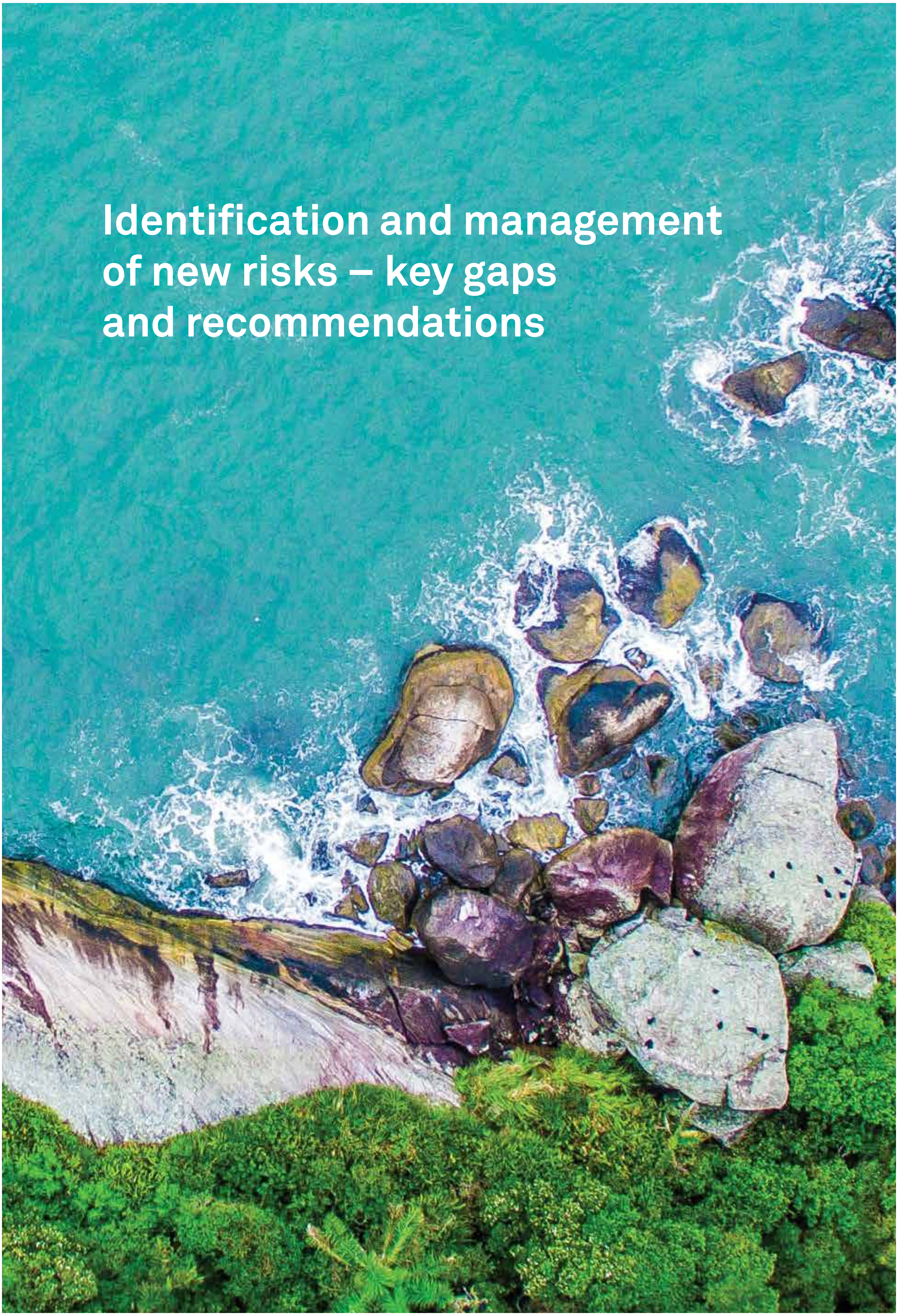
Identification and management of new risks – key gaps and recommendations



Are corporates prepared for disruptive risks?

Traditionally, and even more so since the 2007-08 financial crisis, effective risk management has focused on developing and implementing internal control processes to comply with existing regulations. However, while considered necessary, managing risks from a compliance perspective has been shown to be far from sufficient for managing larger unexpected events triggered by external factors.

S&P Global's Corporate Sustainability Assessment (CSA) asks questions about emerging risks, risk culture, and risk governance. This article analyzes companies reporting on emerging risks and shows how a strong risk culture can arm companies with useful tools to both identify and prepare for these events. Our Media and Stakeholder Analysis (MSA) then considers the relationship between a company's risk culture and the probability of it being subject to controversies. Finally, the external contributions of RepRisk[1] and Tilman & Company[2] provide two compelling perspectives on the topic: (1) Why is the role of ESG risk due diligence essential to identify disruptive risk events from an investor point of view?, and (2) How can leaders successfully navigate a volatile and unpredictable environment occasioned by the occurrence of such disruptive risk events?

