



The Case For Integrating Sustainability And Risk Management

*Why Sustainability Must be a Priority for
Corporate Risk Managers*

October 2009

Prepared by

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Introduction

It is impossible to pick up a newspaper or magazine in any city and not see an article concerning corporate sustainability. From the volume of print devoted to the topic it is clear that something is happening in corporations around the world. The drive for sustainable performance has also put pressure on executives to do more and to disclose more about the relationships between the corporations they lead and stakeholders regarding responsible behavior. For risk managers, sustainability presents both challenges and opportunities. New areas of risk greatly expand their responsibilities, however, the lack of traditional solutions in some emerging risk areas will require risk managers to develop new approaches involving non-insurance strategies.

Sustainability embraces a wide range of issues, from renewable resources to social and employment practices. Understandably, many firms find addressing this broad set of issues challenging. Questions such as how to reconcile long-term with short-term goals, global expansion with local objectives, workplace and community issues, must be answered while not losing sight of the basic goals of profitable operations and increasing shareholder value.

Organizations that are looking at the broader risk management implications of sustainability are reconsidering their approaches to address intangible and long-term risks as well as more traditional tangible risks. Leading corporations that have implemented formal sustainability programs are embracing these concepts as a part of their overall business strategies, and are developing new techniques to address emerging risks associated with sustainability issues.

Sustainability and the Triple Bottom Line

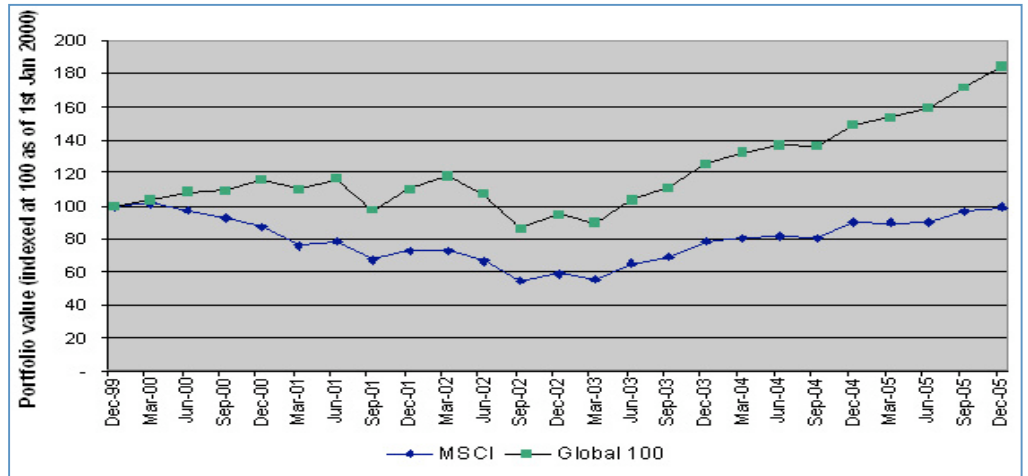
While sustainability is a relatively new concern to corporate executives, the fundamental concepts go back more than 20 years. An often-cited definition came from a 1987 U.N. Conference: "**Sustainable development** is development that meets the needs of the present without compromising the ability of future generations to meet their own needs." British economist John Elkington added the concept of the "triple bottom line", asserting that sustainability has to be measured in terms of the economic, environmental, and social performance of an organization. The three dimensions of the triple bottom line broaden the reach of sustainability to include factors such as the development of a strong brand and reputation, being an employer of choice, engendering the trust of financial markets, increasing shareholder value, and developing new products and services that drive markets. The risk management implications of addressing non-traditional areas is clear – risk managers must now be able to identify, assess and address risks they have not been responsible for in the past. To do so, they will need new analytical tests and new responses to address emerging risks. Risk advisors must also develop new resources to meet the needs of their corporate clients as sustainability concepts become embedded in everyday activities.

Why Corporations Care about Sustainability

For many corporate executives, sustainability is viewed as a means for survival of the enterprise as well as the planet. Enlightened executives also point to sound business justifications for a focus on sustainability as a long-term corporate strategy. Chief

among these is the growing evidence that sustainability can significantly improve corporate performance, with the growth in market capitalization of sustainable corporations outperforming entities with no formal programs by as much as 80% over the past six years.

Comparison of Performance of Sustainable and Non-Sustainable Entities (2000 to 2006)



MSCI – World Index of Global Developed Market Equity Performance

Global 100 Performance of 100 Top Sustainable Corporations (Davos World Economic Forum)

One of the reasons for the superior performance of sustainable corporations lies in the shifting balance between tangible and intangible assets within modern business organizations. Historically, the vast majority of a firm’s value was represented by physical asset value. Brand recognition, reputation, productivity, innovation and other intangible factors did not show up anywhere on the balance sheet. Today, that pattern is reversed for many firms, with intangible assets being regarded as primary determinants of present as well as future corporate value. Risk managers must be aware that intangible factors associated with sustainability tend to be more affected by external pressures, from governments, activist groups, investors and customers than is the case with tangible assets. Many of the risks associated with intangible assets are not fully insurable. This makes sustainability issues challenging for risk managers who are being asked to expand the scope of their activities to include emerging risk areas as well as those that have traditionally been insured.

