ENTERPRISE RISK MANAGEMENT

FINANCIAL CRISIS: TIME TO IMPROVE ERM

The current economic crisis underscores the need to treat risk management as a strategic imperative, with a reassessment of company capabilities and specific steps to strengthen risk management culture.

By Prakash Shimpi

It is now painfully apparent that companies selling financial products and services need to take a sobering look at their approach to risk management. Among the many lessons to be learned, one is immediately clear: The subprime debacle represents a failure to manage risk effectively, not a failure of risk management as a critical business activity.

While we are still in the midst of the crisis and there may be other shoes to drop, some general views are already emerging. One is that there are many reasons why we are in a crisis, and inadequate risk management practices feature high as a contributory factor. Clearly, improvements need to be made. Fortunately, we already know what many of them are and how to address them.

Three aspects of enterprise risk management (ERM) implementation should be strengthened. First, far from being a compliance exercise, risk management is a strategic imperative and should be treated as such. Second, financial managers should urgently reassess the adequacy of their current risk management capabilities. Finally, the greatest shortcoming is cultural; management should improve the engagement of employees, as well as the board members and senior executives responsible for risk management.

FINANCE EXECUTIVES' VIEWPOINTS

Towers Perrin conducted two surveys in 2008 that provide a fact base for the conclusions and recommendations discussed here. The first was a cross-industry survey of 125 top U.S. finance executives conducted during the week of September 22, just as the U.S. Treasury bailout plan was being examined in Congress.* The second was a global survey of over 350 top finance executives in the insurance industry, the fifth in a series of biennial insurance industry ERM surveys, and was conducted during May and June 2008 as the crisis gained momentum.**

Finance executives in the cross-industry survey reported that improving their own companies' risk management was a priority, even ahead of short- and long-term access to capital. In fact, only 4% of respondents feared the current financial meltdown would have a severe impact on their company's financial prospects. However, 72% of respondents expressed concern about their own company's risk management practices and ability to meet its strategic plans.

These findings indicate a renewed resolve on the part of financial executives to invest in more effective risk identification, measurement and management procedures. Moreover, 42% of the respondents also predicted greater involvement in risk management policies on the part of boards of directors as well as increased employee-level involvement.

When asked to lay blame for the current financial crisis, 62% of the cross-industry survey respondents pointed to poor or lax risk management at financial institutions as the single greatest contributor. Other major causes that were cited included increased complexity of financial instruments (59%), financial market speculators (57%), predatory lending practices (50%) and incentive compensation practices in the financial services sector (44%).

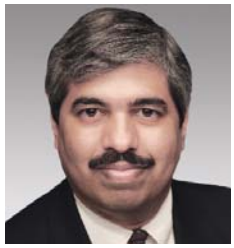
A CLEAR CALL FOR STRONGER ERM PRACTICES

As executives take a closer look at their own risk management practices, one problem they are likely to find is incomplete, slow or uneven application of ERM. Our insurance industry survey found that only a small fraction of companies around the globe can claim to have fully implemented ERM in their culture.

Within the insurance industry, embedding ERM into business processes is proving to be a challenging mission. For example, while economic capital (EC), a robust metric for making risk-based decisions, has become increasingly important to regulators and rating agencies over the last two years, survey respondents reported shortfalls in key areas:

- More than half (55%) believe that substantial work is needed before they can use EC to guide risk-based decision making.
- 60% noted that considerable strides must be made before they can link EC metrics to performance management.
- Only 10% said they have appropriate EC capability fully in place.
- More than 40% said they remain focused on getting the basics right in their EC calculations.

*See "Senior Finance Executives on the Current Financial Turmoil," a report prepared by CFO Research Services in collaboration with Towers Perrin, November 2008.
**See *Embedding ERM — A Tough Nut to Crack,* Towers Perrin, October 2008.



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Nonetheless, despite the slow pace of embedding ERM, significant numbers of respondents indicated their ERM programs have already resulted in key business changes in risk strategy or appetite (36%), asset strategies (35%) and product pricing (31%).

Obviously, it takes time to develop the appropriate oversight, incentives and tools, but the financial crisis has demonstrated that we are already behind on some areas of risk management. We need to adopt a greater sense of urgency to catch up.

More and more companies are beginning to recognize the importance of managing their entire risk landscape, not just those risks that are familiar or easy to quantify. One particular problem area is operational risk. According to the survey, only 7% of insurers believe they have appropriate operational risk capability in place, while 37% admit significant work is still required. Yet despite these admissions, operational risk ranks only seventh among survey participant priorities. Of those companies that have set limits to govern day-to-day risk taking, over 70% have limits for market, credit and insurance risk, but just 26% have limits for operational risk.

