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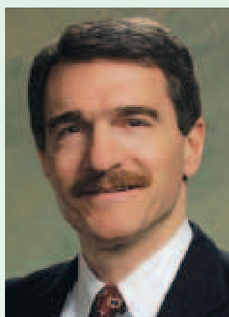
SPECIAL REPORT

TOWERS PERRIN

Turning Risk Into Opportunity: Putting People Into the Equation

An Interview with Mark V. Mactas, Chairman and Chief Executive Officer, Towers Perrin, Stamford, Connecticut

EDITORS' NOTE *In this interview, Mark V. Mactas, chairman and chief executive officer of Towers Perrin, the global professional services firm, discusses the challenges and opportunities companies face in managing successfully in today's rapidly evolving business landscape.*


Mark V. Mactas

COMPANY BRIEF *Towers Perrin (www.towersperrin.com) is a global professional services firm that helps organizations improve their performance through effective people, risk, and financial management. The firm provides innovative solutions to client issues in three areas: human resource services, which provides human resource consulting; reinsurance, which provides reinsurance intermediary services; and Tillinghast, which provides management and actuarial consulting to the financial services industry. Together, these businesses have offices in 25 countries.*

There has been much discussion about the emergence of a "post-industrial economy" – the next phase in the evolution of the business world. Are we finally there?

There's usually some degree of hyperbole in predicting the tipping point from one business era to the next. But I think it's fair to say that there are some truly unique developments today that are fundamentally changing the way companies have to approach business. To use a well-worn, but apt, analogy here, business truly is in the midst of a "perfect storm" – and one that shows few signs of abating.

This won't be much of a surprise to business leaders; the forces creating this perfect storm are well documented. They include globalization, which is occurring at ever faster rates, propelled by the easy flow of capital and goods around the world, intensifying competition for more plentiful and cheaper sources of capital and labor, and the promise of new markets. In addition, of course, is continued rapid technological advancement, which is driving innovation to the top of almost every CEO's strategic agenda. Exacerbating all of this are the dramatic demographic shifts we're just beginning to come to grips with worldwide. Populations are aging rapidly in the developed parts of the world, putting pressure on both governmental and employer-provided safety-net systems to meet people's healthcare, retirement, and related needs. At the same time, we're seeing new sources of labor emerge in the developing parts of the world.

Companies will want and need to turn to these sources, but in doing so, they'll need to develop new approaches to dealing with extremely diverse and far-flung workforces, with different levels of skill, education, language fluency, and work ethic, to name just a few factors.

This sounds somewhat daunting. Are companies prepared for these challenges?

It is daunting, but it's also undeniably exciting. Opportunity is the flip side of challenge, and business leaders know that. Within every challenge are the seeds of both opportunity and risk. The job of the top executive team today is to face risks squarely, identify, measure, and manage them, and make the most of them by turning them into business opportunities over both the short and long term.

Many companies are prepared, in the sense that they're well aware they're dealing with a very different environment and that the old rules and practices no longer apply. But it's one thing to be prepared from a planning perspective and another thing entirely to execute well against the plan. This is traditionally where a lot of organizations have lost ground. They understand in theory what direction to head in, but moving the large corporate ship takes more time than anticipated, or their crew isn't up to the task, or their sails are antiquated, or their navigation is obsolete.

The one thing that hasn't changed, though, is the importance of execution.

You mention risk and opportunity, both of which have always been core to business. Do you see differences in these areas as well?

I do. First, both the opportunities and the risks have been "supersized," to borrow another popular expression. Science and technology have opened doors to previously unimagined areas, but have also created entirely new risks in their wake.

Second, the world is connected in ways that weren't possible in prior generations. As Thomas Friedman observed in his recent, excellent book, *The World is Flat*, the global competitive playing field has been leveled, and we are increasingly connecting knowledge centers across the world into a single, or at least coordinated, global network.

This interconnectedness changes things – adding to the supersizing of risk – because what happens in one place reverberates in many others.

One need only look back at the last few years – characterized by terrorist threats, natural disasters, extreme financial volatility, geopolitical tension, corporate malfeasance, and regulatory scrutiny – to recognize that companies today are exposed to many risks unimagined even 20 years ago. By the same token, they present unprecedented opportunities as well. You need only consider the market potential of roughly one billion Chinese consumers to understand what's at stake today.

