Setting Up the Enterprise Risk Management Office

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Abstract

In this paper, the concept of an enterprise risk management office (ERMO) is examined. The ERMO concept is investigated relative to another recent enterprise-wide entity that has evolved in many corporations and public institutions: the project management office (PMO). The PMO is analyzed for any guidance it can provide regarding the implementation and benefits of a potential enterprise-wide and holistic approach to risk management. Guidelines and best practices for an ERMO are suggested.

1. Introduction

The onset of the Sarbanes-Oxley Act, combined with the increasing popularity of managing firm-wide risk, has exposed risk professionals from around the world to enterprise risk management (ERM). Recognition of the need and desirability of an enterprise-wide approach to managing risks is an important development, but many large companies are yet to establish an effective ERM system within their organizations; this is perhaps due to the novelty of the concept of managing the various types of risks—liquidity, credit, product-liability, operational, etc.—in an integrated and holistic framework. In this paper, the concept of an enterprise risk management office (ERMO) is examined.

The ERMO framework can help companies implement ERM processes and technologies and provide a foundation for holistic coordination of risks. An ERMO will permit companies to manage firm-wide risks simultaneously and efficiently. It is becoming an increasingly common practice for large organizations to hire chief risk officers (CROs), but a CRO can only be optimally effective within a methodical ERM system that can view the full organization with complete transparency. The purpose of this paper is to identify procedures for efficiently setting up an ERMO, define precise roles for the ERMO in managing all risks, consider best practices and popularize the idea of an ERMO by illustrating its dynamic role in any large organization.

The concept of the ERMO was stimulated by the authors' observations of the growth, benefits and continuing evolution of project management offices (PMOs) throughout the business world. A variety of PMO success stories, in both corporate and public environments, suggest that there may be lessons to be gained which might benefit the process of implementing enterprise-wide risk management processes. In this paper, we examine the ERMO concept with an eye toward the experiences of organizations with PMOs.

The remainder of this paper is structured as follows. In Section 2, the PMO is described, and its key characteristics are highlighted. The PMO will be looked at in some depth, as there should be processes and experiences in implementing PMOs that are relevant and useful for the development of ERMOs. Section 3 considers how, according to financial theory, risk management can add value to a firm. Section 4 discusses the ERMO and some guiding principles for its planning and implementation. Section 5 concludes.

2. The Project Management Office

While it is perhaps the case (although probably not as frequently as we sometimes think) that many projects in large organizations are, and can be effectively addressed as, standalone tasks at the "micro-level" in a particular department or division, many other projects only have value—or have their value maximized—when considered and coordinated at the "macro-level." Those assignments that involve participation across an entire enterprise may be, potentially, the most fulfilling to an organization's employees and the most important to its health and success. But precisely because of their widespread nature and influence, such tasks can be extremely difficult to manage and coordinate to an effective and timely conclusion. Human nature—often exacerbated by corporate culture—tends to produce local focus and the creation of institutional barriers to effective firm-wide communication and operation.

Today's businesses and public organizations are finding it increasingly important and difficult to efficiently manage their projects. As a result, in order to meet their strategic goals, organizations have begun focusing on how to direct and coordinate resources enterprise-wide. This focus is the underlying concept revolving around *project management*, and the mechanism through which it is implemented often takes the form of a PMO. The basic and ultimate goal of the PMO is to achieve the completion of "macro-projects" successfully, while optimizing the use of available resources.[3]

Over the past decade or two, the idea and role of "project management" has become increasingly popular and influential. However, despite the evolution of this concept and process, it appeared to many that something was still missing—specifically, an entity dedicated to logistical support for the project management process, particularly in cases where projects required crossing of sacred divisional boundaries within an organization. This need led to the development of the PMO, essentially within the context of a "business venture"—macro-project management—within the larger firm. The PMO is a mechanism used to address common project management issues in an organization in order to support and facilitate project success.

