

Fanaticism is just one of the political risks faced by international corporations. Others include corruption, currency crises, suffering extortion and threats of staff kidnappings. The events of the last few years have meant that political and terrorism risks are no longer geographically confined, resulting in corporations having to revise their approach to these risks.

Ecological risks

The world economy depends on a base of natural resources – our 'natural capital' – that is showing signs of severe degradation. Without improved environmental performance, future business operations will be exposed to additional risks such as rising prices for water, materials and for waste disposal.

Our knowledge of the wealth and resilience of our ecosystems is quite limited. We do not know if we are close to some critical limits that could cause step changes in the way ecosystems are functioning. For example, between 1990 and 2000, Africa and South America respectively lost 8 percent and 4 percent of their total forest coverage. These percentages represent huge areas: 16.1 million hectares of forest were lost globally each year to deforestation and conversion, primarily to agriculture crops, during the 1990s. Some 94 percent of this was in the tropics.

Water is arguably the world's most pressing resource issue. Growing water scarcity and alarming declines in aquatic biodiversity are evidence that water policies and practices in most parts of the world are failing to protect life's most vital resource. Population growth, industrialization, urbanization, agricultural intensification and water-intensive lifestyles are placing great stress on freshwater systems. An estimated 2.3 billion people – 41 percent of the world’s population – currently live in water-stressed areas, and this is projected to rise to 3.5 billion by 2025. Water scarcity has led to conflict between upstream and downstream areas within countries, and to tense relations between countries sharing a transnational waterway or watershed.

The interdependency of our natural systems is clear; the risk of disruption to one threatens the balance of all.

Globalization of litigation risk

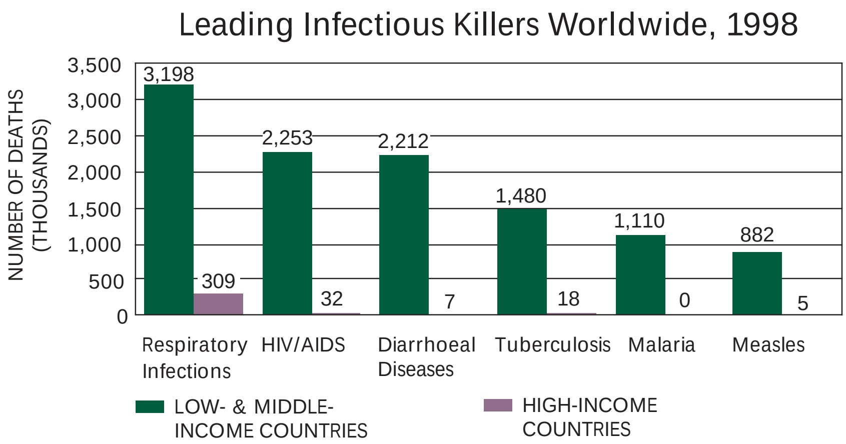
There has been an exponential increase in society’s willingness to get involved in litigation, primarily driven from the US. This globalization of the propensity to litigate – which is affecting countries where citizens and corporations rarely resorted to the law to settle issues – has had a dramatic impact on the way both individuals and corporations approach their activities.

A specific example of the globalization of litigation is a new use of The Alien Tort Claims Act (ATCA) of 1789, which grants jurisdiction to US Federal Courts over “any civil action by an alien for a tort committed in violation of the law or a treaty of the United States”. In 1980 a Paraguayan man successfully used ATCA to sue the policeman who had tortured his son to death in Paraguay.

An interesting development has been the recent efforts to use ATCA to sue transnational corporations for alleged violations of international law in countries outside the US; the foremost example of this is a case involving Nycal and its involvement in Myanmar.

This globalization of litigation risk has led to corporations taking a risk averse approach to certain activities that are perceived to have a greater degree of risk.

