European Risk Management Council

Risk Landscape Review

June 2021

- Capturing the value of sustainability
- UK Risk Sentiment Index: Q2 2021 Update

DEAR READER,

I am delighted to present Q2 2021 edition of the Risk Landscape Review.

Q2 2021 has become an important milestone for the European Risk Management Council. This quarter, we launched the Sustainability Think Tank, our new and extremely exciting project. The inaugural meeting dedicated to a journey to the sustainable business model took place on 22 June.

To continue a conversation about ESG and sustainability, today we share an article "**How companies capture the value of sustainability**", from McKinsey & Company. Co-authored by Anna Granskog (Partner, Helsinki), Eric Hannon (Partner, Frankfurt), Solveigh Hieronimus (Senior Partner, Munich), Marie Klaeyle (Consultant, Paris), and Angela Winkle (Consultant, Chicago), this is an abridged version of an article presenting findings of a recent survey conducted by McKinsey, which was originally published on McKinsey's website.

We also continue our publication of the **Risk Sentiment Index (RSI)**, an expert driven forward-looking index that reflects expectations of experts about the risk landscape of the financial sector in the next 12 months. The results of surveys that we recently conducted in the UK suggest that the optimistic expectations regarding the economic recovery start prevailing among Chief Risk Officers and other risk decision-makers.

My huge thanks to all contributors and survey respondents.
Enjoy the reading.

Yours sincerely,

Dr Evgueni Ivantsov

Chairman of European Risk Management Council

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How companies capture the value of sustainability

By Anna Granskog (Partner, Helsinki), Eric Hannon (Partner, Frankfurt), Solveigh Hieronimus (Senior Partner, Munch), Marie Klaeyle (Consultant, Paris), and Angela Winkle (Consultant, Chicago), McKinsey & Company

Amid widening recognition of how environmental issues such as climate change create business opportunities and risks, results from a McKinsey Global Survey [1] show that companies that generate value from their sustainability programs follow a distinctive set of management practices. Our survey showed that these companies are more likely than others to make sustainability a strategic priority and to set out specific aspirations and targets. Responses also suggest that value-creating companies are more likely than others to make sustainability an element of their corporate culture and train employees on how to integrate sustainability into their work.

Survey results indicate that value-creating companies are more apt to engage customers and business partners in their sustainability agendas. Respondents from value-creating companies say they collaborate with customers and suppliers on addressing sustainability issues, adjust product portfolios to be more sustainable, and account for sustainability factors when selecting and evaluating suppliers. These value creators are also more likely than others to report that sustainability issues inform how their company manages its facilities and its transportation networks.

Looking five years ahead, about two in five respondents to our survey say they expect their companies to generate value from sustainability. Understanding the distinctive practices of today's value-creating companies could help others find a way to join their ranks.

An optimistic outlook

Sustainability endeavours often make good business sense, promising to deliver revenue gains, cost savings, and other benefits that lift enterprise value. In our survey, 22 percent of respondents—the value creating group that this article focuses on—say their companies realized modest or significant value from sustainability in the past five years. Respondents are also optimistic that their companies' sustainability programs will yield value in the future.

[1] *The online survey was in the field from January 21 to January 31, 2020, and garnered responses from 2,475 participants representing the full range of regions, industries, company sizes, functional specialties, and tenures.*

Strategic, purposeful intent

Survey results suggest that to catch up with the value creators, other companies might start by understanding which practices are most closely linked with positive financial impact. Value creators exhibit a strategic, purposeful approach that differs from that of other companies in several ways. Motives for engaging on sustainability also appear to matter. Respondents at value creators are significantly more likely to say their organizations address sustainability topics to fulfil their organizational purpose—to align with their goals, mission, or values, or to make a tangible, positive impact on an issue.

Sharp focus

When it comes to implementing sustainability strategies, value creators place greater importance on translating the sustainability strategy into definite terms: value creators are significantly more likely to establish clear and focused priorities, set targets or goals, and develop key performance indicators for sustainability.

Engaging employees

Survey results also show that value creators are doing more to engage their workforces in sustainability efforts. Nearly three-fifths of respondents at value creators say that sustainability is a part of the corporate culture. Among the value creators, employee engagement is also a more important element of the sustainability agenda. A greater share of respondents at value creators say that all employees receive training on integrating sustainability practices into their work and that employees understand how sustainability efforts align with the company's strategy. Incentives are another factor: a greater share of respondents at value creators say their organizations consider sustainability performance to a moderate or significant extent when making decisions about employees' compensation.