While the COVID-19 pandemic is considered a disruptive emerging risk, it has generated a new environment that amplifies current known risks and creates related new emerging risks. According to the World Economic Forum's (WEF) COVID-19 outlook[3], the most worrisome risks for businesses linked to the COVID-19 crisis are a prolonged global recession, a surge in bankruptcies, and a wave of consolidation, cyberattacks, and data fraud due to a sustained shift in working patterns.

The current health crisis is placing companies in a position they have never experienced before and reinforcing the need for effective risk management practices. The analysis of the CSA data provides insights on how prepared companies are for current and future disruptive risk events.

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[2] A strategic advisory firm that helps companies and investors effectively navigate disruption and uncertainty; an independent firm not affiliated with S&P Global or any of its divisions; http://lmtilman.com/.

[3] "COVID-19 Risks Outlook: A Preliminary Mapping and Its implications", WEF, May 2020, www3.weforum.org/docs/WEF_COVID_19_Risks_Outlook_Special_Edition_Pages.pdf.

The current health crisis is placing companies in a position they have never experienced before and reinforcing the need for effective risk management practices.

Identifying emerging risks remains a substantial challenge

The current global health crisis has undeniably confirmed that complying with existing risk regulations and standards is not equipping companies well enough with useful tools to cope with external risk events, such as a global pandemic. To consider such events within a risk management approach requires that they be defined. While most businesses are usually good at defining and managing material risks – those that pose clear and present danger – the identification of new and emerging external risks is still underdeveloped. External risks that are beyond the control of businesses are often considered unlikely to occur in the near future and, although their impact may be viewed as significant, they are frequently ignored or remain unreported. This is because they compete for the same capabilities and resources that immediate risks have already started to draw upon.

With the objective of demonstrating why the identification of global risks, such as a pandemic, is still unsatisfactory, we have categorized risks into three distinct categories, which require different methods of identification and management: internal risks, strategic risks, and external risks.

Internal risks that originate from within an organization include unlawful or unethical behaviors or failure in operational processes. Such risks are easily identifiable, and an organization can often avoid or eliminate them by implementing traditional internal control processes and compliance mechanisms.

Strategy risks are ones that a business intentionally accepts in order to potentially generate higher returns. Such risks are easily identifiable and can be managed with the help of a risk management framework that enables a business to define tolerance levels and reduce the likelihood that the risk materializes.

External risks arise from events outside an organization and are typically beyond a company's control. They include natural disasters and geopolitical and macroeconomic shifts. A company cannot prevent such risks from occurring and, consequently, needs to focus on the identification of such risks and related mitigating measures.

This is precisely the focus of the CSA question on "emerging risks". Introduced in 2015, this question focuses on external risks, characterized as distant threats that may cause damage to a company in the long term. Emerging risks may not be quantifiable and may contain a high degree of uncertainty. They are unlikely to have any significant impact on a company's operations or profitability for the next three to five years but, potentially, may have begun to impact the company today.

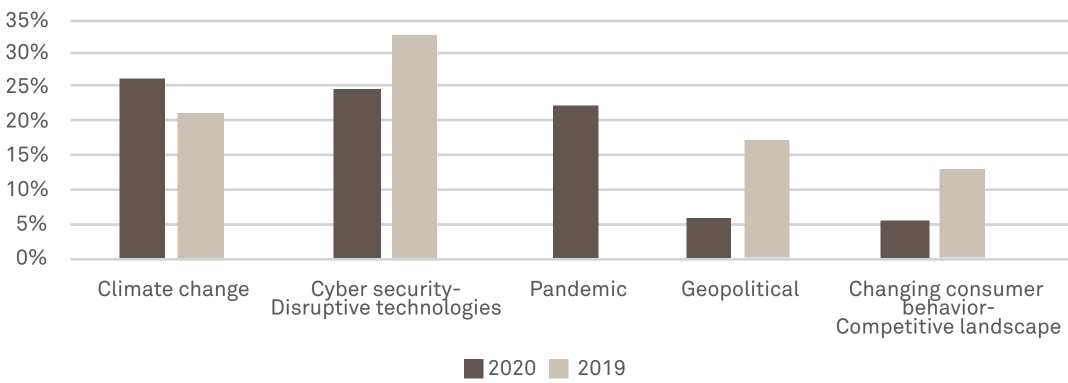
In order to more precisely define how companies are expected to respond to the CSA question, the following criteria have been outlined to characterize an emerging risk. The risk:

– Has to be new or increasing in significance.
– Has to be long term, i.e., its potential impact on a company's business should span more than three years.
– Needs to potentially have a significant impact on a company, requiring it to adapt its strategy and business model.
– Needs to be an external risk stemming from, for example, natural, geopolitical, technological, societal, and/or macroeconomic factors.
– Should be specific, impacting a company, as opposed to an entire industry.

"While nearly all companies named COVID-19 as a major preoccupation in their 2019 reporting, only a few have been able to describe it as a long-term risk with potential long-term impacts on their business."

