

**Getting
Sustainability Risks
onto Management's
Agenda**

**Moving from
Theory to
Opportunity**

Future Leaders Team 2013





Effective risk identification and appropriate risk responses are vital to the sustainability of any organization. However, the identification and management of sustainability risks remains a major challenge for many businesses. This brochure discusses how sustainability risks can be assessed in an effective and practical way, and gives insight into theoretical approaches as well as best practices from the companies represented in the Future Leaders Team (FLT) 2013, convened by the World Business Council for Sustainable Development (WBCSD).

The challenge: assigning monetary values to sustainability risk

Sustainability is on the agenda of many companies with varying degrees of engagement. Even for those that have strong sustainability policies and strategies, sustainability risks are often not included within companies' Enterprise Risk Management (ERM) systems. Furthermore, few risks are disclosed in the risk factors even when large sustainability reports are being issued by a company.

Why is this happening? Anecdotal evidence suggests that this is mainly driven by the complexity of a business to understand, identify and prioritize such risks in the ERM process, given that it has a bias for short-term risks linked to strategic objectives of one to two years.

Discussions with some companies have shown that it is relatively easy to identify sustainability risks (e.g., economic, environmental or social) that might have a financial impact on the business. However, risk managers as well as sustainability experts are struggling to quantify such risks in a meaningful way that allows for business leaders to allocate resources. The absence of standardized approaches hampers this further.


To allow capital providers such as shareholders or banks to make informed decisions on capital allocations, they need accurate, timely and reliable information. In addition, other stakeholders are becoming more demanding on holding companies accountable for their impacts on environmental and societal capital, furthering the need for adequate disclosure on risks.

In some jurisdictions, there are also regulatory obligations to disclose sustainability risks, such as risks associated with climate change in the United States. A recent report by ISS Corporate Services¹ analyzed disclosures by the 100 largest public companies from the US, and found that just 51 made any reference to climate change in their 2009 10K filings². Only 22 discussed climate change opportunities, and only 24 addressed physical risks to their assets from climate change.

In the absence of a universal standard, some companies have developed their own approach to quantifying sustainability risks by developing methodologies and models that assign a monetary value to human capital, or modeling the stock market price impacts linked to sustainability events that have attracted a negative reaction.

By embedding sustainability into ERM systems, companies increase the effectiveness of their overall risk management, as risks are looked

at with a broader view. Traditional concepts to risk management hardly cover all risks, especially social and environmental ones, and consequently do not meet the expectations of respective stakeholders. A risk management approach that also includes sustainability indicators provides management with a better and more complete view of the company's exposures.



“Neglecting uncertainty is problematic, because it allocates all risk-related costs to future generations, which contradicts the main tenet of sustainable development.”

Frank C. Krysiak
Professor University of Basel

The FLT 2013 working group compared company-specific approaches to sustainability risk management and identified that some approaches could be classified as “best-practices” and could be adopted by other companies to help create a standard in this area.

Traditional risk assessment methods have a bias for monetizing risk since this is the accepted language of corporate reporting and investment analysis. However, embedding sustainability into business models and strategies has also been recognized as means to differentiate companies and create value.

The traditional calculation for defining risk has been to multiply the financial impact of an event by the probability of its occurrence. Sustainability risks by their nature are perceived to have a long lead-time and are difficult to anticipate. Thus, current risk assessment methods may not be suitable to assess the estimated value at risk.

1. As cited by CERES in “Disclosing Climate Risks & Opportunities in SEC Filings”.

2. A 10-K filing is a comprehensive summary report of a company's performance that must be submitted annually to the U.S. Securities and Exchange Commission.

The limitations of conventional risk models

ERM provides important benefits, but limitations exist. For example, it is dependent on human judgment (i.e., prone to human error that can lead to inadequate responses) and can therefore contribute to ill-informed decision making.

