Spotlight

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Building the Optimal Risk Management Function in an Unpredictable Operating Environment

Perspectives of a Risk Manager

MARCH 2024

Key insights

1. Rapid change, digitisation, and unpredictability has called for a rethink on the scope and design of risk management functions within businesses and organisations across the globe.

2. While most businesses are generally risk aware and embracing the need to prioritise key risks, the approach for many is not where they need it to be, often due to resourcing challenges.

3. Designing the optimal risk management function takes a range of considerations into account in terms of structure, enablement, and focus.

4. Distinguishing risk management from insurance remains a key challenge and opportunity. Understanding and assessing risk within the business determines the scope of insurance required.

2024 presents a moving picture for risk managers

The risk management brief has been gradually reframed due to rapid technological advancements, emerging markets, and changing global dynamics. Risk management is critical for businesses and organisations of all sizes, industries, and geographies. It covers the protection of assets, finances, and operations as well as ensuring legal compliance, corporate governance, and robust due diligence. Effective risk management will protect your reputation, longer-term growth objectives, and build deeper resilience.

Operational risks facing risk managers today versus what the picture could be in two to three years' time — resourcing, product complexity, business understanding — reflects a moving picture. Markets have become more aggressively competitive, with ongoing supply chain disruption and geopolitical tensions leading to increased complexity, uncertainty, and disruption. With rising operating costs and a tougher trading environment, business owners and leaders are looking for practical tips for risk 'owners' and ensuring key stakeholders fully invest in risk management tools and critical skill building.

Business owners, directors, and risk managers are looking for ways to right-size their risk function to align with the market, and gauge the optimal structure. Resourcing models are adapting to heightened unpredictability, with some organisations building out existing in-house capabilities. In contrast, others have elected to operate using a hybrid model involving internal resources and external specialists' network.

A risk management framework structures the way a business identifies, assesses, and mitigates risk. This includes guidance on how to manage various types of risks, including financial, operational, strategic, and compliance-related risks. With many businesses and industry sectors looking for new ways to diversify, reduce cost, and tap into emerging growth streams, this can lead to a fragmented customer base and increased risk complexity.

"Businesses should ideally be looking more closely at their risk profile at this time, and how it helps their business move forward. While some of us view risk in a negative light, there is the flip side where risk enables opportunity and growth. Considering the range of risks that exist in your business helps to identify something that could go wrong, gives you the ability to put it right before it causes a problem. That's an opportunity to do something better. Ultimately, it's important to view each risk in context. It's often easy to overlook that aspect.

One of the key issues with larger corporate organisations assessing their in-house risk management function is that, while they're risk aware and embracing the need to prioritise risks, the approach is still not quite where they need it to be, often due to resourcing issues.

Elsewhere, mid-tier businesses are generally doing things well. Some are at the forefront of current thinking, and more evolved in their approach to risk management; closer to the context of the business, customer, and market environment. They understand that something relatively minor can knock them off their stride, easily and with minimal warning.

The pandemic shifted how people view risk, providing a valuable test of resilience and preparedness. It was a pivotal moment in time across all industries and sectors. Moving from assessing risk on paper at a strategic level to actually going in to the business and directly resolving the issue, shifted the process from reverse engineering once a problem happened, to understanding why this issue could occur and finding a way to rectify that issue."

*— **Neil Hodgson, Managing Director — Risk Management Consultancy at Gallagher***

What defines an optimal risk function design?

Whether you're starting from scratch or revisiting an existing approach to scoping your risk management function, setting out initial thoughts on paper (or whiteboard) and identifying/agreeing on the fundamentals can help you cover all the most important bases. A sensible starting point is a **smart prioritisation of risks** — essentially, agreeing on the four to five strategic risks for the executive team and the risks that can be operationally managed within the business. Consider the biggest challenges, immediate concerns, and underlying issues that could significantly impact the normal operations of the business, and then map those priorities back to the skills and roles you have or need to appropriately manage the risk.