So what's required for companies to both plan and execute well?

If you think about all of the trends we've just discussed, two themes stand out. One is the increased size, nature, and scope of business risk. As companies move into new regions and markets, dealing with differing employee and customer bases, their risks expand and connect in increasingly complex ways. Addressing these risks requires a far more holistic approach than has traditionally been the case.

The second theme is people. If you think about the premise of Thomas Friedman's flattening world, it's a world that is increasingly fueled by knowledge and information. Businesses will vie for knowledge capital, and knowledge capital comes

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down to people. Until our technologists crack the code of artificial intelligence, successful companies will need to depend to a greater extent than ever on human intelligence, innovation, and inspiration.

I believe companies have a unique chance to look at people and risk in a way they never have before: to view people as both a core component of risk and one of the principal avenues to risk mastery. Or, to put it another way, to view risk holistically and put people in the center of that equation.

Do companies tend to think of people and risk together?

Traditionally, no, largely because risk was defined more narrowly – either as hazard risk, which was handled through insurance, or financial risk, which was handled through various financial strategies. Companies rarely viewed people as part of the equation.

But with people's skills and knowledge more central to business success than ever before, the risks associated with people may be the paramount ones a company faces. And they take shape both positively and negatively. In some respects, we tend to think of the downside risks first: unethical or inappropriate behavior, fraud or other forms of individual malfeasance that can directly affect a business. Eliminating or mitigating the potential impact of such behavior is the reason so many companies have well-crafted codes of conduct and governance practices.

The risks we might label positive all relate to performance. Who will develop the next blockbuster drug? Who will design an environmentally sound car that's both affordable and appealing? Who will wow customers with service to such an extent the company effectively changes the nature of competition? Who can help control costs through diligent attention to sophisticated just-in-time purchasing and inventory systems? The list goes on.

In this regard, it all comes down to whether companies will have sufficient numbers of the right people, with the necessary skills, doing the right things – the things that drive value in the business – and who are fully engaged in their work and committed to the company.

Is people risk a very well-known concept?

It has become far more common, for all the reasons we've discussed. There are obvious risks in the people arena, mostly connected to the cost of labor and related financial risks. We've all read about the impact that high labor costs are having in some companies that can't price their product to compete. But it's only in the last few years that we've begun to understand the true dimensions of people risk in a knowledge-based economy.

One way to think about it is the extent to which an organization will lose competitive or financial ground due to issues like talent gaps, low employee engagement and motivation, excessive turnover, global deployment costs and risks, sourcing gaps, and a host of related issues. There's no question most business leaders intuitively understand these concerns. But until recently, they've addressed this in a relatively informal and ad hoc way, chiefly because there weren't adequate approaches to defining, quantifying, measuring, or managing both how people create risk and what they can do to master that risk. Today, such approaches exist, and more and more companies are beginning to adopt them.

Make every individual in the organization a risk manager.

What advice would you give your fellow CEOs in regard to people and risk today?

First, understand the full magnitude of what's happening in the world and what's still to come. You can't respond to globalization by pulling inward and taking protectionist measures. You have to see and act on opportunity. Leading companies are turning fear of the unknown into opportunity.

Second, recognize that all risks are interconnected and that managing risk – across the board – is ultimately what business is about today. Virtually everything a leader has to do today comes down to managing and mastering risk in the service of improved performance. It takes shape in the decisions a company makes about its capital structure, its scope of operations, its global footprint, its governance structure, its people strategy, and its operating processes. Every decision an executive makes must be underpinned by an assessment of the risks involved and ways to address those risks.

In today's flat world, it's not only difficult, but counterproductive, to manage risks in siloed disciplines. The savvy executive team will look at risk comprehensively – from financial, operational, legal, and environmental to human, geopolitical, and reputational – and find solutions to risk mastery in those very connections.

Third, as we've discussed at length, integrate people into the risk equation. People are central to every kind of risk decision: From the cost structure of labor and the competitiveness of that structure to the emerging skill sets required and where they will be in high or low supply and demand; from the impact of using contract or on-demand workforces that expand and contract continually along with business need; to the management approach required to maximize people's accountability for results and to reenergize a workforce that's doing little more than keeping the lights on at night.