Even if risk is acknowledged, controls can be circumvented by collusion of two or more people, and management has the ability to override ERM decisions. This is particularly the case when the analysis of likelihood is used to determine the remoteness of a catastrophic issue in order to avoid having to invest in management strategies. The end result is that these limitations preclude a board and management from having absolute assurance that the company will achieve its objectives.

Conventional risk methods focus on risks that can be financially quantified such as rebuilding of a facility, or legal costs due to improper business behavior. However, they rarely focus on risks concerning brand valuation or human rights and if they do so, it is from a qualitative perspective. These risks are more difficult

to financially quantify and many companies are struggling to find ways to overcome this challenge. In addition, most risk models exclude the potential for extreme events as they are deemed improbable.

By embedding sustainability into ERM systems, companies can increase the effectiveness of their overall risk management processes by capturing and prioritizing risks through a wider lens.

“Never in all history have we harnessed such formidable technology. Every scientific advancement known to man has been incorporated into its design. The operational controls are sound and foolproof.”

E.J. Smith
Captain of the Titanic

The Committee of Sponsoring Organizations (COSO) ERM framework is a good starting point for companies to design and build their risk management process. COSO’s framework provides insight into the key risks businesses are exposed to, which can direct management’s attention towards the development of a risk response (e.g., innovation, avoidance, transference, management or tolerance), as well as establishing ongoing monitoring of these uncertainties.



One theory put forward in the book *“Surviving & Thriving in Uncertainty”*, by Rick Funston and Stephen Wagner, is that companies need to use unconventional methods to assess risks including sustainability risks. They argue that resilient companies are those that understand and appreciate the worst case scenario that their business faces on the basis that the improbable can and does happen, sometimes with little warning. Tools have been developed to assist companies to perform scenario planning so they can be ready to react should an extreme event occur.

It can also be argued that companies within the same industry may face similar risks and challenges particularly with regard to resource access, human capital and attracting talent, safety and industry specific regulations. The ability to measure, manage and take action on sustainability risks may be used as an opportunity to create a competitive advantage.

What we did

To assess the current state of ERM and gather examples of best practices connecting sustainability and ERM, 13 WBCSD member companies took part in this study.

A variety of industries including oil and gas, building materials, chemicals, tires, agriculture, mining, metals, power and automation technology, were encompassed in this research.

Questions were asked to determine if:

- Sustainability issues are part of their ERM process;
- Sustainability risks are identified and connected to the company's overall risk assessment;

- Projects are evaluated for sustainability events, and;
- Sustainability events have an important weight on the overall project evaluation.

Questions were also included in the study that would give insight into how companies deal with long-term, low-risk sustainability or emerging issues, and how these all are connected to the company's overall business and financial metrics.

What we found

All companies in our sample agreed that sustainability risks have the power to halt, delay, restrict and affect the approval of projects but many companies differentiate in how sustainability risks are treated.

When companies were asked to comment on the frequency and level of management review of sustainability risks, responses varied from monthly to annually, and from project teams to boards of directors. Additionally, the level of identification of sustainability risks differed. For example, some companies leave it up to project and business unit levels (i.e., bottom-up approach) and some companies have a corporate directive (i.e., top-down approach). Although companies aim to properly manage risks, not all companies set metrics for sustainability measures nor do they include all sustainability categories in their risk assessment processes (i.e., environmental risks are considered more often than social risks).

Depending on the size, complexity and financial strength of the company, financial thresholds for considering sustainability risks are applied

uniformly or just for significant projects that exceed a certain investment threshold. Although data may be collected, not all companies perform a review or audit to ensure assumptions regarding sustainability risks were correct and adjusted accordingly. In addition, companies find it difficult to assign a monetized value to certain sustainability risks and therefore often omit such risks.

Finally, we noted that there is no global consistency in how companies categorize sustainability issues. Some companies review economic, environmental and social issues separately and others do it in an aggregated form (including all of them into one overall ERM system).



Best practices

Examples of best practices and excellence were found in all companies surveyed, although no company had all best practices fully implemented across the entire ERM process.

