Risk Management vs. Enterprise Risk Management

Kate Lark – Dartmouth College
Paul L. Walker - University of Virginia
Feb 4th, 2008
Definition of Risk Management

…the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the adverse effects of accidental losses on that organization at reasonable cost.

George L. Head
1972
Careers

Elizabeth M. Fowler

The Need For Risk Managing

Risk management is a field often overlooked by college graduates. With new emphasis on corporate productivity, however, risk management has been receiving much attention.

Sanford Schreiber, an Allied Corporation executive in this field, recently called it a good area for college graduates. "It's good because we have trouble attracting young people," he said. "They don't understand what risk management is."

One cause of confusion is the fact that risk management involves a variety of corporate needs, and each company adopts its own approach.

The Bureau of National Affairs says risk managers are "corporate officials in charge of business insurance and loss control programs."

The bureau, an independent research group, recently surveyed the field and found that the median salary for risk managers falls in the $50,000-to-$60,000 range.

An ideal background for risk management probably would be a combination of insurance and engineering. It might consist of a major in engineering (perhaps industrial, mechanical or electrical) plus courses after college in insurance and accounting.

Mr. Schreiber explains his job this way: "I am director of safety and loss prevention, reporting to the vice president of the environmental department."

Other units on the same level as Mr. Schreiber's and under the same vice president are pollution control, medical and employee safety and product safety.

Risk management at Allied is organized this way because it is an overlapping concern, Mr. Schreiber said. "I work, for example, with the insurance department, which places the insurance coverage," he said. "We buy insurance to cover the unforeseen. We pay premiums based on our loss experience. We also use insurance carriers as auditing arms like an early warning system."

"Our job is loss prevention and to protect the environment in which we operate, as well as to protect corporate assets and assure continuity of operations," he said.

In his unit, Mr. Schreiber employs mainly engineers. His own major was in business administration, with a minor in engineering, and he has taken graduate courses in engineering. Before joining Allied in 1960, he worked in the engineering departments of insurance brokerage firms.

"We look for a bare minimum of engineering courses," he said. "The person we want should have some graduate work in a specific engineering skill. We don't bring in anyone with less than 10 or so years of field and managerial experience in implementation of programs, along with knowledge of Federal regulations."

In his unit, he added, there are "some people who do computerized programs to follow trends, such as the question of whether our experience is getting better or worse."
5 step process in analyzing risk:

1. Identify
2. Assess
3. Evaluate
4. Mitigate
5. Monitor

George L. Head and Stephen Horn II
1985
RIMS
Risk Management Models

- Traditional Risk Management
- Progressive Risk Management
- Strategic Risk Management
Risk Management Models

Traditional

- Risk Identification
- Loss Control
- Claims Analysis
- Insurance and Risk-Transfer Methods
Risk Management Models

Progressive

- Alternative Risk Financing
- Business Continuity
- Total Cost of Risk
- Education and Communication
Risk Management Models

Strategic

- Enterprise-wide Risk Management
- Indexing of Risk
- Use of Technology
Definition of Enterprise Risk Management

...is a process for ensuring the effective identification, assessment, and management of all significant risks to an entity. This includes not only the traditional areas of hazard risk and financial risk, but also operational risk and strategic risk.

RIMS/Marsh
ERM software vendor

Enterprise Risk Management Process Steps
1. Identify
2. Assess
3. Evaluate
4. Mitigate
5. Monitor

2005
ERM

- Effective support of strategic and business planning
- Proactive risk management
- Integrated, holistic approach
- Concise and consolidated reporting
- Continuous risk assessment, reevaluation and management
ERM
con’t

- Risk ownership assigned in management business and evaluation plans
- Open communication
- Risk management roles and responsibilities clearly defined and communicated

Marsh
Why is ERM Needed?

- Risk are becoming more complex
  - Task is global
  - More strategic alliances
Why is ERM Needed?

- More difficult to:
  - Protect assets
  - Allocate capital
  - Manage threats to operations and resources
  - New focus on corporate governance
ERM is more than accidental risks
Risks include...

- Operational
- Financial
- Operational
- Strategic
- Compliance
- Reputational
Risk Appetite

is the amount of risk, on a broad level, an entity is willing to accept in pursuit of its mission.