HIV/AIDS: A deadly trend

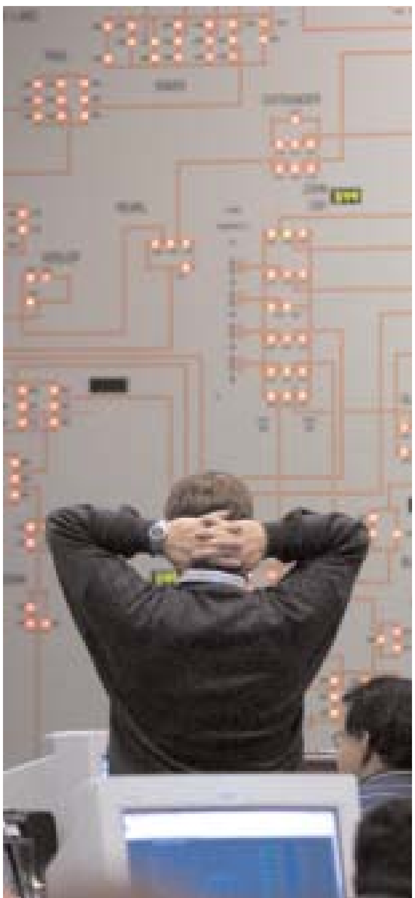


Source WHO, 1999

Infrastructure and security

All major systems are becoming more vulnerable. Health services, transport, energy, food and water supplies, information and telecommunications are examples of sectors with vital systems that can be severely damaged by a single catastrophic event or chain of events.

Power crisis in California (2003)
A worker at the California Independent System Operator Control Center in Folsom, CA, monitors the power reserves in the state’s power grid during the second power alert.



Infrastructure is becoming increasingly centralized and distributed systems can respond to an event in the same way as a centralized system. An example of this was the power outages in North America during 2003 and the similar effect, but for different reasons, in London, a few months later. As infrastructure is increasingly linked, any unexpected event can lead to compounded implications.

By the same token, the threat of computer viruses, such as the I LOVE YOU and MYDOOM virus, has clearly demonstrated how systems that are distributed are vulnerable to rapidly increasing damage because of their connectivity.

Pandemics/health risks

Despite a century of rapid progress in improving human health, many people do not have access to basic healthcare or hygiene to protect them from infectious agents in the environment. Infectious diseases conquered long ago in the industrialized world – diarrhea, tuberculosis and measles – continue to kill millions in poor countries and to thwart the growth of fledgling economies.

The newest worldwide killer is HIV/AIDS. In the 20 years since it was identified, AIDS has killed more than 21 million people and devastated the fabric of some of the world's poorest countries. It is a grim reminder of the cost of disease: AIDS undermines economies by decreasing life expectancy, killing productive adults, and raising costs for training and healthcare services.

The rapid spread of the SARS virus has shown the effect of increased mobility on global health. While the newly identified virus has killed relatively few compared to the diseases mentioned above, it has caused widespread disruption and damage to the tourism and travel industries in the Far East, Canada and elsewhere.

Innovation and technology

New technologies offer substantial benefits, but are seldom risk-free. Moreover, these risks are not always obvious at the time of introducing a new technology. For example, freons led to the ozone hole, coal fired power stations have aggravated climate change and cars cause urban air pollution.

Scientists have lost part of their credibility in the wake of these and other developments, such as the BSE and foot and mouth crises in Europe. This loss of credibility has been accompanied by declining trust in the people who make scientific and technological judgments.

Intellectual property rights are also relevant. Companies will only finance new technologies if they are sure that their investment will be protected. If there is a risk that their intellectual property rights will be infringed and there is no effective redress, companies will be highly reluctant to make the required investment.

Key messages

- New mega risks present unprecedented challenges to companies and governments alike.
- Innovation is required in dealing with the potential impact of these risks.
- Long-term trends in areas such as energy consumption and population growth require similarly long-term approaches to risk management.
- Since risk is increasingly global in nature, companies need to respond in kind.

How should companies respond

what are the implications for business?

Risk can be characterized as anything that stops a company from achieving its objectives, including: what could go wrong; and what must go right.

Undoubtedly, business causes risk. It is equally clear, however, that society is putting risk into business. This in turn requires companies to ‘internalize’ the risks and related costs (to the extent that they can actually be determined).