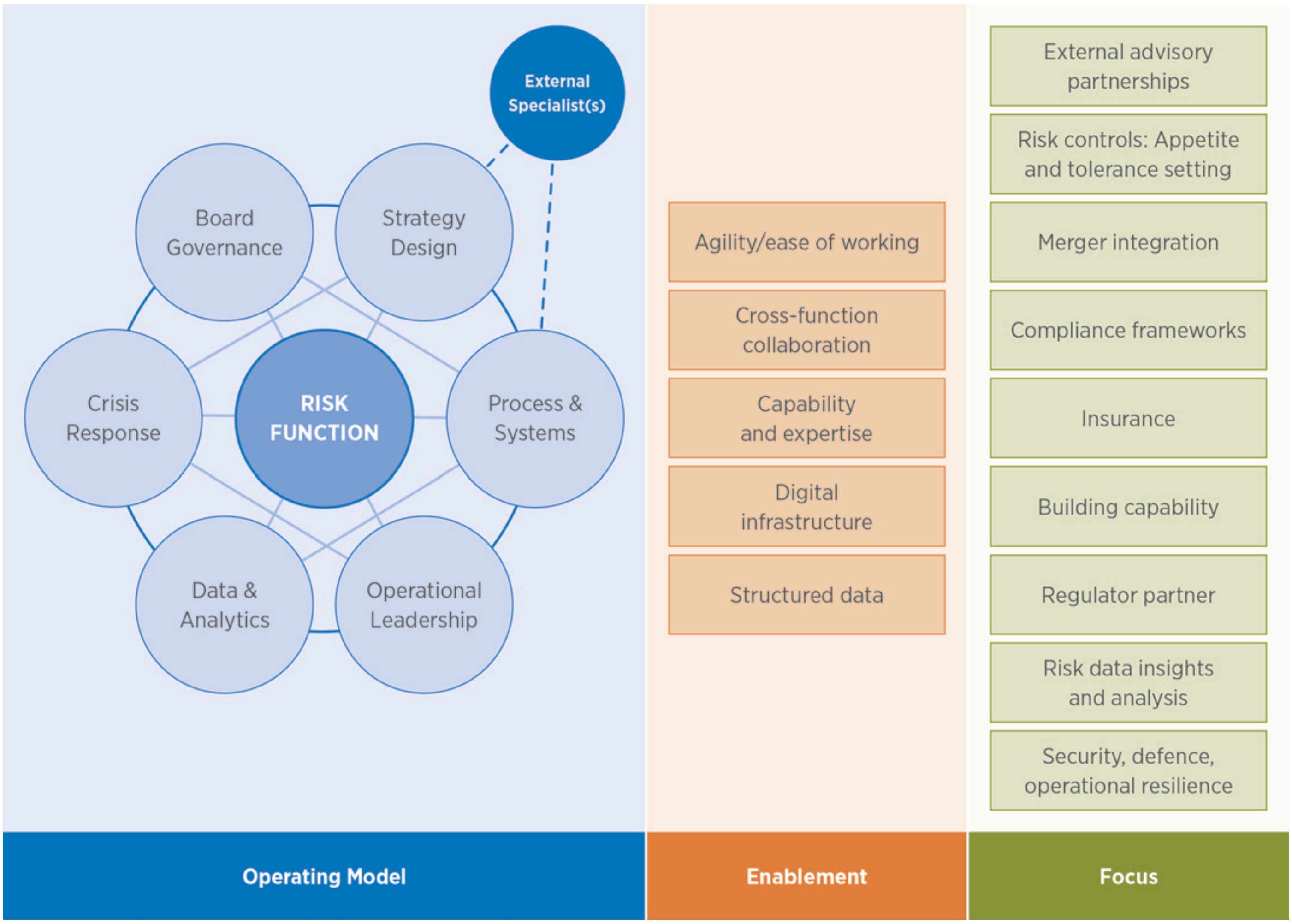
Having the **right brains and technical skills around the table** is central to optimal risk function design. Consider whether having a panel of specialist expert partners to work with the risk team on an 'on-demand' or contractual basis would support the broader vision.

The operating model should also offer **built-in flexibility to evolve capability** in line with prevailing risk exposure and scale up/down as appropriate to support the broader business objectives and customer experience. Risk managers and 'owners' should **be able to work across functions**, rather than assigning risks vertically by operating function. This offers a range of benefits, including the ability to holistically respond to risk and view the same risk through different lenses.

Risk management must be **integrated across the organisation**. Successful risk leaders encourage open communication to build awareness of risk and create a **positive risk culture**. This culture is built on transparency, where you address concerns directly, and the organisation provides the necessary training to embed the required behaviours, skills, and responses.

Designing a risk management function takes a range of considerations into account in terms of structure, enablement, and focus, as outlined in Figure 1 below.

Figure 1: Building a scalable risk management function



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The risk register: Setting strategic priorities that can be actioned and monitored

Risk management is a 365-day, 24/7 commitment. Rather than being an onerous task, a well-designed risk register can be a game changer, motivating smart collaboration across teams and using risk as a growth strategy. There are pitfalls, however, that should be considered.