COSO
The goal of good risk management is not to minimize risk, but to achieve the best balance of risk and opportunity.

Dan Borge, “The Book of Risk”
ERM Definition

ERM is a process,
- effected by an entity’s board of directors, management and other personnel,
- applied in strategy setting and across the enterprise,
- designed to identify potential events, that may affect the entity, and
- manage risks to be within its risk appetite,
- to provide reasonable assurance regarding the achievement of entity objectives.
  - COSO Fall 2003
ERM – The Goal

• In short, “the goal of an enterprise-wide risk management initiative is to create, protect, and enhance shareholder value by managing the uncertainties that could influence achieving the organization’s objectives.”

# New View of Risk

<table>
<thead>
<tr>
<th>Old Paradigm</th>
<th>New Paradigm</th>
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<tbody>
<tr>
<td>Historically focused</td>
<td>Strategic</td>
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<tr>
<td>Ad hoc activity</td>
<td>Continuous activity</td>
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<tr>
<td>Accounting, treasury and internal audit</td>
<td>All of management</td>
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<tr>
<td>Fragmentation (Silo Approach)</td>
<td>Focused and coordinated (Holistic)</td>
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<tr>
<td>Financial risk</td>
<td>Business risks</td>
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<tr>
<td>Inspect, detect, react</td>
<td>Anticipate, prevent, monitor</td>
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<tr>
<td>Focus on people</td>
<td>Focus on processes and people</td>
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</tbody>
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The Economist Intelligence Unit, *Managing Business Risk*, p. 10
The ERM Process

Set Objectives

Monitor

Act

Identify Risks

Measure and Prioritize Risks

Adapted From Deloitte & Touche, Perspectives on Risk, p. 9
Canada Post ERM Process
Enterprise Risk Management

Business Vision
- Market Share
- Respect Individual
- Service to Customer
- Strive for Excellence

Business Objective
- Expansion Opportunity
- Distribution
- Customer Service
- Retention
- Development
- Leadership

Risk Framework
- Categorize Risk
- Standard Framework
- Reference

Identify Risk Universe
- Survey Stakeholders
- Compile Data
- Share Data
- Schedule Workshop

Risk Workshop
- Cross Divisional
- Discussions
- Additional Risk
- Prioritize Risk

Control & Action Workshop
- Evaluate Risk
- Existing Controls
- Deficiencies
- Action Plan
- Responsibility

Monitor Evaluate Manage
- Action and Timeline
- Monitor Progress
- Address Gaps
- Report Results
ERM Keys

- Know and understand risks
- Think strategically
- Increase focus and consistency
Prioritize Key Risks

Craig Farris: Wal-Mart
Strategic Risk: Value Collapse in The Fortune 1000

- Competitive: 58%
- Operational: 31%
- Financial: 6%

Source: Mercer Value Growth Database, Mercer analysis.
Note: 1S&P 500 index is the sum of the S&P indexes corresponding to time period for each of the 100 companies suffering stock drops.
2Data was not available for all companies for all 24 months after the stock drop (e.g., for stock drops in the last two years. Where data was not available, companies were excluded from that month for both the 100 companies index and the S&P 500 index.
The Management Challenge: Four Barriers to Strategy Execution (per BSC newsletter)

- **The Vision Barrier**: Only 5% of the workforce understands the strategy.
- **The People Barrier**: Only 25% of managers have goals/incentives linked to strategy.
- **The Resource Barrier**: 60% of organizations don’t link budgets to strategy.
- **The Management Barrier**: 85% of executive teams spend less than one hour per month discussing long-term strategy.

9 of 10 companies fail to execute strategy.
“What have you done to increase shareholder value this last week?”
ER M at Wal-Mart: The Basic Process...