Several types of PMOs have evolved, to respond to the specific needs of the organization—e.g., the type of firm, the organizational location of the office and the existing maturity of project management within the organization. The roles taken on by a PMO can involve all or a subset of a wide range of functions, from providing project management-support in the form of training, software, templates and standardized policies and procedures, to actual direct management of projects. A specific PMO can

[3] Such resources include time, people, knowledge, money, energy, space, etc.

receive authority to act as a key decision maker during the initiation stage of each project, and this authority will enable them to make recommendations or terminate projects to keep the firm's business objectives consistent.

Based on the authors' understanding, it appears that there are a number of key "macro-principles" that characterize a successful PMO.

Key PMO Macro-principles

(1) A clearly expressed ***purpose or mission***, which is widely and effectively communicated throughout the organization. The mission statement is often the most important aspect of an entity—and yet it is often given inadequate attention.

(2) A ***high-level sponsor*** within the organization. While many PMOs report administratively to a chief information officer (because the evolution of PMOs was somewhat a function of firm-wide projects involving information systems), other senior-level sponsors are equally possible (and perhaps in some cases even preferable).

(3) Adequate ***governance***. In addition to a mission statement, clear and transparent procedures should be promulgated by which the PMO operates, and by which it prioritizes the firm's projects (a potential serious bone of contention internally). An evaluation and assurance process should also be in place as part of the overall PMO governance structure.

(4) Consistent with the overall ***culture*** of the firm. The PMO should not be an entity that conflicts with other firm values or procedures, but rather exists to serve the firm's primary objectives.

(5) An ***education*** program to instill in firm management and employees an understanding and appreciation of the purpose and benefits of the PMO and of the firm-wide project management process.

In addition to these five key macro-principles, there are a number of other characteristics that appear to exist in successful PMOs. Some of these, appropriately, are outgrowths of the macro-principles; other characteristics are more standalone in nature.

Other PMO Principles

- ***Implementation*** of a PMO can conveniently involve one or more ***pilot projects***, since projects tend to be somewhat self-contained.

- The ***maximum size*** of a project should be considered at some point. Lengthy or especially large projects might be more manageable if broken up into several shorter or smaller projects.

- ***Regulatory issues*** and considerations (e.g., requirements from Sarbanes-Oxley) should be considered in the structure and procedures of the project management function.

- ***De-centralization*** might ultimately be appropriate. Part of the PMO process should be to improve project management skills, and to embed an effective project management culture, throughout the organization.

- A project ***status monitoring system*** should be created and frequently evaluated for effectiveness. Projects can be periodically flagged or graded, possibly with a readily identifiable code (e.g., colors or numbers), with monitoring of any corrective activities.

- There should be ***transparency of information*** between projects, allowing for efficient consideration of project interdependencies.

- ***Standardized segments or processes*** should be considered in areas common to multiple projects.

Finally, the benefits accruing to firms from an effective PMO appear to be many.

PMO Benefits

- ***Quicker and more effective reactions to market and customer needs*** stemming from greater speed and efficiency of internal projects.

- ***More efficient resource utilization*** stemming from closer attention to, and greater transparency of, time and expense devoted to projects.

- ***A more holistic firm culture*** stemming from the reduction of internal firm boundaries, necessary to effectively manage firm-wide projects.

- ***Greater cross-boundary communication*** stemming from the use of a common and consistent language.

- ***Improved employee morale*** and a sense of participation, from being more exposed to a firm-wide process.

Why have we spent so much time on PMOs, when the ultimate goal of this paper is to discuss ERMOs? Because many of the lessons that have been learned by business and public organizations with respect to setting up an enterprise-wide PMO are useful for considering and implementing an ERMO. In fact, we believe that, with respect to most of the items mentioned above, there is a very significant parallel between PMOs and ERMOs.

Specific discussions regarding ERMOs will occur in Section 4. First, however, we examine how and why an ERM process might create value for an organization.