Fourth, understand the power of employee engagement – especially in turning people risk into opportunity. Engagement is an increasingly important concept in companies today, especially enlightened ones that know there is a direct relationship between the energy and commitment of employees and business results.

Fifth, hold leaders accountable for engaging people. Executives have heard this for many years in one form or another. Still, Towers Perrin research with over 85,000 employees in every part of the world shows that it's still more slogan than reality. People, irrespective of geography, have significant doubts about their leaders' caring and competence in taking the company forward successfully and keeping their best interests in mind. And these doubts translate into bottom-line outcomes, in terms of how likely people are to stay with the company and provide discretionary effort on an ongoing basis. This view leads naturally to the final principle.

Finally, make every individual in the organization a risk manager. Towers Perrin research shows that employees value autonomy over their sphere of influence and input into decisions that affect their work and that of their unit. It's a short step from there to helping each individual understand the business risks inherent in his or her job and ways to master those risks. While the risks range in severity – from extremely high impact for those in the health professions, for instance, to product quality or cost risk in manufacturing or administrative jobs – a collective focus on understanding and managing risk can help bring every employee more closely into the business, and pay huge dividends in focus and performance.

In closing, can you share some of the steps Towers Perrin is taking to help companies with these critical and complex issues?

We've always been heavily involved in helping companies manage their people risks and, through our Tillinghast and reinsurance business, in helping financial services companies, in particular, manage their risks. We have three business practices that dig deeper into these issues and take a quantitative and more holistic approach to both people and enterprise risks. They are workforce effectiveness, enterprise risk management, and legacy pension solutions.

On the following pages, you can read more about these practices as well as our reinsurance business, which also provides risk solutions. ●

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Global Business Management: New Issues, New Solutions

EDITORS' NOTE *To add meaningful shareholder value, today's corporations must pick their way through a thicket of challenges posed by such factors as globalization, changing workforce demographics, and toughening competition, as well as an increasingly complex regulatory environment. In the following article, consultants from Towers Perrin discuss solutions that can help drive shareholder value.*

Enterprise Risk Management

After years of systematic evaluation and successful implementation, enterprise risk management has become part of the financial landscape for banks and many insurance companies. For nonfinancial corporations, however, the embrace of enterprise risk management, or ERM, has been tentative and sporadic.

There are several reasons behind the reluctance to take an ERM approach – the perceived complexity, costs versus benefits, organizational resistance, and so on. But many corporations are taking a fresh look as an unexpected consequence of heightened regulatory and compliance requirements, according to Prakash Shimpi, head of the ERM practice at Towers Perrin.

So just what is enterprise risk management?

"Definitions are all over the place, but the underlying concept can be very simple," Shimpi says. "For a CEO, it might be best to think of ERM as a form of dynamic business planning that enables a company to maximize the probability of success."

Shimpi cites the example of a company that might want to grow its business in China. A risk analysis begins with the obvious – such as risks related to manufacturing and distribution, currency shifts, etc. – but should extend to any risk that might potentially threaten a strategic plan.

"Maybe you've got to think about the Mandarin-speaking skills of expatriate professionals, probability of avian flu, shifts in client needs, and so on," Shimpi says. "Given the information-gathering capacity we have today, there is no reason why a CEO can't have this kind of knowledge at hand before making a decision to invest."

Corporations have adjusted to the post-Enron business environment by taking a more strategic approach to financial management combined with sophisticated data-gathering. CEOs in nonfinancial companies are now awash in information that has the potential to help them understand their business and manage in a way that has not been possible in the past.

From an ERM perspective, the ability to gather and interpret financial and operational information gives CEOs an opportunity to move their companies from compliance into the realm of value creation.

"Senior executives have been challenged to make integrated, enterprise-level risk analysis an explicit part of their decision making," Shimpi says. "This requires an expansive view of risk, as well as a better understanding of the connection between risk and capital. The outcome can be significant value creation."

CEOs face the age-old challenge: How to determine the optimum balance between risk and rewards. In other words, how can value be created consistently by taking business risks without jeopardizing the financial soundness of the organization?