By means of these criteria, we have reviewed the emerging risk categories reported by companies in the CSA. Climate change and technology remain the two most frequently cited emerging risks categories in 2020, representing 26%, respectively 25%, of all emerging risks fulfilling the criteria listed above. Figure 1 below displays the emerging risk categories most frequently mentioned by companies.

Figure 1: Emerging Risk Categories



Source: CSA Survey Results, as of November 23, 2020, S&P Global, for illustrative purposes only.

While most companies report risks that they consider to be emerging, only 12% were able to present at least one emerging risk that fulfilled the criteria listed above. This, unfortunately, illustrates the fact that a large majority of companies mainly focus on risks that have already materialized, and struggle to appropriately identify and describe external emerging risks that might have a significant impact on their business in the long term.

The fact that no company in the CSA mentioned pandemic as an emerging risk in 2019 illustrates that, until a risk materializes, a company is unlikely to consider it as an emerging risk and describe its potential long-term impact.

Interestingly, pandemic appears as a new emerging risk category in 2020. While nearly all companies named COVID-19 as a major preoccupation in their 2019 reporting, only a few have been able to describe it as a long-term risk with potential long-term impacts on their business using, for example, tools such as a scenario analysis to evaluate possible future situations.

The fact that no company in the CSA mentioned pandemic as an emerging risk in 2019 illustrates that, until a risk materializes, a company is unlikely to consider it as an emerging risk and describe its potential long-term impact. Such emerging risks are usually not disclosed in traditional financial reporting, or cited as part of a long list of external factors that might impact a company's performance. However, in line with the increased expectations on companies related to sustainability disclosure, there is a growing demand from investors for companies to identify emerging risks early on and report on such topics as part of a holistic risk management approach.

In line with these findings, the U.S. Securities and Exchange Commission (SEC) is currently pushing for better disclosure of risks related to COVID-19. It recognizes that it may be difficult to assess or predict the effects of COVID-19 on individual companies, and that the actual impact will depend on many factors beyond a company's control. It stresses, however, that the effects COVID-19 has on a company, what management expects its future impact will be, how management is responding to evolving events, and how it is planning for COVID-19-related uncertainties can be material to investment and voting decisions.[4]

[4] "Coronavirus (COVID-19)", SEC, March 25, 2020, www.sec.gov/corpfin/coronavirus-covid-19.

An effective risk culture facilitates the identification of emerging risks

The early identification of emerging risks enables companies to be better prepared for their materialization. A number of elements may facilitate this early identification, including: detailed scenario analysis for non-traditional external risk events, frequent communication with internal and external stakeholders, an improved tracking of frequent (but small) operational failures, and a strong risk culture. The latter element is the focus of this section.

> The early identification of emerging risks enables companies to be better prepared for their materialization.

While an effective risk management structure focusing on compliance and the implementation of risk control mechanisms is essential, several high-profile disasters, such as the Tepco's Fukushima nuclear catastrophe[5], have demonstrated the need for a strong risk culture throughout an organization. This can help underscore the importance of risk for all employees and that risks should be reported directly to the highest governing body of a company.

According to R.S Kaplan and A. Mikes[6], having a broad risk management function independent from strategy but reporting directly to the board is what differentiated the banks that survived the 2008-2009 financial crisis from those that failed. "The failed companies had relegated risk management to a compliance function; their risk managers had limited access to senior management and their boards of directors. Further, executives routinely ignored risk managers' warnings about highly-leveraged and concentrated positions. By contrast, Goldman Sachs and JPMorgan Chase, two firms that weathered the financial crisis well, had strong internal risk management functions and leadership teams that understood and managed the companies' multiple risk exposures."

in line with this finding, we analyzed the responses received for the CSA question "risk governance". This question identifies whether the highest-ranking person with dedicated risk management responsibility on an operational level is either reporting to the executive committee or to the board of directors. With only 51% of companies having a direct reporting line to the highest governing body of the company, the conditions necessary to avoid large disasters appear to be unmet.

In addition to having a strong risk management function reporting directly to the highest governing body, the following elements are essential for a strong risk culture:

- Clear directions from the board of directors and senior management related to risk identification and management.
- Clear accountability and ownership for specific risks at all levels.
- Transparent and clear communication throughout the organization, including group-wide risk training.
- Measures to enable all employees to report potential risks and incidents.
- Rewards for appropriate risk behaviors and sanctions for inappropriate behaviors.
- Inclusion of a diversity of perspectives and values to show that new, unconventional ideas and opinions are considered.

[5] "Fukushima Daiichi Accident", World Nuclear Association, May 2020, www.world-nuclear.org/information-library/safety-and-security/safety-of-plants/fukushima-daiichi-accident.aspx.

[6] "Managing Risks: A New Framework", R. and A Mikes, Harvard Business Review, June 2012, https://hbr.org/2012/06/managing-risks-a-new-framework.