3. Creating Value through Enterprise Risk Management

Before discussing the ERM office itself, it is worth examining whether, and how, ERM can provide value to a firm. When risk management is looked upon as a "financing" strategy—i.e., it appears on the right-hand side of the balance sheet—it comes up against the Modigliani-Miller capital structure irrelevance hypothesis. Basically, this says that, given certain assumptions, the financial structure of the company (which is reflected on the liability, or right-hand, side of the balance sheet) is irrelevant to the value of the company. In other words, it doesn't matter how money is brought in the door—whether, say, through issuing equity or debt; what *does* matter is how that money is used and invested. If this is strictly true, then risk management, when viewed as a financing item, should not in theory affect the value of the firm.

Of course, like many theories and hypotheses, the key to fully understanding this irrelevance hypothesis is to understand, and appreciate the impact of, the underlying assumptions. Modigliani and Miller made three critical assumptions in positing their hypothesis:

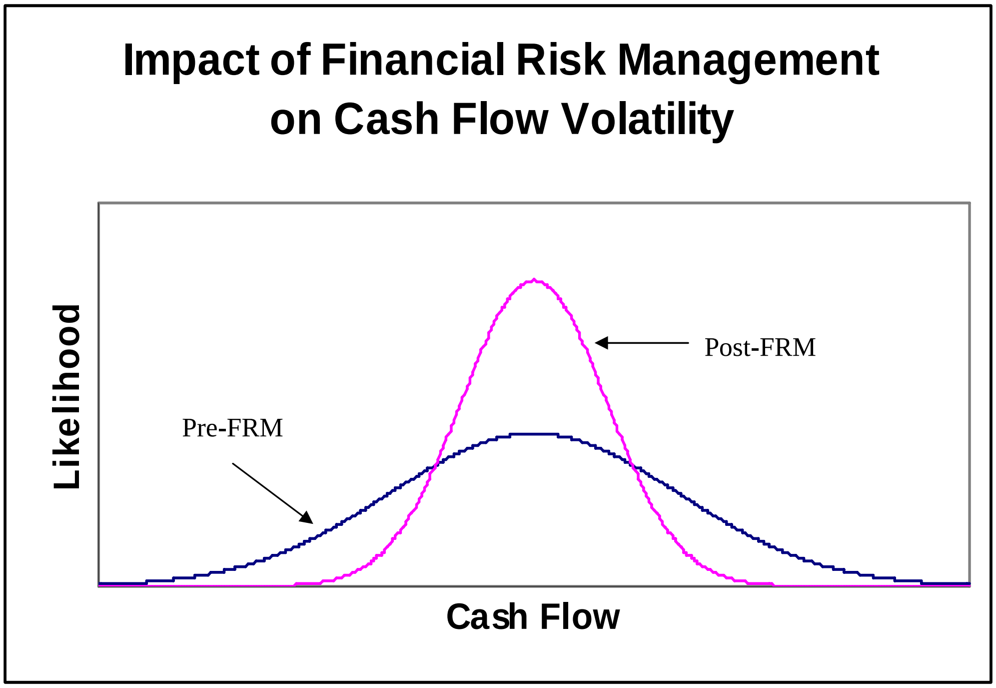
- Tax effects are ignored.

- Bankruptcy costs are ignored.

- Capital investment policy is static.

It is primarily through violations of these assumptions that risk management can be seen to impact the value of a firm.

The following exhibit identifies the benefit to be gained from risk management:



This exhibit (which refers to *financial* risk management, but applies to any form of risk management) suggests that what risk management does is reduce the volatility associated with the original outcome distribution. This lower level of volatility can add value to the firm via considerations such as taxes and the costs of financial distress. For example, it can be shown that in the presence of a convex tax structure (that is, a progressive tax structure, where higher marginal rates apply to higher levels of income), incurred taxes will be smaller when the volatility of the income distribution is lower (all else equal). Similarly, potential negative impacts on firm value stemming from financial distress will be reduced by lowering the possibility of financial distress (by reducing outcome volatility).