The UK National Audit Office provides a succinct definition of the management of risk: “Having in place a systematic process for evaluating and addressing the impact of risks in a cost effective way, and having staff with the appropriate skills to identify and assess the potential for risks to arise.”

Difficulties arise from the fact that risk is multi-dimensional. Managers tend to associate risk with loss rather than equally weighing upside and downside risks. There is also a tendency within many organizations not to reward those who bring up risks to an agreed business plan – the messenger is punished. A further drawback is that managers generally assume they have a greater capacity to reduce risk than they actually have.

Shifting to the new reality

A shift has already taken place in those companies that have understood the new realities of business. Coping with the prospect of mega risks has led to new perceptions of the nature of risk:

From

Risk identification and assessment
Risk as individual hazards
Focus on all risks
Risk mitigation
Risk limits
Risk with no owners
Haphazard risk quantification
Risk is not my responsibility

To

Risk in context of business strategy
Risk 'portfolio' development
Focus on critical risks
Risk optimization
Risk strategy
Defined risk responsibilities
Monitoring and measurement
Risk is everyone's responsibility

The traditional approach to risk has been fragmented, largely reactive and orientated toward the short term. Risk assessments were conducted to achieve compliance with corporate governance requirements, roles and responsibilities for risk were confined to functional personnel, and options for treating the mitigation of risk were often limited to insurance mechanisms. Links to corporate policies were widely missing.

Recognizing that responding to risk involves more than risk assessment alone, these same organizations have generally developed what are termed 'enterprise' or 'integrated' approaches to risk – and it is not just in the corporate world that the benefits of such an approach to risk management are being realized.

A key conclusion of the OECD's recent International Futures Program report is that mega risks require a systemic response. In an effort to develop responses, the OECD put forward a number of policy recommendations to governments that are united by two common themes: the first is the need for collaboration between corporate and societal stakeholders; the second is the requirement for a coherent, forward-looking approach to risk that anticipates the impact of changes in the risk landscape.

An 'enterprise' approach to risk

As the heading implies, an 'enterprise' or 'integrated' approach to risk necessitates the bringing together of previously disparate roles and activities. This has led to the development of unifying frameworks designed to articulate how these activities interrelate.

Many organizations, driven by compliance, have developed an approach to the management of risk that starts and ends with an assessment of key risks and associated control effectiveness. The results of these assessments are all too often left to gather dust on a shelf until an approaching financial year end requires them to be updated. This leaves the identification and understanding of how risk, in all its forms, impacts the organization, isolated from core operations and decision-making processes. Unsurprisingly, these organizations are increasingly questioning why they do not appear to have realized a return on the risk management investment they have made.

Through developing a structured, yet practical, risk management framework that is aligned around the business, organizations are better able to coordinate their risk management activities and provide a unified approach for continual development. This is important, as management will only support a plan to develop risk management if that plan builds on existing activities and processes, does not increase bureaucracy and is not seen as yet another corporate-sponsored initiative where the value to them has not been articulated.

An example is on the next page of an enterprise risk management framework to integrate previously disparate risk management activities in a practical way.

Organizations can be ranked against a continuum of approaches, such as – 'reactive', 'tactical' and 'strategic'. The reactive organization, as typified by the traditional approach to risk, manages risk only for compliance purposes and in response to a crisis. The tactical organization will be better prepared for risks, but it is the strategic organization that anticipates risks and actively drives value for the stakeholders.

Framework element	Reactive Reactive to risks	Tactical Prepared for risks	Strategic Anticipating risks
Strategy	Risk policy & guidelines	Risk & business strategies aligned	Value for stakeholders
Structure	Risk management function	Group-wide roles & responsibilities	Risk embedded in infrastructure
Portfolio	Risk analysis	Risk/business model	Risk aggregation
Measuring & Monitoring	Risk registers	KPIs & balanced scorecard	Early warning systems & leading indicators
Optimizing	Risk treatment	Risk reward trade-off	Risk portfolio optimization

Source: KPMG

How it works

The framework enables the review of risk management in relation to five key framework components:

Risk strategy: its alignment to business planning, change management and the control environment.