For example, risk managers may be asked to develop techniques that protect brand value and reputation, neither of which are risks that are insured by currently available policies. The challenge is to identify and implement alternative risk management strategies to address such risks. Part of the risk may be addressed by existing insurance policies such as those written for product recall. Existing policies will have to be expanded or supplemented by new forms of insurance and non-insurance techniques to address the broader risks of sustainability.

Consumer pressure may be the most direct driver of change in business priorities today. Media coverage of global warming, rising energy costs, credit market fluctuations and product recalls indicate that customers’ perceptions have changed

substantially. Information (good news or bad news) is instantaneously available to the entire customer base and to other stakeholders. To address urgent risks, risk managers must be involved in corporate communications. This may include having plans to counteract bad news through accurate and complete information. Corporations must be prepared to discuss and defend their activities and decisions.

In business-to-business transactions, “customers” are increasingly mandating that their suppliers have a formal sustainability program in place as a condition of doing business with them. For example, Wal-Mart has recently announced a program to measure the amount of energy used to manufacture and distribute some of its products. While it is not clear that the retailer will cut off suppliers that do not measure up to its energy saving criteria, it is an obvious possibility with this type of initiative. Risk managers must be prepared to advise executives on supply chain issues and assist in the development of strategies to make certain that the corporation is in compliance with customer requirements that assure continuity of business relationships.

Implementing a Risk Management Strategy as Part of the Sustainability Program

Among the most significant challenges in implementing a sustainability program are identifying significant issues and establishing priorities for the deployment of scarce resources. Since both the risks and opportunities of emerging sustainability issues are influenced by long-term trends such as changing demographics, changing climate patterns, emergence of newly industrialized economies and innovation, risk management programs must operate over longer time-frames than have been customary in the past, and they must have the flexibility to address broader categories of risk. The valuation of corporate (and risk management) performance by a disparate network of stakeholders also adds a new dimension of concern to those associated with traditional reviews involving financial results. Risk managers must develop new sources of information and new ways of communicating the results of their work as they respond to these challenges.

The first step is to understand the risks to be managed. A starting point might be to divide all risks into categories such as those risks that are associated with sudden events and those that are more likely to arise out of long-term activities and operations since each requires a different pattern of response. Catastrophic environmental incidents such as Chernobyl, Bhopal and the grounding of the Exxon Valdez in Prince William Sound have horrified the world, causing irreparable damage to the environment as well as to the reputations of the firms involved. Such sudden events are not restricted to chemical, oil or energy sector industries. The series of anthrax attacks that took place in the USA in 2001, outbreaks of SARS across Europe and Asia, lead paint in toys, tainted pet food, and unexpected large losses in the sub-prime credit market share many of the same characteristics and demand similar risk management responses.

Obviously the best way to deal with a sudden event is to prevent it from happening. Risk managers and operational teams do a great job every day in conducting the vast majority of their operations and activities in a safe and environmentally sound manner. But you also need to plan for the single catastrophic event that occurs in spite of taking all reasonable precautions.

Emergency response and crisis management plans are essential to ensure that the organization is prepared for catastrophic events, rather than simply reacting as they unfold, but even well designed programs may not be set up to address the interests of the wider stakeholder network. With the level of scrutiny of corporate responses to events being higher than ever, the implementation and execution of emergency response plans needs to be flawless. Managing the reputational aspects of an incident, and its impact on stakeholders both inside and outside the organization, is crucial to sustaining profitable operations and recovery of pre-incident performance levels. Risk managers must be able to address these new corporate risks with traditional and non-traditional responses to emergency situations.

There are a number of long-term trends related to sustainability that must be addressed in risk management programs, and may not be insurable in currently available property and casualty policies. Some of the most important of these are climate change, worldwide water shortages, the growing demand for energy, environmental management, reputation, and internal and external social issues. While a discussion of all of these factors is not possible in this brief report, global warming and energy demand will be reviewed to provide examples of how these long-term issues affect risk managers in the sustainable corporation.

Global Warming

After years of debate, scientists now agree that we are experiencing a pattern of global warming. There is, however, still considerable uncertainty about the level of warming that is likely to occur, the effectiveness of human measures to reverse this trend, and whether we will reach a tipping point beyond which the rise in temperature will accelerate and the effects become irreversible. Regardless of these uncertainties, there has been a global call to action to address climate change.