There was a common theme that sustainability risks should not be treated differently than other risks. Once identified, sustainability risks have to be measured and mitigated. In addition, ERM processes should be updated periodically to consider new trends, emerging issues and stakeholder concerns.

The most advanced risk management processes are those that proactively assess the following sustainability risks prior, during and after a project is completed: financial, legal, social, reputational, environmental and safety & health. Some companies routinely evaluate geo-political, economic and technological risks, and others also assess potential and strategic impacts and assign weights to each component to calculate an overall risk rating.

Another best practice trend observed is when the management of sustainability risks is tied to financial compensation for employees.

“Environment, social and governance risks are inherently significant to our company and 20% of variable compensation is tied to environment, health and safety performance.”

A WBCSD member company

Additionally, some companies are incorporating sustainability metrics in supplier qualifications and in business development practices.



Conclusions & Recommendations

By combining the results from the literature review, interviews with risk management experts and the feedback of 13 WBCSD member companies, the following key conclusions can be drawn:

- It is difficult for companies to assign a probability to certain sustainability risks, especially those that are more difficult to articulate (e.g., social risks, risks linked to human rights) as it is often unclear how certain circumstances may develop;
- Companies experience problems assigning a monetary value to certain sustainability risks as they do not have full insight into their value chain to estimate the entire financial impact if a respective risk occurs;
- There are many valuation and assessment methods available. Consequently, companies often have problems in finding the approach that best fits their requirements.

One key recommendation from the FLT 2013 working group is for risk managers and corporate sustainability experts to develop adequate methods that capture the respective needs of the individual company and its sustainability exposures. At the same time, a merger with conventional valuation methods, such as a discounted cash flow model to monetize sustainability risks, should be explored.

As best practices show, some companies have developed their own methodologies to overcome some of the limitations in standard approaches. It was also observed that some companies have developed their own method of adapting already-existing approaches, whilst other companies have created a completely new risk assessment approach which is tailored to their individual requirements. Such an approach could be risk assessment through scenario analysis.

It is recommended that companies develop analyses and tools to support their risk management approach. This can be done alone or in collaboration with other companies. Organizations such as the WBCSD can act as a catalyst by arranging respective project groups or work streams.

Furthermore, companies need to change their thinking with regards to risk assessment. Companies need to review the whole value chain since there are major sustainability risks at the beginning or at the end of the value chain which may have an indirect but material impact on the company. Therefore, risk assessment should try to cover all possible areas of events to identify the most critical elements for the survival and performance of the company.

It is also critical that companies do not become blasé about excluding material impacts on the basis of their unlikelihood. It is prudent to estimate the vulnerability and resilience a business has to all scenarios including remote worst-case scenarios and how quickly they can occur. For all identified risks, including those that cannot be measured by probability, as they are classified as uncertain, risk managers have to assess scenarios on how bad can it get and how fast can it get bad.

In summary

Incorporating sustainability risks into risk management processes is becoming a strategic topic for management and boards of directors. By understanding and developing an appropriate response to sustainability risks, companies are able to gain a holistic and transparent view of their exposures and opportunities. These are also likely to be the companies that are able to cope with related challenges in a structured, cost-effective and efficient manner. Last but not least, such companies will most probably be in a better position to create business opportunities and gain competitive advantage.

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The World Business Council for Sustainable Development is a CEO-led organization of forward-thinking companies that galvanizes the global business community to create a sustainable future for business, society and the environment. Together with its members, the Council applies its respected thought leadership and effective advocacy to generate constructive solutions and take shared action. Leveraging its strong relationships with stakeholders as the leading advocate for business, the Council helps drive debate and policy change in favor of sustainable development solutions.

The WBCSD provides a forum for its 200 member companies – which represent all business sectors, all continents and combined revenue of more than US\$ 7 trillion – to share best practices on sustainable development issues and to develop innovative tools that change the status quo. The Council also benefits from a network of 60 national and regional business councils and partner organizations, a majority of which are based in developing countries.

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