Risk structure: the approach for supporting and embedding an organization's risk strategy, including accountabilities and reporting structures.

Risk portfolio: identifying, assessing and aggregating risk across the organization.

Measuring & monitoring of risk information: the establishment of measurement criteria, such as performance indicators.

Risk optimization: balancing exposure and opportunity within the portfolio, based on willingness and capacity to accept risk.

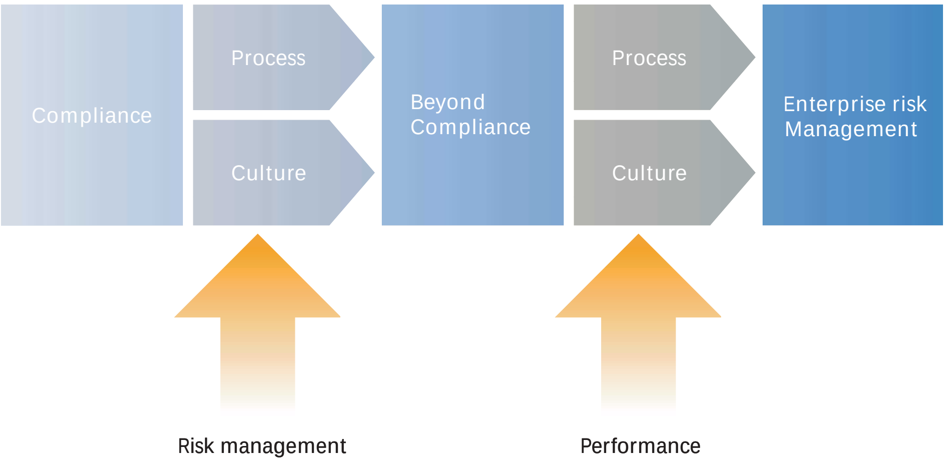
Such a framework allows organizations to identify their current position with regard to risk management and to determine where they aspire to be. It also enables organizations to identify the gaps between current and desired states, helping the creation of a clear action plan, and 'road mapping' the route to get there.

As a minimum, a framework for developing your organization's approach to risk should:

- Enable improved coordination of all risk management activity by building upon existing formal, or informal, risk management mechanisms.
- Be simple to use and understand, ensuring new risks are escalated quickly and effectively.
- Be aligned with the company's business strategy, vision, objectives and initiatives for growth and sustainable development.
- Help define achievable objectives and develop an understanding of the barriers to success and provide the company with a clear implementation plan.
- Be flexible to the needs and culture of the organization.

Companies that truly embed risk in their organizational behavior and recognize that sound risk management can contribute to performance come closest to 'the holy grail' in terms of their risk approach. Indeed, the importance of embedding risk management within an organization's culture cannot be overstated: it is the only way to overcome the initial barriers to acceptance, to educate employees about its centrality and to achieve best risk management practice.

The following illustrates that it is the combination of process and culture and focus on performance that leads to genuine Enterprise Risk Management.



Source: KPMG

Securing the benefits

Organizations that invest in risk management to deliver regulatory compliance will not reap the benefits of an integrated risk management approach. In that case, risk management will remain a 'necessary evil' rather than a 'business enabler'.

The realization of the goal of a genuine enterprise approach to risk management is not common. Even the more developed organizations would admit they still have some way to go before it is a reality in their organizations. A view supported by the results of interviews with 1,400 Chief Executives by PricewaterhouseCoopers issued in January 2004 which revealed that only 15% regarded their organizations as "advanced practitioners" of enterprise risk management. What matters is that, by establishing a structured and integrated approach to developing risk management, they are already realizing benefits – an opinion shared by almost 75% of the "advanced practitioners" in the survey.

Organizations have struggled with the task of embedding their approach to risk in their core operations and processes. As a result, many have realized that it is only through the improved definition of organizational roles, responsibilities and accountabilities for risk, and the formal incorporation of risk in decision-making and other existing organizational processes, that this challenge can be overcome.