The CSA question "risk culture" encompasses most of the above elements, as displayed in Table 1 below. The figures indicate the percentage of companies that apply each of the elements included in the risk culture question. The results are divided into two categories: The first category contains all companies assessed in the 2020 CSA as of November 2020, including those that actively participated in the CSA survey and those that did not actively participate and were assessed based on public information only. The second category includes only companies that actively participated in the CSA survey.

Table 1: Companies Applying Risk Culture Elements

	Structured feedback process on risk management practices	Inclusion of risk criteria in human resources review	Risk metrics in financial incentives	Risk metrics in financial incentives for senior management	Inclusion of risk criteria in product development	Group-wide risk training	Whistleblowing mechanisms
2020- All companies	22%	18%	16%	20%	25%	26%	27%
2020- participating companies[7]	55%	41%	38%	43%	59%	61%	66%

Source: CSA Survey Results, as of as of November 23, 2020, S&P Global, for illustrative purposes only.

It appears that companies find it most difficult to incentivize employees to make the right decisions about risks. Risk culture elements that are the least frequently implemented are the inclusion of risk metrics in financial incentives for line managers and the inclusion of risk criteria in the human resources review. In contrast, group-wide risk training and the implementation of measures to report incidents are applied most often. Companies are more inclined to have policies and processes in place, but struggle to implement incentives to make sure that those policies and processes are applied.

In order to demonstrate that a weak risk culture is a major obstacle for companies to identify emerging risks and adequately manage them once they materialize, we have examined the relationship between an effective risk culture, evaluated through the CSA score for the question risk culture, and the ability of companies to identify emerging risks.

Table 2: Risk Culture Performance And Reporting Of Emerging Risks

Score for the risk culture question (out of 100)	Share of actively participating companies reporting at least one acceptable* emerging risk	Share of all companies reporting at least one emerging risk
> 80	43%	42%
between 1 and 79	19%	16%
0	8%	2%

***Acceptable means met our definition outlined earlier.**

Source: CSA Survey Results, as of as of November 23, 2020, S&P Global, for illustrative purposes only.

[7] The significant difference between the general results (2020 – All companies) and the results for participating companies (2020 – participating companies) can be explained by the fact that this question allows for private information, therefore giving an advantage to companies that actively participate in the CSA.

An effective risk culture enables better management of controversies

The final step of our analysis examines whether a strong risk culture, measured through the score for the risk culture question in the CSA, reduces the probability of a company being subject to controversial issues.

A strong risk culture enables companies to be better prepared for controversies and take appropriate timely measures to mitigate the impact of the controversy and avoid its reoccurrence in the future.

Controversial issues are realized risks that result in financial and reputational damage for companies. Our analysis of company controversies is carried out through the MSA. The MSA process is used to identify controversies and damages that are linked to poor corporate policies, structures, and practices on a range of sustainability issues. When an MSA case is created, it is linked to the criteria in which the company's policies, processes, or mechanisms failed, such as business ethics, corporate governance, human rights, environmental management, and/or risk and crisis management.

In 2020, 86 companies were subject to an MSA case that negatively impacted the criterion risk and crisis management, indicating that the controversy was linked to a failure in the risk management practices of the company. Table 3 below shows that, out of these 86 companies, 62% received a low score for the question risk culture. In addition, just under three quarters (72%) of all companies received a low score for the risk culture question. Contrary to our expectations, these figures indicate that companies with a low score for this question are less likely to have an MSA case related to their risk management practices. However, when comparing how a company reacted to an MSA case, measured by its ability to take appropriate measures once the case has occurred, a company with a high risk culture score is nearly three times more likely to take appropriate measures than a company with a low score.

We subsequently considered companies impacted by MSA cases that affected the criterion corporate governance on top of the risk and crisis management criterion, meaning that the highest decision body of the company was directly implicated in the wrongdoing of the company. Examples of such cases include the involvement of Japan Post Holdings in the sale of fraudulent insurance products, in which case the company's executives knew about the issue

Table 3: MSA Cases And Risk Culture Performance

Number of companies	... with low score for risk culture (< 40)	...with low score for risk culture and appropriate measures taken in response to an MSA case	... with high score for risk culture (>40)	... with high score for risk culture and appropriate measures taken in response to an MSA case
	All companies 2,459 (72%)			
86 companies with an MSA case impacting risk and crisis management only	53 (62%)	7of 53 (13%)	33 (38%)	13 of 33 (39%)
27 companies with an MSA case impacting risk and crisis management and corporate governance	20 (74%)	3 of 20 (15%)	7 (26%)	2 of 7 (29%)

Source: CSA Survey Results, as of November 23, 2020 S&P Global, for illustrative purposes only.

but failed to take action until a year later[8], or the accounting fraud and market manipulation that occurred by Wirecard and led to the company's bankruptcy and the arrest of the CEO[9]. The probability of such cases occurring is significantly higher for companies with a low score for risk culture, with 74% being affected compared to 62% for cases that only impacted the criterion risk and crisis management.