Meeting customer expectations

Just as value creators engage employees in their sustainability programs, they also put more effort than other companies into understanding customers' expectations and respond with changes to their products. Disproportionate shares of value creators seek customer input on the sustainability attributes of their products and services and highlight those attributes in their marketing efforts. Their orientation toward sustainability issues in customer relations extends to the management of product portfolios: value creators are more likely than other companies to change product designs, develop new product-as-a-service models to address sustainability issues, and offer sustainable brands.

Value-chain collaboration

For most companies, the majority of sustainability impacts result from the activities of their suppliers, contract manufacturers, distributors, and other value-chain partners. Value-chain engagement can thus be a telling indication of how much companies are doing about sustainability—and it's an area where value-creation leaders demonstrate distinctive approaches. Value-creation leaders are more likely than others to make sustainability a priority in managing energy, water use, and waste generation at their own facilities, as well as making decisions about their site portfolios.

They're also more likely to collaborate with and monitor suppliers' sustainability performance and to seek improvements in the efficiency of their transportation and distribution networks.

Looking ahead

Experience also suggests that companies with effective sustainability programs tend to plan and manage these programs with the same discipline and commitment that they apply to other business initiatives. Here are a few directional considerations that executives might use to focus their companies' sustainability efforts and derive more value from them:

— *Approach sustainability issues as business opportunities.* Leading companies develop business cases for their sustainability programs based on the value that they stand to create (or protect) through their handling of sustainability issues. They set tangible, concrete aspirations for their sustainability programs and convert those aspirations into quantitative performance targets, which reflect their competitive position, their consumers' expectations, and their investors' demands.

— *Build organization-wide accountability for results.* Product-focused business units, functions such as supply-chain management, and geographic departments are the parts of a company that ordinarily generate most of its sustainability impacts. And unlike the central sustainability team, these departments also have the authority to change day-to-day operations. Recognizing this, savvy executives assign responsibility for sustainability initiatives to heads of functions and divisions and give them related performance targets. In this way, executives can hold senior managers to account for the company's sustainability achievements.

— *Seek impact through collaboration.* While companies can do a lot on their own to improve their sustainability performance, some face challenges that span industries or regions. The problem of plastic waste, for example, bedevils the entire chemicals industry, not just one company. To address these systemic difficulties, companies might form coalitions with industry peers and work together on setting new standards, promoting technological innovation, or advocating for policy shifts. Since value chains produce the majority of the typical company's environmental impact, most companies will also benefit from working closely with their value-chain partners.[2]

This is an abridged version of an article by the same name, originally published by McKinsey & Company, 28 April 2021. The full article can be viewed and downloaded from the firm's website: www.mckinsey.com.

Risk Sentiment Index: Q2 2021 Update
The crisis will be over in the next 12 months …

The European Risk Management Council has updated its UK Risk Sentiment Indices (RSI). Fresh data have been collected for Q2 2021. Chief Risk Officers and other senior risk executives from banks provided their views on the future trends of seven types of risk (credit, market, liquidity, operational, cyber & IT, conduct and regulatory risks). Using the survey results, the Council aggregated the data into forward-looking index that reflect expectations about a change of the risk landscape for the financial services sector in the next 12 months. Numerically, the RSI reflects the adjusted percentage of respondents who consider that risk will increase in the next 12 months.

Q2 2021 UK Risk Sentiment Index

- The main conclusion that can be drawn from Q2 2021 RSI survey results is “The crisis will be over in the next 12 months”. Respondents are increasingly optimistic about the overall dynamic of risk environment. The optimistic trend that first appeared in Q1 2021 has been reinforced in Q2. The aggregated RSI for seven risk types decreased further from 0.45 in Q1 2021 to 0.43 in Q2 2021 (Figure 1). While the quarter-to-quarter drop of 0.02 points is not large, the overall level in Q2 2021 is now in line with the RSI level observed before the pandemic.

- The vote distribution among main categories is pretty similar to that in the previous quarter. However, an increasing number of respondents anticipate no further escalation of risks and more respondents expect no change in the risk environment in the next 12 months (25% expect no change in risks vs 23% a quarter before). It is a clear indication that respondents believe that the turmoil stage of the crisis is now behind us and expect a smooth transition to a stable risk environment in the near future (Figure 2).