Nowhere is this more evident than in how businesses respond to identified long-term threats. In such cases it is unlikely that individual corporate functions or business units operating in isolation can respond to the threat. A cross-functional, cross-organizational approach to the management of risk is critical.

Developing a 'joined up' approach to risk

Historically, the assessment and reporting of risk has been fragmented, with different forms of risks originating in different areas of the organization being reported separately to the board. This has understandably left business leaders unable adequately to assess their organization's risk environment in a holistic way – an especially acute issue for non-executive directors, who were disadvantaged in the level of challenge they could feasibly provide.

It has therefore become critical to assign roles and responsibilities to risk management throughout an organization. The transparent assignment of roles and responsibilities, together with improved accountability and awareness of risk, is required for any risk or assurance-related activity to be successful.

Additionally, defining clear roles, responsibilities and accountabilities, aligned to a common strategic path, can significantly improve knowledge sharing and break down organizational silos. In this environment, the ownership of risks and their associated controls can be better and more efficiently shared as a common interest is defined and understood.

Recognizing the limitations of a fragmented approach to risk, some organizations have sought to create a single senior corporate position for the enterprise-wide coordination of risk management. This is the Chief Risk Officer (CRO), whose main responsibilities are to:

- identify, assess and monitor the complete portfolio of factors that could jeopardize the profitability and viability of the organization in both the short and the long term

- work closely with the CEO, the board and its sub-committees (including the risk management committee when in place) to achieve an enterprise-wide perspective on risks and associated strategies for mitigation, looking across all business units to anticipate all the risks that threaten the organization
- leverage risks to optimize the risk-return relationship within the organization, taking into account shareholder expectation, and the organizational appetite and tolerance for risk, in relation to organizational strategy and objectives

Delivering performance

Bringing together roles, responsibilities and accountabilities for risk at senior functional levels should not obscure the fact that it is the business operations themselves that own and manage risk on a day-to-day basis.

Ultimately, developed corporate structures for the identification and reporting of risk information will be rendered meaningless if the businesses' operations fail to be engaged in the process of managing risk. It is here that risk management is reduced to its most basic level – how employees regard and evaluate risk in their daily activities.

At this level, risk management is in essence a behavior, although the thought that individuals give to the risks within their particular environment varies considerably – which is probably unacceptable for organizations requiring a consistent and thorough approach at all levels. Generally, the successful interpretation and implementation of an organizational risk strategy relies on a common understanding of the level of risk acceptable to the organization.

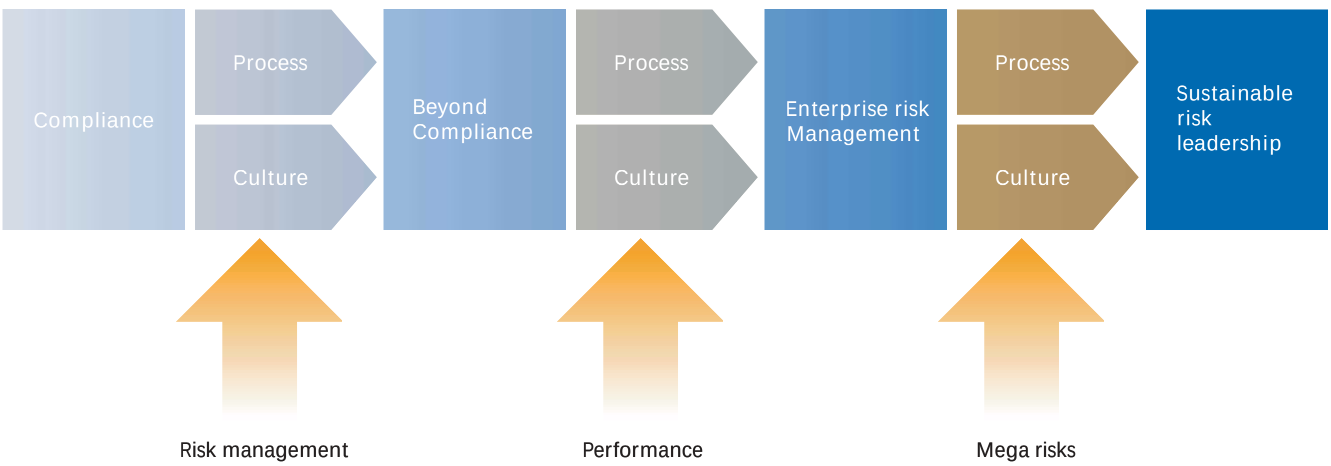
As a result, some organizations are focusing on how they can influence their employees' approach to the risks they encounter from a behavioral perspective. Elements of such an approach may include training programs for new joiners and developing managers, and risk management as a defined organizational behavior in management and executive appraisals.