STRENGTHENING ERM IMPLEMENTATION

Based on these surveys and discussions with finance managers in a variety of industries, it is clear that the commitment to ERM remains strong and there is a growing urgency to strengthen ERM implementation. Although there are many ways to do this, we have identified three areas of focus and recommend specific actions within each area that require immediate attention.

1. Treat ERM as a Strategic Imperative.

If ERM is to be truly integrated with how firms are managed, then implementation must begin with active engagement of the firm's board and senior executives.

■ **Reinforce the role of the chief risk officer.** This is the single most important action that a company can take to recognize ERM as a strategic imperative. Many companies have appointed a senior executive as chief risk officer (CRO) to oversee risk management. However, the current financial crisis has shown that merely making such an appointment is not sufficient. If, as we believe and our surveys indicate, ERM is viewed as critical to the survival and profitability of a firm, then the CRO's responsibility must be commensurate. Studies have shown that problems arise when risk management does not have a seat at the management table, when risk management's warnings are ignored or when risk management is performed unevenly.

The current crisis reconfirms the importance of the risk management function and should result in a dramatic improvement in corporate influence. Just as a CFO has an enhanced set of responsibilities resulting, in part, from crisis-driven demands that resulted in Sarbanes-Oxley and new accounting standards, we may soon see a convergence of risk-related responsibilities that are aligned with the CRO. Indeed, these new responsibilities may require the establishment of enhanced professional standards and higher levels of experience for future CROs. As stakeholders come to realize the importance of risk management, CROs may see their professional and fiduciary obligations increase. And, as regulators and the financial industry seek ways to prevent past mistakes and avoid future ones, risk managers will likely play an increasingly important public policy role.

■ **Increase board engagement on risk.** We expect that boards should and will demand better metrics and information about risk management performance. Not only will the board's level of questioning dig deeper and be less satisfied by traditional compliance or audit reports, the questioning will place a premium on verifiable evidence of employee involvement. We anticipate a significant increase in the number of board-level risk oversight committees, and we expect that their scope of oversight will be broad.

■ **Align incentives to reflect risk.** Although this has been a topic of discussion for some time, the current crisis has demonstrated that compensation practices can be at odds with managing risk appropriately. We believe that compensation programs will undergo a transformation as companies attempt to rid themselves of inducements to exceed stated risk tolerances. We expect the scrutiny of incentive com-

EXHIBIT 1
Five key areas of ERM integration

	Why Risk Management Programs *Fail*	Why Risk Management Programs *Succeed*
Risk Management Foundation	■ Poorly defined objectives ■ Ineffective reporting systems, tools, staffing ■ Compliance-focused ■ Risks not well identified or understood	■ Consistent economic framework for defining, measuring, prioritizing and controlling risks ■ Regular and systematic examination of risks on a consolidated enterprise basis
Risk Management Governance	■ Overlapping or conflicting units, responsibilities and controls ■ Too little senior management/board involvement	■ Clear responsibility and accountability for key risks ■ Supervision by senior risk officer (CRO), independent of operations; dotted line to the board
Risk Management Culture	■ Weak, inconsistent tone from the top ■ Unclear risk strategy ■ Low employee risk awareness or concern ■ Open communication discouraged	■ CEO and board of directors lead ■ Integration of risk management and strategy ■ Clear risk culture ■ Link to risk acceptance
Risk Management Metrics	■ Inconsistent risk metrics and controls ■ Metrics not well understood or monitored ■ Risk metrics not linked to performance metrics	■ Simple, well-designed risk dashboards ■ Risk metrics embedded in investment decisions and performance targets and assessment
Risk-Reflective Pay	■ Employee incentives conflict with risk management objectives and risk metrics ■ Mismatch of short-term incentive awards and long-term profit	■ Rewards that encourage risk taking within risk limits ■ Incentives calibrated with risk limits ■ Incentive payouts timed with risk impacts

pensation programs, historically left to policymakers and investor groups, will come increasingly from boards of directors and fellow managers, who are loath to share the fate of the companies that have failed.

2. Improve Your ERM Capabilities.

Companies need a variety of skills, methodologies, tools and processes to manage risk appropriately. Each of these areas is probably worth reassessing in the current environment to identify and overcome any significant shortcomings. Still, much of the current inadequacy lies in a failure to integrate the component parts into an effective overall program. There are five key areas of integration to work on:

- *Risk management foundation* — objectives, risk identification and definition, prioritization, controls, measuring tools, economic framework, reporting and mitigation/transfer
- *Risk management governance* — responsibility, accountability and engagement of senior management and the board of directors
- *Risk management culture* — board and CEO leadership, staff awareness of key risks and cross-silo coverage
- *Risk management metrics* — actionable risk metrics related to firm value-building and linked to performance standards and incentives
- *Risk-reflective pay* — incentives that support risk taking within established limits.