1. Identify Critical Risks
   - Business Plan Killers
   - Exposures / Threats

2. Define Risk Drivers (causes)
   - What & Why of the Risks

3. Prioritize and Select Top 4-6 Risks
   - Determine Critical Focus

4. Develop / Implement Action Plans
   - Focus Into Action

5. Measure and Link Value Added of Actions to 'Bottom Line'
   - Analyze, Adjust, Achieve

- Individual Country Specific
- Corporate Level

Source: Craig Farris
**Product Flow - Action Impact**

Impact of mitigation actions are considered on two levels:
1) Actual Product In-Stock Rates (on the shelf)
2) Customer Perception of Wal-Mart’s Product Availability

The metrics measure both reality and perception to provide a balanced view of how well we are mitigating this risk.
Earnings Variability by Key Factor

Sales Volume
Prices
Environmental
Fuel Cost
Transmission Congestion
Interest Rates
Plant Availability
GDP
Pension – OPEB
Total (not additive)

(Cents per share)
Actual Earnings Versus Risk Corrected Earnings
Purpose of ERM at GM

- No big surprises
  - Risks are understood
  - Exposures are accepted

- No big mistakes
  - Risks identified
  - Risk management effective

- No big missed opportunities
  - Organization is ready and able to accept greater risks based on risk / reward
  - Increased certainty of business plan achievement
  - Reduced variability in key growth processes
Does SOX mandate ERM?
SOX Section 302

- Discussion of Disclosure Controls and Procedures
  - “The procedures should capture information that is relevant to an assessment of the need to disclose developments and risks that pertain to the issuer’s business.”
SOX Section 409

- Requires rapid disclosure of material events.
  - Are these risks?
SOX Section 404

- Mandates companies adopt a “control framework.”
  - Management must assess themselves using this framework
  - Management must report
  - Auditors must assess/report
“A Control Framework”

- Original COSO
  - Control Environment
  - Control Activities
  - Information & Communication
  - Monitoring
  - Risk Assessment!!
Public Company Accounting Oversight Board (PCAOB)

- Company level controls include management’s risk assessment process.
- An ineffective risk assessment function is considered a material weakness
  - But primarily relates to ____________?
SEC Rules

- Management required to certify they have programs and controls to disclose developments and risks pertaining to business.

- SEC Final Rules 2003, RIN 3235-AI54
Audit Committee

- The audit committee should understand the corporation’s risk profile and oversee the corporation’s risk assessment and management practices.
  - The Business Roundtable 2002
The Board

Among the core responsibilities of the board are understanding the issues, forces and risks that define and drive the company’s business.

The Conference Board 2003
Board Involvement

- "The board should, as a minimum, disclose that there is an ongoing process for identifying, evaluating, and managing the significant risks faced by the company."
  - Turnbull Report, 1999

- "The Board has reviewed the risk management process and confirms that it complies with the Turnbull Committee Guidance on Internal Control issued in September 1999."
  - Rolls-Royce plc Annual Report 2003, p. 32
303A.07 Audit Committee Additional Requirements:

- (D) discuss policies with respect to risk assessment and risk management
303A.07 Audit Committee Additional Requirements: Commentary

- While it is the job of the CEO and senior management to assess and manage...risk...the AC must discuss guidelines and policies to govern the process
What about the Board?
SEC MD&A

"ERM is an important tool companies can use to enhance disclosure in MD&A and to run the business more effectively. I think it would be helpful for companies to explain the risk management process and the level of accountability for it."

SEC Commissioner Cynthia Glassman
Compliance Week
ERM and Corporate Governance
ERM & Corporate Governance

- Chief Risk Officer
- ERM Committee
- Change in Audit Approach
- Management Follow-up
- Volume and Frequency of Information
- Internal Audit Follow-up
- Board Reporting
- Audit Committee Reporting
- Risk Champions
- Management Accountability
Reporting to the Board of Directors

- Top risks identified.
- Assessment of top risks.
- Control effectiveness (over time).
- Outstanding action plans.
I will show the committee the risk maps, which identify the top risks for each division, and give them an example of the action plans under development. I will also describe how the monitoring process works, and the manner in which we will link action plans and metrics to shareholder value.
Achievability of Objectives
(Source: Canada Post)
**FUNCTIONAL RISK ASSESSMENT SUMMARY 2000 / 2001**

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Average premium on share price investors are willing to pay for good governance

Quality of Governance & Returns
Annualized stock returns for a three-year period ending 08.12.03

Data source: GovernanceMetrics International
Ten former WorldCom directors will personally pay $18 million to compensate for investor losses from an accounting scandal that caused one of the largest bankruptcies in U.S. history.
Final Lessons
Making us all wish we were blind.

SPEEDO
Thank you

Contact:

pw4g@virginia.edu

Catherine.Lark@Dartmouth.EDU