Building accountability for risk needs to occur at all levels of an organization to establish credibility. What is asked of employees at an operational level needs to be mirrored in the business planning process undertaken at more senior management levels.

Toward sustainable risk leadership

A framework approach will be successful if risk is effectively managed and monitored within a company's overall strategy. This remains a key challenge for many organizations.

The task for those organizations moving toward the goal of an enterprise approach to risk is how they successfully integrate mega risks of the type outlined in this paper into their particular enterprise approach.



Source: KPMG

For companies adopting this approach, their attitude to risk management will have moved well beyond traditional risk mitigation (using controls to limit exposure) toward risk optimization and even risk leadership – that is, determining the organization's risk appetite and capacity among a group of risks (including mega risks) across the enterprise, seizing opportunities within those defined parameters and capitalizing on the rewards that follow.

A strategic approach to managing mega risk is essential to ensuring sustainable development.

Accountability

The potential responses that companies can make to the issues and implications of mega trends raise an important question: what should companies be accountable for?

This is the subject of a separate major WBCSD project – Accountability and Reporting, the results of which will be published during 2004.

Key messages

- Companies should rethink traditional approaches to risk.
- Global businesses should adopt more comprehensive risk strategies.
- A 'framework' approach to risk management can provide companies with ways of assessing existing business practice and adapting to a more strategic approach.
- Aligning corporate risk assessment with broader business planning functions is a key step in anticipating risks.

Key challenges for boards and CEOs

are you ready for a new approach?

The challenges involved in embracing newer approaches to a wider view of risk are increasingly interchangeable with the sustainable development agenda. These challenges have to be faced by individuals, communities, governments, international institutions and, of course, companies.

The specific challenges facing boards and CEOs are explored below.

Challenge 1: Developing a wider appreciation of risk

The forms of risk identified by organizational risk profiles have changed over recent years. They have moved away from traditionally insurable exposures to physical assets toward a wider appreciation of more complex exposures, many of which threaten the intangible, rather than tangible, asset base.

The long-term sustainability of a business requires mega risks to be identified and their potential impact on the future of the business understood. This can be problematic, as senior management may have a limited understanding of mega forms of risk. Overcoming this 'information gap' is key to getting to grips with and developing a response to risk in this context.

In addition, as with long-term strategy setting, focusing on mega forms of risk often requires a collective mindset, in which people are encouraged to 'think the unthinkable'.

Challenge 2: Focusing on the long term

Perhaps the biggest challenge that business leaders face when accepting the responsibility of not only defining and delivering short-term objectives, but also actively taking on the role of guardian for the long-term performance of the business, is in establishing and communicating the value of and approach to risk for the organization.

Take the example of multinational oil companies. It has been clear to many within these organizations that although oil and gas will sustain their businesses in the short- to medium-term, their long-term sustainability requires a change to their objectives, their strategies for achieving these objectives and the very way in which their employees and other stakeholders regard the future of the business. In that process, many oil companies have repositioned themselves as energy companies.

It is only by effectively identifying, managing and communicating risk in the context of overall business strategy that risk can be appropriately addressed. It is little wonder, therefore, that risks to the long-term sustainability of an organization are often overlooked or ignored when objectives are focused on the delivery of short-term performance targets.