"It's not unusual to see a risk register with say 50–100 items on it. It should set out the 10–15, highest-priority risks, simply and effectively so that key stakeholders understand the risk at root cause level. The executive team, operational leaders, or even the company Board have to assess a long list every time they review that document. In reality, they pay minimal attention to it and it becomes a tick box exercise. A reset to focus on a maximum of say 10 high-priority items can be a game changer. It's focused, it presents the important detail, and the discussion is targeted and prioritised. It also becomes more issues and opportunity focused, that leads to decision-making and shared agreement/ownership of mitigation priorities. A risk register doesn't mean anything unless a business has been through a deep dive process to look at every aspect of its operations, supply chain, and customer base."

The risk register isn't a stand-alone tool for the risk function

A supporting risk management framework is a model and set of guidelines employed by businesses to identify, eradicate or reduce potential risks. Risks stem from a variety of sources, including financial uncertainties, legal liabilities, technology issues, strategic management errors, accidents, and natural disasters. Regularly review and update your framework to address emerging risks and changes in your organisation.

Taking a passive view of risk and doing nothing to either resolve or mitigate it, is a lost opportunity with potentially significant consequences. Using the risk register and risk framework together drives action and collaboration around the table. It helps to unpack risk in all its dimensions, thereby enabling the business to agree on its appetite and tolerance, and what controls need to be put in place to manage (ideally remove) the risk.

"Teams often try to build a risk framework themselves and manage the work in-house. Involving specialist partners at the early stages of the conversation can be beneficial, to guide critical thinking in the initial development stages to ensure the team is going down the right path. Businesses often bump into issues and gaps in a self-developed ERM [enterprise risk management] framework when it's generic and high level. They can misunderstand the premise and lack a robust methodology to build the framework, and ultimately how to utilise it. That's where specialist advice from an experienced risk expert asking the right questions can be advantageous.

We've seen examples of businesses going online, printing a plan, or risk framework template, put their name on it and sending it off. It's not fit for purpose. At best it ticks a box, and while people are happy ticking boxes, they're storing up a problem for a future date."

"Businesses are operating in a highly dynamic environment right now, leaving owners, operational leaders, and executives juggling a complex agenda. The conversations surrounding AI and Chat GPT are a moving picture and the use case is still not fully understood. People and workplace transformation are a heightened risk at this time as the war for talent continues, and employees gradually return to the office, and flexible working patterns are fully bedded into business operations. Inclusivity, diversity, and mental health awareness are on the agenda and central to employee satisfaction. Talent retention and leadership capability will be key to delivering business plans and ensuring longer-term success."

What does the risk team need to be good at?

Best practices in risk management come from having a wide and connected view. Taking out the siloes and working across the business rather than vertically by function. This provides a holistic view of a specific risk, including its gravity and priority. The risk team, therefore, needs to work with a partnership mindset, building relationships at all levels of the business/organisation, and having the ability to work with agility and strategically.

Guiding principles that underpin optimal risk function design, include:

1. Ability to anticipate decisions
2. Adequate resources and capacity to respond to changing conditions
3. Free flow of information into and throughout the organisation
4. A willingness to learn and adapt
5. Connecting historical data and market trends with corporate strategy, and understanding both the current position and future direction of the business

Risk management is a strategic business function and an essential leadership skill that needs to be present at all levels of management. Managing risks, once they are identified and assessed, is about coming up with a strategy to reduce their likelihood or impact.

Assessing the likelihood and impact of risks coming to pass requires that you analyse and monitor changes in the external environment, such as regulations, industry trends, and geopolitical events. Risk mitigation will be informed by how external factors affect the organisation.

Does data deepen our understanding of risk, or make it more complex?

Although risk involves varying degrees of unpredictability, the availability of structured data is helping businesses (and leaders) make informed, 'real-time' decisions to minimise disruption to normal business operations. Enabling the business to get closer to customer preferences, data-driven insights contribute to longer-term resilience, powering revenue growth, improved customer experience, and better informed investments into capability, tools, and sustainability.

Fully leveraging data to interpret risk strategically comes with a set of challenges. Hiring experienced analysts and data specialists may involve significant investment at a time when access to capital and the cost of borrowing restrict what a business can reasonably achieve in the near term.

AI could be the answer (or at least a part of it?)