Scientists have suggested these climate changes are connected with accumulations of greenhouse gases (GHGs) in the Earth's atmosphere. Emitters of carbon dioxide (CO₂) and other GHGs are under increasing pressure to reduce airborne emissions. If they are forced to do this, they are likely to incur significant costs for modifications or replacement of existing equipment. They also may face long term risks of liability for the effects of global warming. Risk managers must be working now to understand their current exposures to global warming risks while also developing long-term risk management strategies to address climate change. They should also assist their corporations to identify and address risks associated with new business opportunities developed as a result of the climate change phenomenon.

Energy Supply and Demand

Energy demand is projected to increase by 57% over the next 25 years, with most of the increase coming from India and China, areas that are heavily reliant on energy generated from fossil fuels. If global caps on the emission of greenhouse gases are enforced, meeting the growing demand for energy through the continued construction of coal-fired power plants will be difficult. Unfortunately the alternatives (nuclear, geothermal, hydroelectric and wind power) will take longer to build, cost at least 1/3 more, and create other environmental and sustainability risks. Companies that fail to recognize that energy costs will experience substantial increases may put their future financial performance at risk and expose executives to personal liability. Risk managers should develop strategies to address increased costs of energy and to

mitigate risks associated with energy and climate change transactions including the purchase or trading of carbon credits or offsets.

Coming to Grips with Sustainability

The challenge of embracing all these areas of risk (and opportunity) can be daunting, and many firms become overwhelmed in the early phases of the process. Corporations that are making progress start with a broad analysis of risks and quantify the potential impacts to give some order of magnitude to the resources that should be devoted to solving identified problem areas. Recognizing that you cannot do everything at one time, it is better to identify and address a smaller number of issues that really matter than to take on too many tasks and fail at all of them.

After a manageable group of critical risk factors (and opportunities) has been identified, action plans can be created to address the prioritized risks. These plans should consider all feasible risk alternatives, from prevention and mitigation to financing and risk transfer. It is often assumed that insurance cannot play a significant role in mitigating emerging sustainability risks. In reality insurance may be a useful tool in addressing both conventional as well as emerging areas of risk.

For example, environmental insurance policies have been available to address third-party claims and cleanup costs for releases of pollutants for more than thirty years, but they have not been purchased by most corporations in spite of pollution exclusions in virtually all commercial property and casualty policies over that same period of three decades. Now environmental policies are being used to develop creative solutions for risks from bioterrorism to legacy liabilities associated with past manufacturing of asbestos-containing products or careless handling and disposal of hazardous wastes. Similarly risk managers have identified other triple bottom line impacts that can be addressed by insurance which may allow corporations to meet their long-term financial, environmental and social responsibilities, as well as protecting themselves and their corporations against the risks of immediate loss.

The Bigger Picture

The approach discussed in this paper (risk identification and analysis followed by a systematic selection of cost-effective actions), has a lot in common with established risk management practices that have been used for decades. Risk managers also have many of the skills required to deal with sustainability risks, but they may lack experience in addressing the emerging risks associated with intangible assets and be unfamiliar with some long-term risk strategies that will be required to address sustainability issues.

Organizations that have embraced sustainability view it as an integral part of the business, but the programs have not come about by accident or random unplanned events. The board of directors and senior executives must take responsibility for driving the strategic agenda on sustainability and it must have one or more champions at strategic levels within the organization that can act at the direction of corporate leaders to implement the sustainability program. The seven steps outlined below can allow risk managers seeking to be involved in their companies' sustainability programs to take appropriate actions in all three areas of the triple bottom line:

- Know, understand and monitor the impact of your organization on its community and other stakeholders in terms of the economic, environmental and social factors that are critical to sustainability
- Involve people from all segments of your organization in the process of identifying emerging risks and opportunities driven by sustainability
- Anticipate the possible impacts of evolving issues, social and political trends and look for new market forces that are associated with these trends
- Engage and listen to a broad spectrum of stakeholders
- Make sustainability part of every discussion inside the company and with vendors and customers who are critical to future success.
- Communicate powerfully, especially about successes and new opportunities
- Accept that this is a developing area of knowledge – stay current and be prepared for change. Seek out thought leaders on important topics

Conclusion

Addressing sustainability issues has a great deal in common with established risk management practices, and many of the techniques developed to identify and address risks in other areas of corporate activity are directly applicable to the emerging issues of sustainability as well. One of the most significant challenges is that these techniques must now be applied to new areas of risk, some of which have very long-term impacts. In these areas, risk managers may have less experience and lack the types of data that are commonly associated with traditional areas of insurable risk. Risk managers are used to dealing with uncertainty. The difference in this case is the degree of uncertainty, and the scale of the risks that flow from it. There can be no greater challenge or more significant opportunity than being at the forefront as your company embraces its sustainable future.