The serious and meaningful consideration of long-term threats needs to be built into planning activity.

Challenge 3: Creating an appropriate culture

'Bolt-on' approaches to risk or sustainable development no longer provide an adequate business model.

Communicating an organization's appetite for risk is essential. It gives employees confidence that they can take decisions within a framework that reflects the organization's approach to risk, while allowing appropriate flair and risk taking.

There are particular challenges in aligning an individual's personal approach to risk with that of the organization. Mismatches will result in tensions, some organizations carry out psychological profiles in order to obtain a 'better fit' .

Challenge 4:
Developing a performance-focused approach to mega risks

Risk management has often been viewed as anathema to entrepreneurs – an added bureaucracy that limits instead of increases performance. However, when faced with a modern business environment where the only certainties are increasing complexity, diversity, and speed of change, business leaders are realizing that the more informal ways of understanding, managing and communicating the risks to their objectives are no longer acceptable.

As businesses find themselves having to identify and exploit opportunity more vigorously than ever before, many are seeking to develop the empowerment and entrepreneurialism of their employees. At the same time, they want to be assured that informed decisions, consistent with the overall objectives of the organization, are being taken. The role of a non-bureaucratic, performance-focused appreciation of risk is central to this balancing act.

An effective framework for managing risk is now increasingly viewed as an invaluable decision-making tool by many organizations, linking business strategy to day-to-day risks, aligned with corporate objectives and part of planning and budget cycles.

For example, Johnson & Johnson uses long-range planning systems to make continual assessments of opportunities and threats. As the company revises its projections, managers are forced to answer the questions “What has changed?”, “Why?” and “What are we doing about it?”.

As this suggests, a compliance-based approach to risk management is simply not enough. A clearly articulated link between risk management and the achievement of performance objectives is essential in encouraging people to engage actively in risk management-related activities.

Challenge 5:
Recognizing that risks also present opportunities

Central to developing a performance-focused approach is the need to establish that not all risk is downside risk and that some risks actually present opportunities for competitive advantage to early adopters.

Examples include the production of recyclable packaging in response to the impact of deforestation and increasing public sensitivity to global warming, the development of pollution detection and control technology, and non-fossil fuel powered transport.

Challenge 6:
Recognizing the need to engage with multi-stakeholders

The sharing of information on, and responsibility for, risk is a developing area of modern approaches to risk management. Many organizations recognize that their performance, and the performance of their customers and suppliers, is intrinsically linked, and that sharing risk is ultimately beneficial to all concerned.

As these same organizations develop their long-term focus and understanding of the breadth of risk that may impact their aspirations and objectives, they will also come to redefine their value chains, developing new partnerships with societal stakeholders in order to mitigate the impact of those mega risks on their performance.
The key challenges that are central to commercial sustainability are certainly not new. While organizations are buffeted by changing conditions on the local, national and global stage, the core requirements of their success essentially remain constant.

It is in their preparedness for, and ability to meet, these changing conditions that organizations distinguish themselves. The ability to anticipate, accommodate and exploit change is central to the prosperity of any organization and to its long-term survival.

WBCSD Risk Champions Group

Odd Andersen	DNV
Kit Armstrong	ChevronTexaco
Pierre Béroux	EDF
Alun Bowen	KPMG
Lutz Cleemann	Allianz AG
Jacqueline Cote	Dupont
Michel Croize	Renault
Kaspar Eigenmann	Novartis
Alistair Johnston	KPMG (Risk Group Convener)
Roland Koehler	Holcim
Bill Kyte	Powergen
Daniel Madet	EDF
Keith Massey	Syngenta
Peter Natkanski	Syngenta
Bruno Porro	Swiss Re
Wendy Poulton	Eskom
James Rea	Zurich Financial Services
Peter Rowley	ERM
Steve Ruddell	BVQI
Mark Wade	Shell
Deborah Zemke	Ford