Thus, it does indeed appear that there are valid theoretical reasons to consider ERM as being of value to a firm.

4. The Enterprise Risk Management Office

The ERMO is a concept that was stimulated in our minds by observing the growth, benefits and continuing evolution of PMOs throughout the business world. By learning from the experiences associated with PMOs, successful implementation of ERM processes may be enhanced.

With consideration given to companies' experiences with PMOs, and recognition of issues specific to ERM, we suggest the following as the key macro-principles in setting up an ERMO. Where appropriate, these are arranged in parallel fashion with the PMO principles.

Key ERMO Macro-principles

(1) A clearly expressed ***ERMO charter***, which is widely and effectively communicated throughout the organization. This charter should include a mission statement and refer to the idea of embedding a risk management culture throughout the organization.

(2) A ***high-level sponsor*** within the organization. This should ideally be the CEO and the Board of Directors (or equivalent entity in a non-business organization), but could also be an influential senior-level manager.

(3) Appropriate ***governance*** and organizational reporting relationships. An evaluation and assurance process should be in place, ideally distinct from the risk management process itself. The authors believe that the appropriate functional and administrative reporting relationships for the ERMO involve the CEO and the Board of Directors. (More on this in the Appendix.)

(4) A ***risk management culture*** should not only be adopted by the firm, it should also be embedded within the firm (but as much as possible within the overall climate and cultural context of the firm). Risk management should be a part of most managers' (and possibly many employees') job descriptions, performance evaluations and salary decisions.

(5) An ***education*** program to instill in firm management and employees an understanding and appreciation of the purpose and benefits of the ERMO, and of the ERM process.

In addition to these five key macro-principles, there are a number of other characteristics that we recommend for ERMOs. As with PMOs, some of these principles are outgrowths of the key macro-principles above; other characteristics are more standalone in nature.

Other ERMO Principles

- The ***coordination function*** across the firm should be invested in a risk management committee, with members coming from a variety of departments.

- ***Regulatory issues*** and considerations (e.g., requirements from Sarbanes-Oxley) should be considered in the structure and procedures of the risk management function.

- A ***risk-monitoring system*** should be created and frequently evaluated for effectiveness. Key risks can be periodically flagged or graded, possibly with a readily identifiable code (e.g., colors or numbers), with monitoring of any corrective activities.

- There should be ***transparency of information*** among the departments and units of the firm, allowing for efficient consideration of operational and risk interrelationships.

Finally, the benefits accruing to firms from an effective ERMO appear to be many.

ERMO Benefits

- ***Lower costs*** stemming from greater efficiency in managing various risks and their interrelationships.

- ***Improved likelihood of meeting firm objectives*** due to better understanding of the firm and reduction in volatility of results.

- ***A more holistic firm culture*** stemming from the reduction of internal firm boundaries, necessary to effectively manage risks on a firm-wide basis.

- ***Greater cross-boundary communication*** stemming from the use of a common and consistent language with respect to risks (which, with a risk management culture, is of interest to everyone).