Given the regulatory frameworks in many countries globally requires a competent person to undertake risk assessments and deliver risk management roles, AI should be used with the appropriate risk controls rather than as a substitute of human oversight.

While AI will drive transformation across many businesses and industries, it is realistically in the early stages of discovery and testing, and only partially understood. Although AI can be used to simplify processes, evaluate data, and identify shifts in behavioural patterns that signal potential risks, technology solutions, including generative AI applications, are more likely to play a partnership role with risk managers rather than replace the role altogether. Staying one step ahead of risks helps improve resilience and enable longer-term success.

There are advantages, however. For example, AI can be leveraged to create custom risk profiles, tailoring risk assessments to specific needs and vulnerabilities, enabling the business to focus valuable resources and investments on the highest priorities.

Adopting an outside/in lens to risk management

Risk happens outside the four walls of the business as much as it influences and informs day-to-day operations. While the decision may be to build an in-house risk management function, having access to specialist capability and a trusted sounding board externally offers a range of benefits. Risk vectors to consider include the following:

- **Data management:** The emergence of generative AI, the push for digitisation, interpreting complex data, and the evolving brief for integration of AI into operational processes.
- **Cybersecurity:** A rising trend of cyber attacks targeting sensitive commercial information, privacy breaches, fraud risk, and growing sophistication requires deeper technology infrastructure and expertise investment. Understanding the risk dynamics inside/outside and across the business is a critical priority for a risk function in 2024.
- **Supply chain due diligence:** Understanding the mix of suppliers to your business and customers helps identify where key risks exist. This may involve integrated payment platforms, setting expectations on how data is securely stored and managed, through to cash flow management and solvency.
- **M&A and integration:** Acquiring a business (or team) should consider the way each business manages its risk. There may be common and divergent views on a specific risk. Also, consider risk management strategies that worked historically, but are now out of step with the current market and the newly combined business entity, to align the approach.
- **Customers:** One of the highest points of vulnerability in any business, and present a range of risks that need to be carefully considered and monitored.
- **Regulatory compliance:** Tighter regulation and increased scrutiny of how a business operates require ongoing reporting on effectiveness and evaluating whether current risk management measures fully comply with regulator expectations
- **Climate change and environmental impact:** Given the growing impact and concern of climate change and the demand for sustainable product solutions, having an enterprisewide view of environmental impact risks, including any compliance requirements, is a key driver of the risk framework and register.
- **Recruitment/talent attraction:** Resilience, business continuity, and workforce retention are key risks in the current trading environment. Aligning processes with risk culture and the operating model is an essential component of the risk framework to ensure critical skills are retained and drivers of employee attrition are fully understood.

Taking a holistic approach to risk management builds resilience and grows opportunity

Ultimately, there is no 'one-size-fits-all' solution that delivers an optimal risk management function design. Getting closer to the risks inside and outside the business, clearer on priorities, and coordinated with risk mitigation enables businesses of all shapes, industries, and sizes to navigate a more complex trading environment. Risk functions can also be scalable and adaptable, equipped to bring in specialist advice when needed, and have built-in flexibility to respond to emerging opportunities.

Prioritising strategic risks to enable timely decision-making and resolution is the key to success. Optimal risk functions enable a business to work with agility and adapt the approach as the market/customer/product base continue to evolve over time.

Risk and opportunity are essentially two sides of the same coin. By taking a strategic approach to managing risk, decision-makers can be empowered to take risks and capitalise on opportunities with a clearer view of upside and downside. This equips the risk team to demonstrate its value, closely aligned to leadership team and Board objectives, while shifting the perception of the risk function from cost centre to growth enabler.

Hodgson concludes, "There is still some work to do to distinguish risk management from insurance. Risk management is a big subject, and insurance is a risk transfer mechanism. Assessing and understanding the risk in a business identifies the scope of the levels of insurance cover required, not the other way around."

"A risk manager opening a conversation by asking how your business manages its operational risk, is a very different conversation than 'tell me how you insure yourself'."

About the Author

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Neil created and leads the Gallagher Risk Management Consultancy division and leads Gallagher Business Assist, a claims preparation and advocacy service for the UK. Offering strategic direction while ensuring the service proposition identifies problems and offers solutions across all industry sectors.

Neil has advised on general risk management, health and safety, business continuity planning, fleet risk, property, and security across his career. Neil is a Certified Fellow of the Institute of Risk Management, a Fellow of the International Institute of Risk and Safety Managers, a Registered Safety Practitioner, and a regional chair for the Institute of Risk Management.

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