"Economic value is created by reducing the cost of capital and by increasing profits through better risk-based decision making," Shimpi adds. Value is also created by reducing the volatility of earnings.

"CEOs instinctively understand there are upside risks as well as downside risks. The trick is to optimize the risk/return profile of the enterprise and not simply focus on eliminating risk," he says.

The "downside" of each business activity is the risk of financial loss, while the "upside" is higher profitability. When evaluating options to mitigate the downside, there is a need to also consider whether it reduces the upside. ERM gives management the means to embed this evaluation into the normal way of doing business.

"Companies that have met compliance and regulatory requirements have already cleared the highest hurdle for enterprise risk management," Shimpi says. "The remaining steps are organizational and, to a degree, mindset."

Once risk is viewed in a more holistic way, CEOs and senior managers have to institutionalize the gathering and analysis of information that too often occurs in a company on a piecemeal basis.

"Among the biggest obstacles to successfully implementing ERM are developing a common understanding and getting buy-in throughout an organization," Shimpi says. "There are critical change management issues that must be respected and handled with thought and sensitivity."

Workforce Effectiveness

It has always been a priority for organizations to have capable people with the right skills and competencies, committed to achieving collective success. Today it is imperative for leaders to get this right. And just when people have become one of the last remaining sources of competitive advantage, the challenges of attracting, retaining, and engaging them has intensified.

One of the factors behind this development is the rise of a knowledge- and service-based economy that is "powered" to a far greater degree than ever before by human and intellectual capital. Innovation, collaboration, customer service, and process excellence all depend on people. A second factor is the rapid globalization of business, which is occurring at ever faster rates as companies move operations to different parts of the world for cost, efficiency, or other reasons. The shift in demographics in both developed and developing parts of the world is also contributing to challenges with the workforce, as both labor surpluses and gaps emerge in different locations.

Evolving social attitudes and expectations about work contribute to the challenge. As people choose how much of their time to "invest" in an organization's success, they are judging the return on their investment in terms of the entire work experience. Organizations that create a work environment that attracts and keeps the best people under an optimal cost structure – and focuses them on the things that drive financial value – will gain a true competitive edge.

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Is it any wonder that workforce effectiveness is a topic in both executive suites and boardrooms?

A recent talent management survey that Towers Perrin conducted with senior HR executives at roughly 250 large companies in North America bears this out. Fully 40 percent of the respondents indicated that talent management was already a top concern for their company's senior team, and another 34 percent cited it as a somewhat critical issue. Just over half of the group (51 percent) indicated their company's biggest future challenge was retaining the right leadership talent, with developing existing talent running a close second in importance. About half also agreed that the driving factor behind the intensifying focus on talent – especially leadership and key skills groups – was the changing competitive landscape, which demands new skills knowledge and behavior on the part of leaders, managers, and the overall workforce.

Julie Gebauer, head of Towers Perrin's workforce effectiveness practice, puts it this way: "It's a new world. The complexities and competitive realities inherent in doing business today – across regions and industries – require a rigorous and strategic approach to workforce management. Companies need to build an effective 'people supply chain' to deliver on their growth plans, especially when it comes to emerging leadership talent and people with sought-after technical skills. They need to develop and fully deploy the capabilities of leaders, managers, and employees. And they need to judiciously manage labor cost and risk to ensure the optimal use of financial resources."

"In our view, workforce effectiveness is about bringing the same business-like approach to the practice of people management that companies have traditionally brought to the practice of financial and operational management," she adds. "The stakes are too high to do otherwise."

Towers Perrin's approach to workforce effectiveness integrates rigorous business and workforce analytics with proven solutions that will drive sustainable improvements in company performance. It also focuses on complete workforce strategies designed to deliver against the business strategy, rather than on piecemeal tactics that may simply fix short-term problems.