- Among individual risk types, changes in individual RSIs in the past three months were relatively balanced. We registered a decrease of RSIs for credit, market, operational and conduct risks, while RSIs for liquidity, cyber and regulation risks modestly increased (Figure 3). The biggest positive shift in this quarter was the RSI for credit risk which had a substantial drop by 0.16 points and reached its pre-pandemic level.

- Cyber& IT risk remains the prime concern for respondents. In Q2 2021, RSI for cyber risk stands at 0.72 which was an increase by 0.03 points from the previous quarter (Figure 4). This high level reflects a very negative sentiment of respondents – 90% of respondents expect that cyber risks will continue growing in the next 12 months. After a substantial reduction of RSI for credit risk, regulatory risk occupies the second spot at the “worry list” after the cyber risk. RSI for regulatory risk reached 0.52 with almost 80% respondents expect this risk to go up in the future.

Figure 1. UK RSI trend: Q4 2018 – Q2 2021

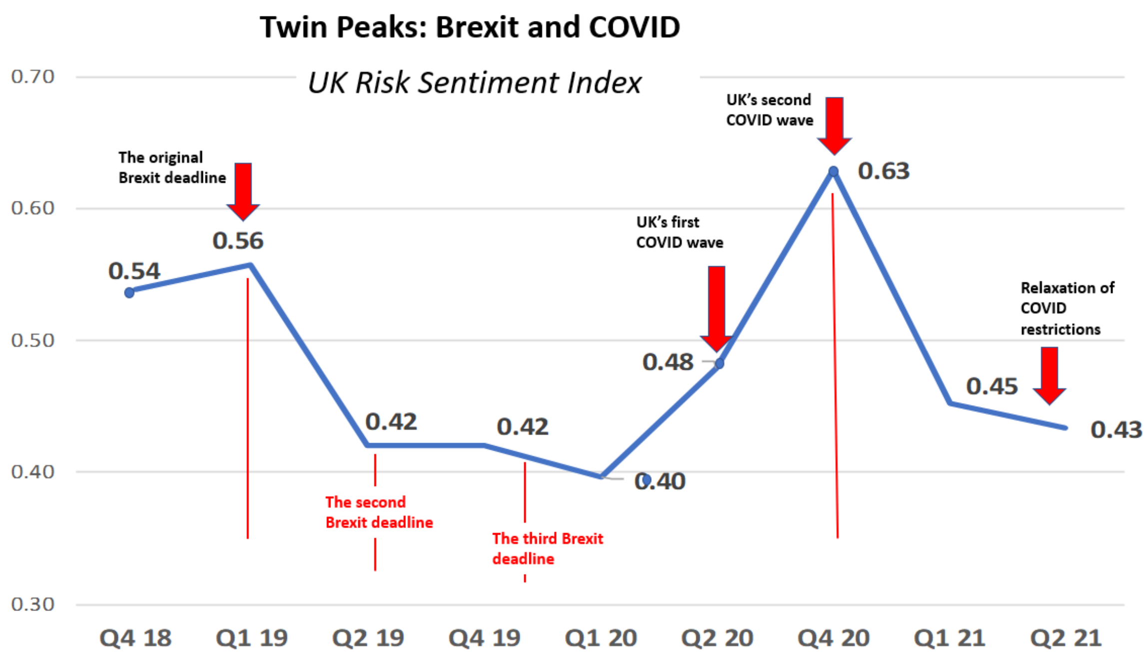

Figure 2. UK RSI: Distribution of respondents' votes

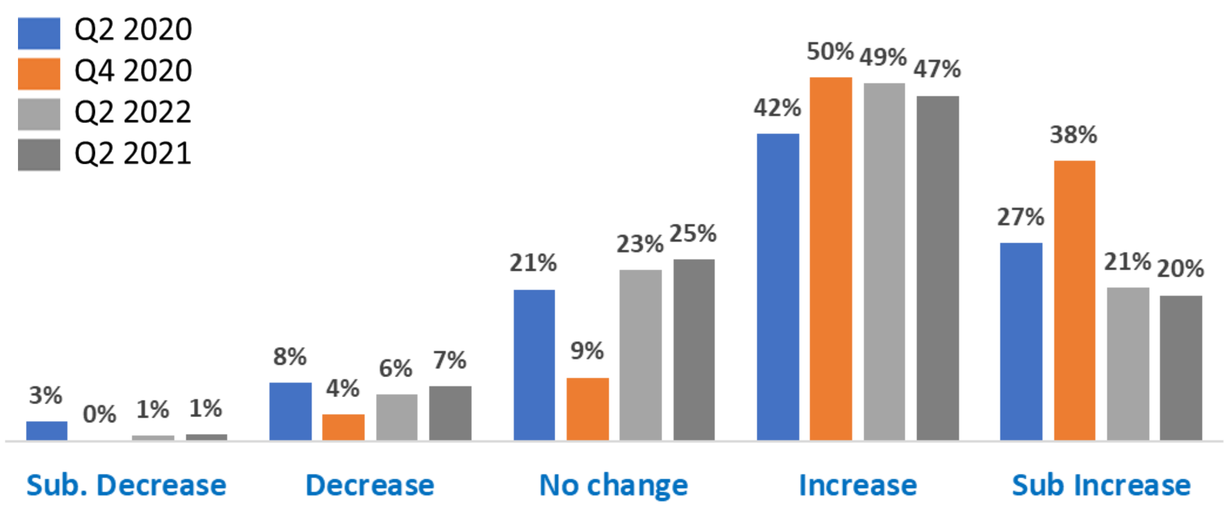

Figure 3. UK RSI: 1-year RSI trends for individual risk types

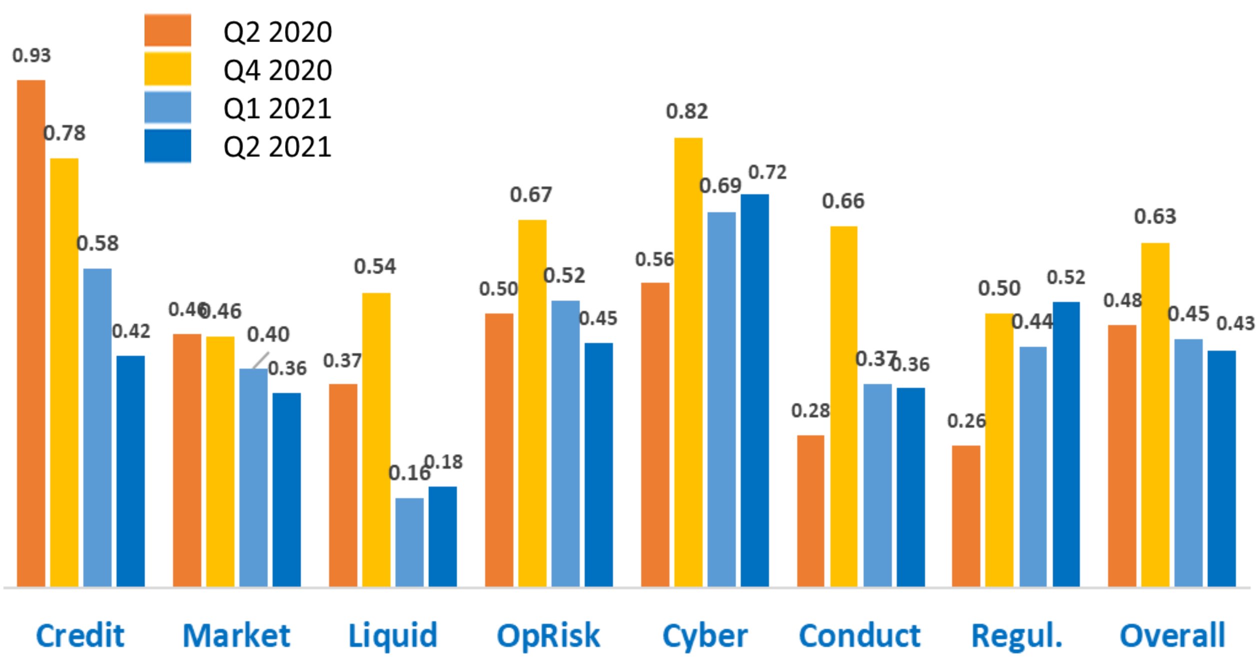

Figure 4. UK RSI: Comparison of RSIs for different risk types in Q2 2021