Reaffirming Your Company's Commitment to ERM in Light of the Financial Crisis

by Prakash Shimpi

The current financial crisis underscores the need for companies 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 in risk management, rather than a failure of risk management.

While we are still in the midst of the crisis and there may be other shoes still left to drop, some general views are already emerging. There are many reasons why we are in a crisis, but inadequate risk management practices feature high as a contributory factor. Clearly, improvements need to be made, and we see three aspects of enterprise risk management (ERM) implementation that 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 in order to do so. Finally, the greatest shortcoming is cultural; management should improve the engagement of employees, as well as the board 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 study was a cross-industry survey of 125 top U.S. finance executives[1] conducted during the week of September 22, just as the first U.S. Treasury bailout plan was heading for legislative approval. The second study was a global survey of over 350 top finance executives in the insurance industry,[2] the fifth in a series of biennial insurance industry ERM surveys, which was conducted during May and June 2008, as the crisis was brewing.

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 percent of respondents feared the current financial meltdown would have a severe impact on their companies' financial prospects. However, 72 percent of respondents expressed concern about their own companies' risk management practices and ability to meet their strategic plans.

These survey findings indicate a renewed resolve on the part of financial executives to invest in more effective risk identification, measurement and management procedures. Moreover, 42 percent 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 percent of the cross-industry survey respondents pointed to poor or lax risk management at financial institutions as the single greatest contributor. Other major causes included increased complexity of financial instruments (59 percent), financial market speculators (57 percent), predatory lending practices (50 percent) and incentive compensation practices in the financial services sector (44 percent).

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 into their culture.

Within the insurance industry, embedding ERM into business processes is proving to be a challenging mis-

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[1] *Senior Finance Executives on the Current Financial Turmoil.* A report prepared by CFO Research Services in collaboration with Towers Perrin. November 2008. *http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2008/200811/TP_Financial_Crisis_Survey_Report.pdf.*

[2] *Embedding ERM — A Tough Nut to Crack.* Towers Perrin. October 2008. *http://www.towersperrin.com/tp/showdctmdoc.jsp?country=global&url=Master_Brand_2/USA/News/Spotlights/2008/Oct/2008_10_28_Spotlight_Embedding_ERM.htm.*

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sion. For example, 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. However, more than half (55 percent) of survey respondents believe that substantial work is needed before they can use EC to guide risk-based decision making, and 60 percent noted that considerable strides must be made before they can link EC metrics to performance management. Only 10 percent of the firms responding said they have appropriate EC capability fully in place. More than 40 percent said they remain focused on getting the basics right in their EC calculations. But in spite of 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 percent), asset strategies (35 percent) and product pricing (31 percent).

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 percent of insurers believe they have appropriate operational risk capability in place, while 37 percent 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 percent have limits for market, credit and insurance risk, but just 26 percent have limits for operational risk.

Strengthening ERM Implementation

Based on these surveys and discussions with finance managers in a variety of industries, the commitment to ERM remains strong, and there is increased 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 (chief risk officer, CRO) to oversee risk management. The current financial crisis has shown us 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, or when risk management's warnings are ignored, or when risk management is performed unevenly. No doubt, authors and academics writing the history of the current crisis will find evidence of all three.

The current validation of the risk management function could result in a dramatic improvement in corporate prestige. Just as a CFO has a specific set of responsibilities, we may soon see a convergence of responsibilities that are aligned with the CRO. Indeed, these new responsibilities may require the establishment of new professional standards and 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, 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

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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 compensation programs, historically left to policymakers and investor groups, will come increasingly from boards of directors and fellow managers, who are loathe to share the fate of companies that have failed in the wake of this crisis.

2. Improve Your ERM Capabilities

Companies need a variety of skills, methodologies, tools and processes to manage risk appropriately. Each of these is probably worth reassessing in the current environment to identify and overcome any significant shortcomings. If one of the aims is to add up all the bits to develop a 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 only a small part of operational risk, which is driven in large part by catastrophic failures in management (e.g., inappropriate sales practices or unauthorized activities). Data shows 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 so many levels.

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

At the end of the day, 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.

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. Ultimately, though, it is management's own actions in holding people accountable in a way that reinforces the alignment of 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 management's impression of the company's risk culture is borne out by rank-and-file opinion. Employee risk awareness and engagement should be assessed regularly to identify gaps between management expectations and employee understanding, with appropriate measures undertaken to bridge the divide.

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These three aspects of risk management and supporting recommended actions were put forth with the view that had such practices been more firmly established, perhaps we might not be in the midst of such a severe financial crisis. It is the actions we take now that can help us prepare to navigate the complex and inherently risky world of the future.

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