The results above illustrate that an MSA case that impacts the criterion risk and crisis management, but not corporate governance, might indicate an issue in the operational risk control procedures of the company. Such cases are less dependent on the risk culture of a company and more closely linked to risk compliance issues. However, when an MSA case impacts both risk and crisis management and corporate governance, meaning the board of directors and/or the CEO is involved in the controversy, a company is significantly more likely to be subject to such a case if it has a weak risk culture. This would indicate that there is not only a risk compliance issue, but a more profound problem related to the company's risk culture.

Companies will need to manage an increasing number of interconnected emerging risks and will have to rethink their risk culture.

In all cases though, the figures demonstrate that a strong risk culture enables companies to be better prepared for controversies and take appropriate timely measures to mitigate the impact of the controversy and avoid its reoccurrence in the future.

Conclusion and Outlook

The current unprecedented crisis is setting very high expectations for companies. It requires them to rethink their strategy, operations, and culture, with a particular focus on risk management practices.

With the help of the CSA data, this article analyzed whether the preconditions are being met to enable companies to face the impact of disruptive emerging risks. The data has first shown that companies are struggling to report on emerging risks. However, companies reporting on emerging risks is an essential source of information for investors who are paying increasing attention to such data in order to make investment decisions. As illustrated by Reprisk in the next section, a robust ESG dataset is key for investors to effectively manage risk and be better prepared for unforeseen risk events.

A strong risk culture facilitates the identification of emerging risks and companies' preparedness for the materialization of such distant threats. The CSA data has also revealed that a majority of companies still lack a strong risk culture. An effective and inclusive risk culture, with the top management rewarding employees for appropriate risk behaviors and empowering employees with diverse values to report potential risks, enables less traditional risks to be identified. It also supports more flexible responses to risk events. In the guest commentaries below, Leo Tilman gives more substance to this topic and explains how business leaders need to demonstrate agility to navigate through uncertain conditions.

According to the WEF's COVID-19 Risks Outlook, the current crisis offers a unique opportunity to shape a better world: "As economies restart, there is an opportunity to embed greater societal equality and sustainability into the recovery, accelerating rather than delaying progress towards the 2030 Sustainable Development Goals and unleashing a new era of prosperity".

The traditional global risks, such as climate change or technological disruptions, will not disappear. On the contrary, they have been amplified by the current pandemic. Companies will need to manage an increasing number of interconnected emerging risks and will have to rethink their culture to enable more agility, anticipation, and innovation to help fulfill their role in shaping a more sustainable future. ■

[8] "77 Japan Post workers rebuked for improper insurance sales", The Japan Times, April 28, 2020.

[9] "Wirecard, Reeling From Accounting Scandal, Files for Insolvency", The New York Times, June 25, 2020.

Guest Commentaries

Risk lies at the very heart of every ESG assessment. Like seasoned sailors, Leo Tilman and General Chuck Jacoby help us proactively navigate the unknown seas of radical disruption and uncertainty with a will to win the race. In turn, Alexandra Mihailescu Cichon shows us how to dexterously unmask the hidden risks associated with COVID-19 and the rise of the S in ESG for 2020. Read their guest commentaries below.

How Leaders Can Navigate the Unknown Deliberately and Decisively

Success Rests on the Ability to Penetrate Uncertainty and Dynamically Switch between Defense and Offense

Executive Summary

– Our organizations face an environment of radical disruption and uncertainty, as evidenced by the ongoing COVID pandemic, social change, dramatic shifts in the business and economic landscapes, and geopolitical conflict.

– To successfully navigate a volatile and unpredictable environment, defensive adaptations must give way to agility grounded in risk intelligence, preparedness, and the will to win.

– Uncertainty must be explicitly and proactively managed alongside financial, strategic, operational, and cybersecurity risks.

Overarching Action Items:

1. Appropriately resource the fight for risk intelligence and “what if, what next” preparedness – as spearheaded by senior leaders and involving entire organizations.

2. Aggregate risks and create contingency plans across a wide range of scenarios.

3. Assess the relevant areas of uncertainty spanning biosphere, geopolitics, economics, and technology; create contingency plans and action triggers.

4. Deepen the culture of honesty, empowerment, and trust, so that the entire organization can detect, assess, and respond to threats and opportunities in real time.

5. Address the gaps in capabilities and cultures necessary for strategic and tactical agility; embed new skills and mindsets into leadership development.