Risk focal point

James Griffiths WBCSD
Contact: griffiths@wbcsd.org

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Disclaimer

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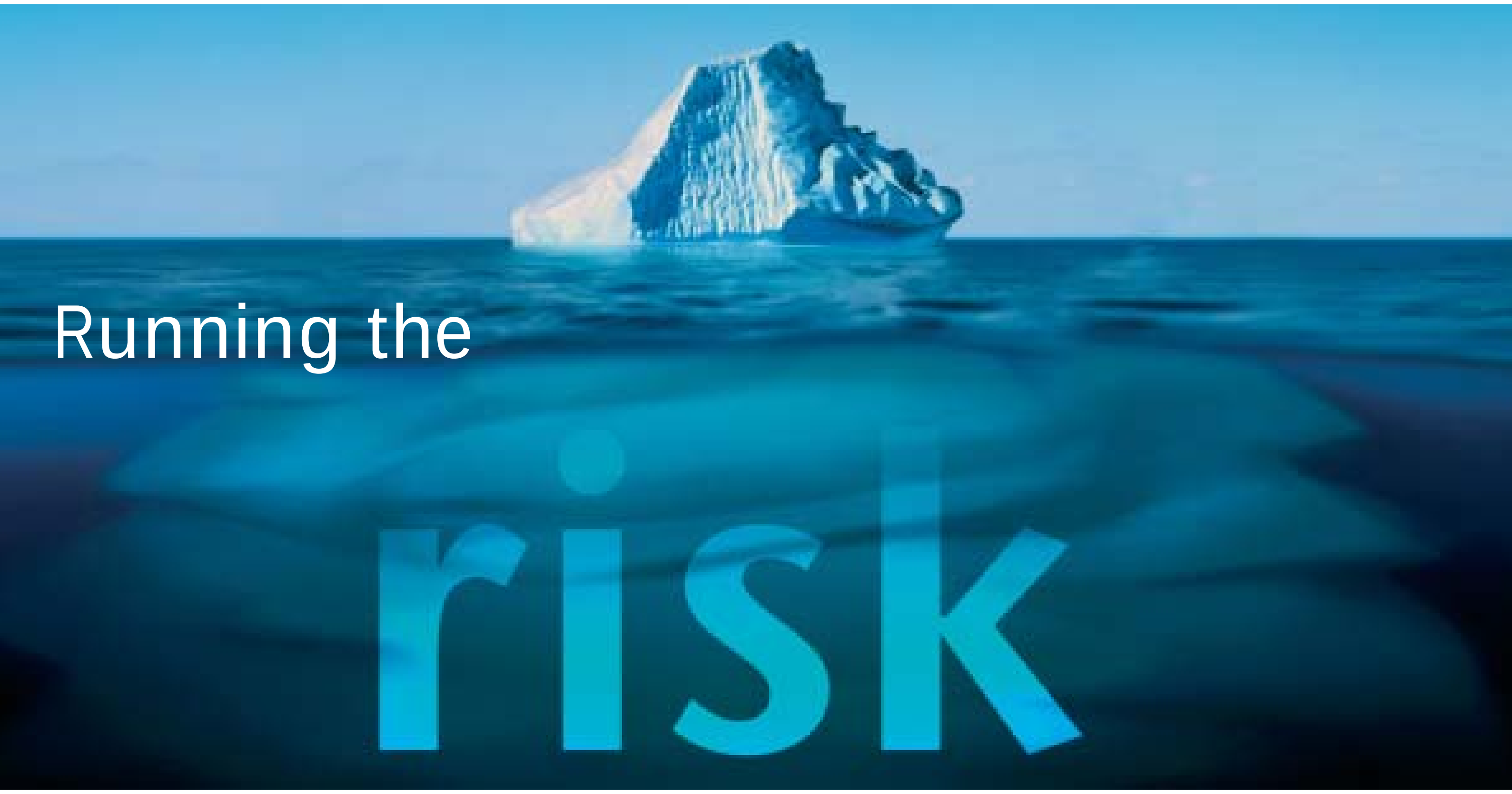

Risk and sustainable development: a business perspective

World Business Council for
Sustainable Development