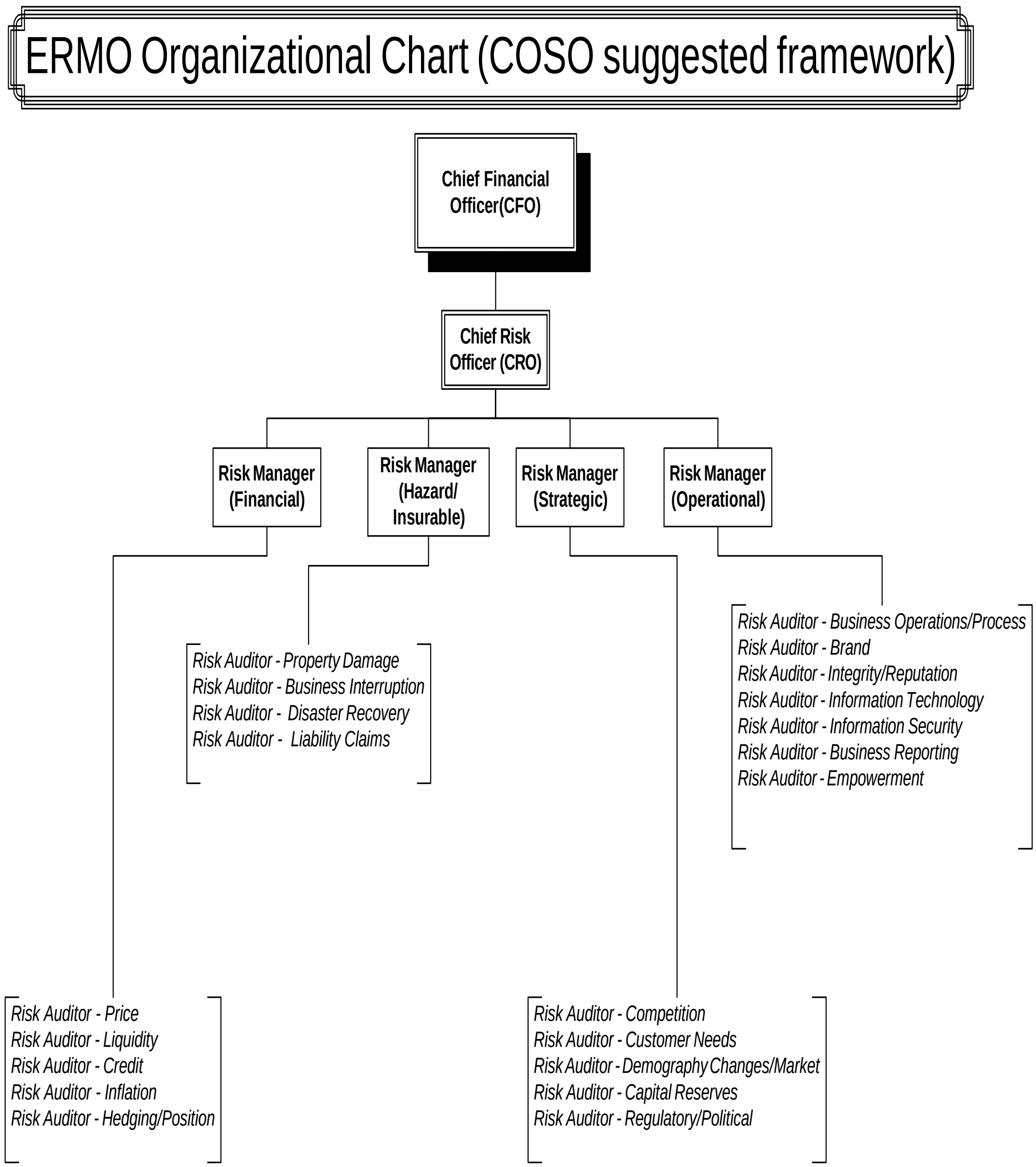
- ***Improved employee morale*** and a sense of participation, from being more exposed to and embedded in a firm-wide process.