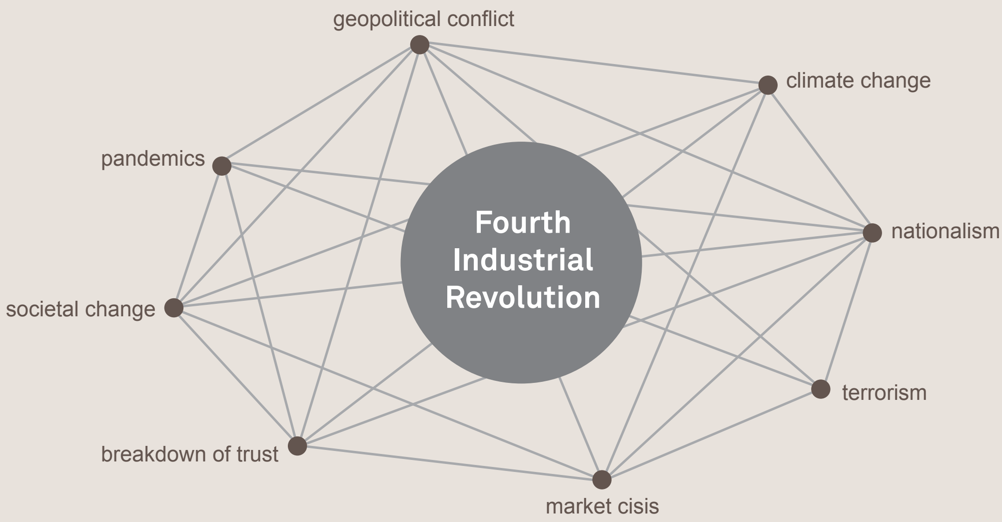
2020: Fog, Friction, and the Edge of Chaos

In addition to an enormous human and public health toll, the Covid-19 pandemic set off a global recession that encompassed a decline in global trade and business investment, massive job losses, disruption of production and supply chains, and plunging consumer sentiment and activity. This happened with unprecedented speed, as aggressive social distancing policies created simultaneous shocks to supply and demand. Historical comparisons date back to 1918 Flu Pandemic, the Great Depression, WWII, and the global financial crisis of 2008-09, but we have never seen something quite like this on a global scale before.

During the early stages of the pandemic, many predictions by government officials and business leaders painted an optimistic picture, forecasting a deep but fairly short recession followed by a quick "V-shape" recovery. As always, the problem with such forecasts and popular narratives is that they were based on limited empirical evidence and many assumptions about the future. Even more importantly, they failed to acknowledge the fundamental nature of dynamic competitive environments that, in the words of Carl von Clausewitz, are a realm of overarching fog (informational ambiguity) and friction (uncertainty and the role of chance).

At the start of the pandemic, we encouraged our clients to imagine the sheer scale and complexity of the following simultaneous endeavors: 1) managing the uncertain trajectory of the pandemic; 2) promulgating, adapting, and enforcing adherence to social distancing guidelines; 3) sequentially restarting the global economy and adjusting course, as new information arrives; 4) navigating the economic and financial fallout within and across national boundaries; and 5) preventing, or at least mitigating social unrest. All of this needed to be executed effectively, even though COVID-19 cures and vaccines would not be widely available for months, and a national

Figure 1: Global Operating Environment



Source: Tilman & Company, Inc, 2020

testing and disease surveillance systems for rapid diagnosis and isolation of newly infected people and their contacts were still in the early stages of development.

In other words, consistent agility was required from the public and private sectors working together to execute in a steady and even-handed manner, while overcoming unexpected challenges and capitalizing on emerging opportunities. The events that followed demonstrated significant limitations in capabilities, processes, cultures, and leadership practices of many players in the public and private sectors.

Takeaway: Effective navigation of environments such as this requires deep environmental knowledge and risk intelligence to enable governments, companies, and investors to detect and assess environmental shifts and signals in real time. The fog and friction of dynamic competitive environments must be explicitly taken into account.

Action Item: In today's world, senior leaders must resource and spearhead a concerted fight for risk intelligence. The entire organization must be primed with respect to the information vital for decision making. An environment where team members have the courage to bear bad news, question conventional wisdom, and voice dissent must be deliberately created and consistently nurtured.

Risk Assessment and Contingency Planning (Management of "Known Unknowns")

Some years ago, when we began working on our recent book, Agility, the attention of boards and executives was centered on the accelerating change and disruption of the Fourth Industrial revolution. We were convinced that an even broader lens was required. In addition to technological, business, and social trends, for example, we believed that a broader perspective and a deep understanding of the inherent nature of competitive environments must be explicitly reflected in how we define and operationalize the organizational capacity to effectively navigate disruption, exploit uncertainty, and stay on the offense.

For executives grappling with the near-term upheavals – all while maintaining a focus on longer-term threats and opportunities – the assessment and planning around measurable risks ("known unknowns") is an important first step. Organizations must systematically assess and aggregate financial, business, operational, and cybersecurity risks.

Takeaway: Due to overly optimistic forecasts regarding a quick recession and "V-shape recovery and as a matter of usual practices, companies and investors discovered that their planning and risk management processes focus on an overly narrow range of economic and market scenarios.

Action Items:

- Foster risk intelligence and preparedness by visualizing, assessing, and planning for a diverse set of scenarios, including those of extreme nature. For example, scenarios that we advocated to companies and investors at the start of the pandemic included:

- Prolonged economic recession and a gradual recovery. "The intractable task of restarting real economies amidst the pandemic will prove more complex than expected. Fog and friction may lead to new outbreaks, and other disruptions may deepen the recession and slow the recovery down."