Towers Perrin's four-point research for developing a total workforce strategy includes:

- Using tools such as value-driver analysis to understand the desired financial performance of the organization against peers and to create clear linkage between workforce strategies and metrics such as revenue growth, operating margin, cost of goods sold, and return on invested capital. This approach focuses HR's attention and investments – and employee behavior – on what creates real economic value for the company.
- A rigorous approach to strategic people planning that integrates sophisticated analytics on the workforce required to meet growth goals (demand), the workforce in place now and projected in the future (supply), and the total labor cost and risk impact under various scenarios. Such planning, enabled by proprietary tools, delivers insights to support both business and HR planning decisions.
- Integrating the right solutions in the areas of employee effectiveness, manager effectiveness, and leadership performance to create a more capable, high-performing workforce. In terms of employee effectiveness, for example, this means looking at deployment, career management, and performance management together. And in the leadership performance area, it means creating a strong leadership pipeline that focuses not only on the development of the existing executive team, but also on identifying and managing (and therefore retaining and better deploying) the next generation of talent.
- Executing change in ways that enhance the organization's capability and refocus the mindset and behavior of leaders and employees alike to deliver and sustain improvements in performance. For example, it takes genuine executive team buy-in and sponsorship to make a new high-potential leader program a success, regardless of how well designed the program may be. And, it takes a more engaged and capable cadre of front-line managers to ensure sustained employee focus on the right measures and behavior.

"At the end of the day," Gebauer says, "there are very few ways for companies to gain a sustainable competitive edge. To win in this global and frankly unforgiving business environment, companies will need to optimize the last, great untapped source of strategic advantage – the commitment, capability, and performance of their people."

Legacy Pension Solutions

An increasing number of companies are struggling to contain the costs – and risks – associated with defined benefit pension plans by closing their plans to new employees or, in some cases, eliminating them entirely. While the trend is expected to continue, many companies seeking to ease their pension burdens find that they are exchanging one set of problems for another.

"Freezing a plan does not mean that the financial exposure and risk management issues suddenly vanish," says Cecil Hemingway, head of legacy pension solutions at Towers Perrin. "Plan sponsors need to establish a structure and strategic approach to managing ongoing legacy pension plans that focus on the long-term issues, while allowing for the flexibility to exit if the opportunity presents itself."

A recent Towers Perrin survey of chief financial officers showed widespread concern about the availability of effective risk management alternatives currently available from insurers, investment banks, and other potential solution providers.

"CFOs want to achieve a stable and predictable outcome for legacy pension plans, while achieving a high degree of continuity for their companies and employees who will be counting on a reliable retirement income," Hemingway notes.

"One of our challenges as a risk and execution partner is to help our clients sort through all the noise to identify the most effective ways to reduce and manage their pension risks at reasonable cost over the remaining lives of the legacy plans," he says.

Several factors have combined to make the management of defined benefit plans a critical business issue for many organizations, including:

- Comparatively low long-term interest rates and the lingering effects of the 2000 to 2002 bear market that battered many retirement plan assets
- Demographic pressures reflected in a changing workforce and, in many cases, a growing ratio of retired to actively employed workers
- Market and shareholder pressures as companies battle for profits and revenues against competitors that may have radically lower cost structures
- Regulatory and accounting changes.

Companies moving to deal with pension risks are sorting through options that include changes in plan design, strategic asset management, plan annuitization, and the use of pension insurance or derivatives, as well as captive insurance-based solutions or administrative outsourcing.

"In thinking about defined benefit plan changes, companies need to examine variables that include the degree of financial and operational risk that they face, their financial flexibility, and appetite for risk," Hemingway says.

"Very often, a company will benefit by dealing with pension risks within a holistic risk management framework," he adds. "Often, this holistic approach is part of enterprise risk management, or ERM. With ERM, the pension risks can be seen in context with other risks and managed in a way that can potentially add significant shareholder value."

Pension risks must be managed with a sharp eye on regulatory and legislative developments, including funding reform and changes to pension accounting rules. Hemingway adds, "As the landscape continues to evolve, companies will need to pay closer attention to retirement plan financial management than ever, regardless of whether their pension plans are frozen or open to new members." ●

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Managing in a Dynamic and Changing Reinsurance Landscape

An Interview with William H. Eyre Jr., Chief Executive Officer and Managing Director of the Reinsurance Business of Towers Perrin, Philadelphia

EDITORS' NOTE *Bill Eyre is managing director and CEO of the reinsurance business of Towers Perrin and a principal of the firm. He joined Towers Perrin in 1984 and is a member of the Towers Perrin Senior Leadership Committee and chairs the firm's Reinsurance Executive Committee.*

William H. Eyre Jr.