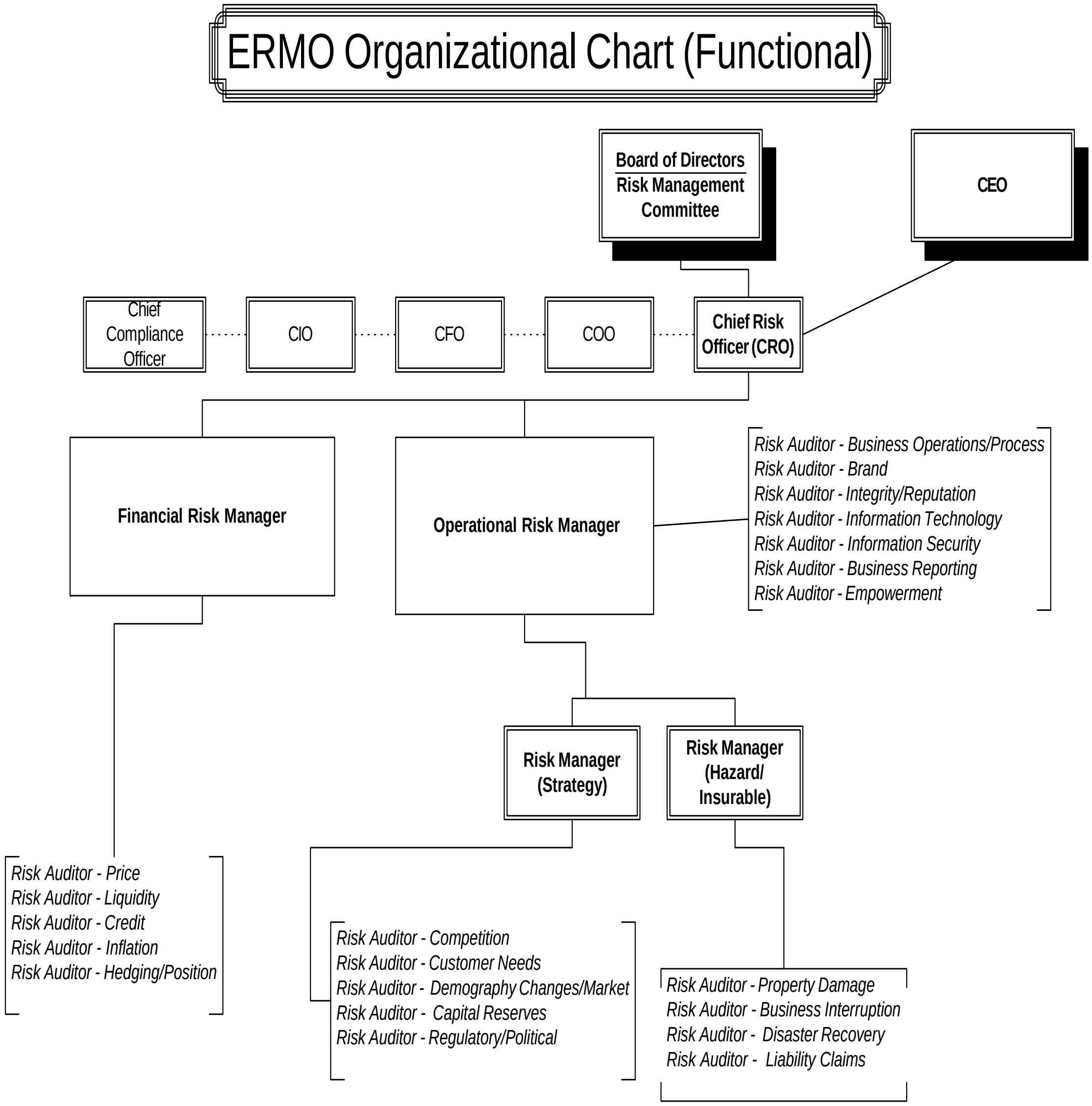
5. Conclusion

A great deal has been said and written about ERM, both with respect to its benefits and the ERM process. In this paper, we have discussed the experiences of business and public organizations in another area involving enterprise-wide considerations—project management. We believe that the experiences and success stories emanating from the implementation of PMOs have a great deal of value for those of us advocating ERM. The notion of an ERMO, as essentially a parallel with the PMO concept, seems a logical next step in the evolution and dissemination of ERM.

Appendix

The following organizational charts were created to depict two different styles of reporting from a top-down approach.





The authors feel strongly that the second ("functional") organizational chart is preferable, and that it represents the most efficient structural hierarchy for the holistic management of risk within a firm, from a management perspective. For reasons of avoiding potential conflicts of interest, reporting lines to the CEO and Board would seem the most logical.

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