Exhibit 1 suggests pitfalls and solutions. *Exhibit 2* suggests the need to integrate these key elements for a well-functioning ERM system.

Risk management governance sets the tone and supports adherence to standards. Risk management culture extends that direction throughout the organization, embedding broad risk awareness and guiding risk acceptance within risk appetite, tolerances and limits. Risk management metrics provide benchmarks for risk acceptance related to performance targets and monitoring through risk dashboards. These elements are kept consistent by the risk management foundation, avoiding confusion and working at cross purposes, as well as any gaps that might arise. Risk-reflective pay ties individual rewards to risk objectives.

If the aim is to add up all the bits for a clear view of aggregate risk exposure across the firm, then two issues need urgent attention.

■ **Recognize operational risk as material.** In our experience, there is a fundamental disconnect between the way institutions view operational risk and the way operational risk management should be implemented. To a large extent, this may occur because the term operational risk conjures up images of day-to-day processing errors. These minor *operations* issues are often

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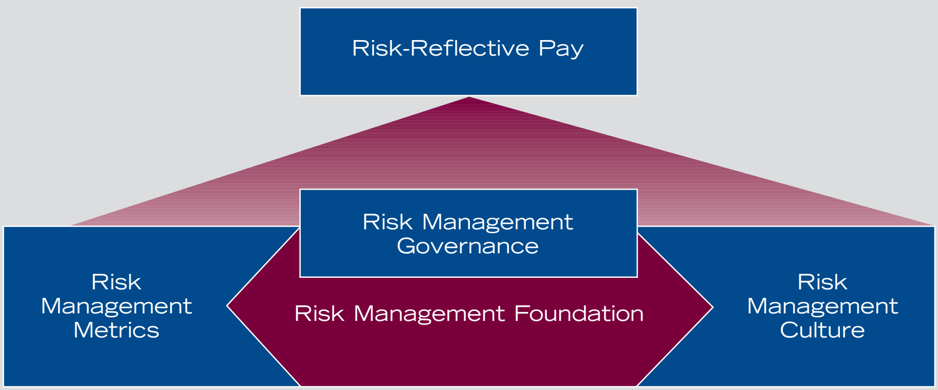
EXHIBIT 2
Integrated risk management model



only a small part of *operational risk,* which is driven in large part by catastrophic failures in management, such as inappropriate sales practices or unauthorized trading activities. Data show that a significant number of corporate bankruptcies and insolvencies during the past 20 years have been caused by operational failure. Indeed, the current financial crisis can be viewed as a failure of operational risk management at many levels (*Emphasis* 2008/2, “Modern Operational Risk Management”).

■ **Fungibility should be stress-tested.** One lesson made clear from AIG’s collapse is that capital and cash are not fungible within the different parts of a conglomerate financial institution. Legal and regulatory restrictions limit the flow of capital and cash between legal entities within an enterprise. Even if the needed funds were available, these restrictions would have prevented AIG from dealing with its problems. Some type of fungibility testing has been suggested within the Solvency II framework, and its potential value to risk management is now evident. Understanding the limits of capital and cash flow between legal entities within the same organization is vital.

3. Understand and Manage Your Risk Culture.
In the final analysis, good risk management results from people doing the right thing. It is not sufficient for ERM to impact only a few people at the top of the organization, nor should it be put on the shoulders of employees without proper guidance. This requires action in two areas.

■ **Establish clear guidance on accountability.** Much has been said about setting the right tone at the top for ERM. Companies still have a long way to go to do that in a way that is clear and engaging to employees. A starting point may be to articulate a company’s mission, vision and values as well as its risk strategy and objectives. This should be supported by a clear statement of risk appetite and risk tolerances. Then employees need to understand their impact on risk taking, and their responsibility for monitoring and acting within risk limits. Ultimately, though, it is management’s own actions in holding people accountable in a way that reinforces the alignment of the interests of employees, management and other stakeholders that will make a difference.

■ **Assess your risk culture regularly.** In order to make a difference in employee engagement, management needs to determine whether its impression of the company’s risk culture is borne out by rank-and-file opinion. Employee risk awareness and engagement should be assessed regularly through targeted surveys to identify gaps between management expectations and employee understanding, with appropriate measures undertaken to bridge the divide.

If these three aspects of risk management and the supporting recommended actions had been more firmly established, perhaps we might not be in the midst of such a severe financial crisis. Nonetheless, by acting now, we can be better prepared to navigate the complex and inherently risky world of the future.

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