Over the past two years, catastrophic events have reshaped the insurance and reinsurance environment. What does that mean to the market?

The 2004 and 2005 hurricane seasons were devastating. To put it in perspective, the estimated worldwide catastrophic event losses for the past 18 months could total $120 billion. Hurricane Katrina, which will cost the insurance industry an estimated $40 billion to $55 billion in losses, is now the single largest natural disaster in U.S. history. The effect will be widespread, and most reinsurers across the globe will feel, or have already felt, the impact on their bottom lines – some far more than others. As a result of these catastrophes, we are seeing a hardening of the reinsurance marketplace, which translates into an increase in premium price and, more often than not, more restrictive insurance terms. These increases are being seen primarily in the U.S. and within the property, marine, and energy sectors. By contrast, the U.S. casualty business and European property/casualty business are stable, although they will probably harden later in the year, as the 2005 catastrophes continue to adversely affect the industry.

How has the market changed in response to the catastrophic events?

The reinsurance landscape has clearly been altered. The increase in catastrophic events has put an even greater emphasis on the need to use and understand the models that simulate both manmade and natural disasters and the risks associated with those disasters. Taking it one step further, because of the far-reaching relationship between the insurance industry, general business, and individuals, being able to translate modeling data into better risk management practices and, ultimately, financial success, is crucial to every business, not just the insurance and reinsurance industry.

How is Towers Perrin working with clients to address these issues and changes?

One of the biggest challenges facing (re)insurers is how to manage various components of risk, which all businesses are increasingly focused on. By helping businesses evaluate and understand their exposure data, we're able to help them manage their risk better and, thereby, become more profitable.

Are you still able to spend time with clients?

I'm a big proponent of one-on-one contact, and everyone who works with me shares that ethic. As commoditized as some say the (re)insurance industry has become, I still believe that relationships are built on trust, and trust is earned by exceeding your client's expectations – over and over again. I think this is just good business sense. So yes, I spend a lot of my time visiting clients. It's a two-way street, because these visits also help me remain very close to client issues as they evolve.

There's a great deal of talk about the increased importance of the Bermuda market as an insurance center. Is this due to growth in the captive insurance market?

The Bermuda market has been an insurance center for more than 30 years, primarily because of the benefits that offshore risk funding could provide companies, including tax exemptions. While probably best known for the development of captives, which are insurance companies formed by non-insurance businesses to self-insure against their exposures, Bermuda has matured and expanded into other lines of insurance, including reinsurance. This expansion was made possible by capital infusions from investment bankers and equity funds that saw the growth potential outside of captives into other (re)insurance markets. For certain lines such as property/casualty insurance, Bermuda is now considered one of the top three global marketplaces, along with London and North America. A series of so-called "new classes of reinsurance" have also been established in Bermuda, following recent catastrophes, including Hurricane Andrew; the tragic events of September 11, 2001; and Hurricanes Katrina, Rita, and Wilma. As far as their sustainability, most reinsurance startups have $750 million to $1.5 billion in capital base, which indicates that there is a strong flow of private equity money coming into Bermuda.

Looking into the second half of 2006 and into 2007, what do you see as the biggest challenges for the market?

As I mentioned earlier, the property, marine, and energy lines of insurance will face higher prices, with a possibility of the entire marketplace hardening. As a result, insurers and reinsurers will have to tightly manage product pricing, catastrophe management, and rating agency challenges. We also expect that increased reinsurance costs will have some effect on pricing during the second half of 2006, primarily as a result of reinsurance catastrophe costs being passed on to the commercial and personal lines carriers.

A cornerstone at Towers Perrin is client relationships, and the reinsurance business epitomizes that. How have you managed to keep your relationships – some spanning as long as 70 years?

At Towers Perrin, one of our key attributes is to always put the client first. By living that attribute and by focusing on our clients' needs, serving as a trusted adviser and advocate, knowing their businesses, and understanding their issues, we have forged strong relationships. By spending time with our clients, we are able to build the right team that will offer the client the best consultative advice and strongest transactional capabilities. It's an easy formula to get right: Focus on your clients and succeed. ●

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