- Defaults-driven financial crisis. "Despite aggressive actions by governments and central banks, a deep recession leads to a rise in credit defaults, triggering a systemic crisis."

- Stagflation. "Unprecedented actions by central banks avert a solvency crisis, but lead to a sharp rise in inflation. Economic weakness prevents central banks from raising interest rates."

- Financial ripple-effects. "Wide-spread forbearance of mortgage and student loan payments (and rents) creates significant ripple effects across the structured product markets, the balance sheets of financial institutions, and the portfolios of institutional investors. This has negative long-term impacts on credit cultures, financial markets, and economies."

Navigating Uncertainty is Different than Managing Risk

In Agility, we describe a fundamental difference between risk (measurable "known unknowns") and uncertainty (where future outcomes and their likelihoods are truly unknown). In the context of this pandemic, different types of uncertainties have arisen, not only affecting the path of the recession and the recovery, but also changing our lifestyles, professional practices, and beliefs on an unprecedented scale. In addition to assessing risk, areas of uncertainty that we discussed with our clients at the start of the pandemic included:

- Lasting psychological and behavioral impact on individuals and societies. Change in social norms (e.g., social distancing); consumer behaviors (e.g., e-commerce, education) and risk aversion (e.g., consumer spending, savings rates; business hiring and investment).

- The future of work and learning. Greater prevalence of remote work and learning significantly impacts corporate operations, cultures, and productivity. These changes have critical implications for technology, including infrastructure (e.g., broadband and cybersecurity); commercial real estate; higher education; and state and local finance.

- Fourth Industrial Revolution. The pandemic is impacting secular trends, such as e-commerce, digital finance, telemedicine, and jobs displacement by AI and robotization, accelerating some trends and changing the trajectory of others.

- Supply Chains. As the vulnerabilities of supply chains have become apparent, governments and companies fundamentally rethink the cost/resilience tradeoffs and the interdependencies/vulnerabilities created by globalization.

- Nationalism. The importance of the nation-state as an evolutionary unit is likely to increase, with strong implications for international trade and cooperation. In addition to supply chains, the emerging "vaccine nationalism" is a case in point.

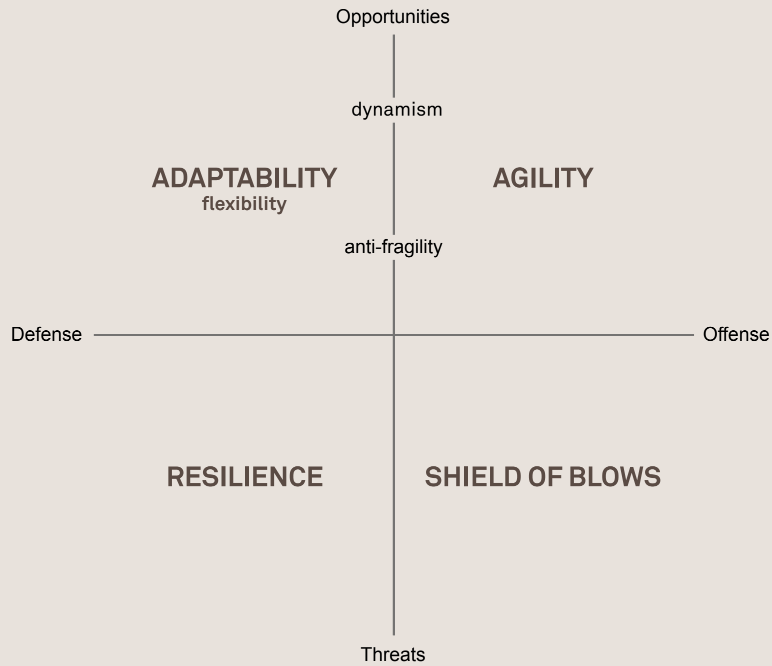
- Populism. The rise of populism is intensifying as the pandemic and the recession disproportionally hurt the disadvantaged, deepen inequality, and burden future generations by the sharp rise in national debts.

Importantly, our organizations are facing these risks and uncertainties in a geopolitical setting of persistent conflict. The volatility and unpredictability of operating environments is amplified by global actors aggressively vying for economic, geographical, and moral spheres of influence.

Takeaway: To be successful, companies and investors must learn how to assess and manage uncertainty systematically and proactively within strategy and ERM processes.

Action Item: Identify the areas of uncertainty – across the biosphere, geopolitics, economics, and technology – that may significantly affect the organization. Envision a wide range of future scenarios and assess the vulnerabilities, consequences, and potential actions – without assigning likelihoods to unknowable future events or excessively relying on predictions of the future. As an integral part of this process, senior leaders must be willing to iterate with their teams to identify assessment and planning priorities and define the triggers for defensive and offensive actions. The development of firm-wide thinking and awareness will foster agility by enhancing situational awareness and trust, recognizing change, and supporting decisive execution.

Figure 2: Agility: An Overarching Quality



Source: Tilman & Company, Inc, 2020

From Defensive Adaptation to Agility

In order to navigate a volatile and unpredictable environment successfully, defensive adaptations must give way to agility: the organizational capacity to effectively detect, assess, and respond to threats and opportunities in ways that are purposeful, decisive, and grounded in the will to win. This is what will allow our organizations to effectively navigate disruption, turn the environment into a critical supporter of their vision, and dominate events, instead of being dominated by them.

Leo Tilman

Founder and CEO
Tilman & Company

General Chuck Jacoby
(US Army, Ret.)

Executive Vice Chairman
Tilman & Company

Unmasked: how COVID-19 strengthens ESG as risk management tool for investors

Now more than ever, investors must recognize the importance of risk management and how ESG is a very effective tool to manage risks. ESG integration done the right way can prevent and mitigate exposure to hidden risks while also enabling quick reactions in case risks are revealed by unforeseen events like COVID-19. Such events can unmask ESG risks, which can lead to financial, reputational, and compliance issues for companies and investors alike.

COVID-19 spotlights gaps in investors' ESG practices

The disruption of COVID-19 revealed ESG risks related to companies and sectors across the world, with a particular rise of 'S' ESG issues; employee, product, and consumer safety were the overarching themes in related ESG risk incidents. Yet, the pandemic was not the only agent of ESG risk acceleration and illumination in 2020. Social unrest over racial injustice in the U.S. and worldwide and massive unemployment and economic strain brought the 'S' in ESG to the forefront of investor consideration.

Outbreaks in warehouses, factories, and distribution centers revealed worker exploitation and occupational health and safety hazards, and sparked conversations between employers and employees around job retention and fair wages. In the travel and leisure sector, cruise lines and airlines faced criticism of mishandling employee and passenger safety onboard. And in the healthcare sector, many health service providers faced allegations of negligence after failures to prevent a disproportionate amount of COVID-19 deaths.

These risks proved to be material, with reputational, legal, and financial ramifications for the companies and investors implicated. Many of these ESG and business conduct risks pre-dated the outbreak of COVID-19 and were revealed by the disruption caused by the pandemic. We believe there was an opportunity to identify and mitigate some of those risks before they caused material loss.

So, what can investors do to be better prepared as we head into a future with more possibility for unforeseen risk?

ESG as an effective risk management tool

The answer: risk management through robust and dynamic ESG integration. This is not an entirely new idea – in mid-2020, 50% of RepRisk clients polled said that COVID-19 strengthened ESG views within their firm. Now more than ever, investors and other financial industry professionals must recognize the link between ESG and risk management. But, there is a twist; in order for ESG to be effective as a risk management tool, investors must consider a number of factors:

- Going beyond company self-disclosures by supplementing with reliable third-party data: look at what the world says about a company in addition to what a company says about itself. Sources on the ground can provide a reality check for how companies conduct their business around the world, and can illuminate hidden risks.

- Multi-dimensional analysis, as opposed to a single rating, leads to a better, comprehensive assessment of material ESG risks.

- Dynamic, timely, and actionable data instead of static data to paint the full picture of a company's past and current ESG performance, and serve as an indication for how it will likely handle future ESG matters – like those brought to light by an unforeseen crisis.

- Data generated by rules-based and consistent methodologies that are built around ESG frameworks such as the UNGC, SASB, and the SDGs enable investors to have reliable, high-quality, and time-tested data at hand.

- Rigorous, industry-leading ESG research like the S&P Global Corporate Sustainability Assessment, which employs the aforementioned factors through its partnership with RepRisk and proactively engages companies on sustainability topics to help them manage long-term risks – allows investors identify areas of strength or opportunity for companies in their portfolios.

It's time to look under the hood

Disruptive events that shape lives and markets worldwide will continue to appear. 2020 may have been the year of the 'S' in ESG, but in 2021 the 'E' in ESG, with climate change often being the figurehead of ESG, could gain traction again – regulatory initiatives such as the EU taxonomy and the outcome of the US election give reason to believe so.

However, we believe ESG factors are not one-dimensional – they intersect and compound upon themselves. A recent study by Harvard illustrated the effect of climate change on viruses, suggesting a higher chance for diseases to cross the species barrier as COVID-19 did – as global temperatures rise and animals migrate towards the poles to stay cool, coming into closer contact. That's why it's important to look at the bigger picture when talking about ESG and we encourage investors to take a holistic approach to their ESG analysis.

Investors should take a similarly holistic approach to their data and processes – engaging not only the companies in their portfolio, but also their data providers. Meaningful ESG integration starts with a robust dataset – we encourage investors to kick the tires and ask the hard questions of their data provider to ensure it is effective for risk management and a reliable foundation for sound investment decisions.

Now is the time to double down on ESG. The pandemic continues to fundamentally change business operations as we know them, and ESG data can serve as a navigational tool to implement that change.

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