



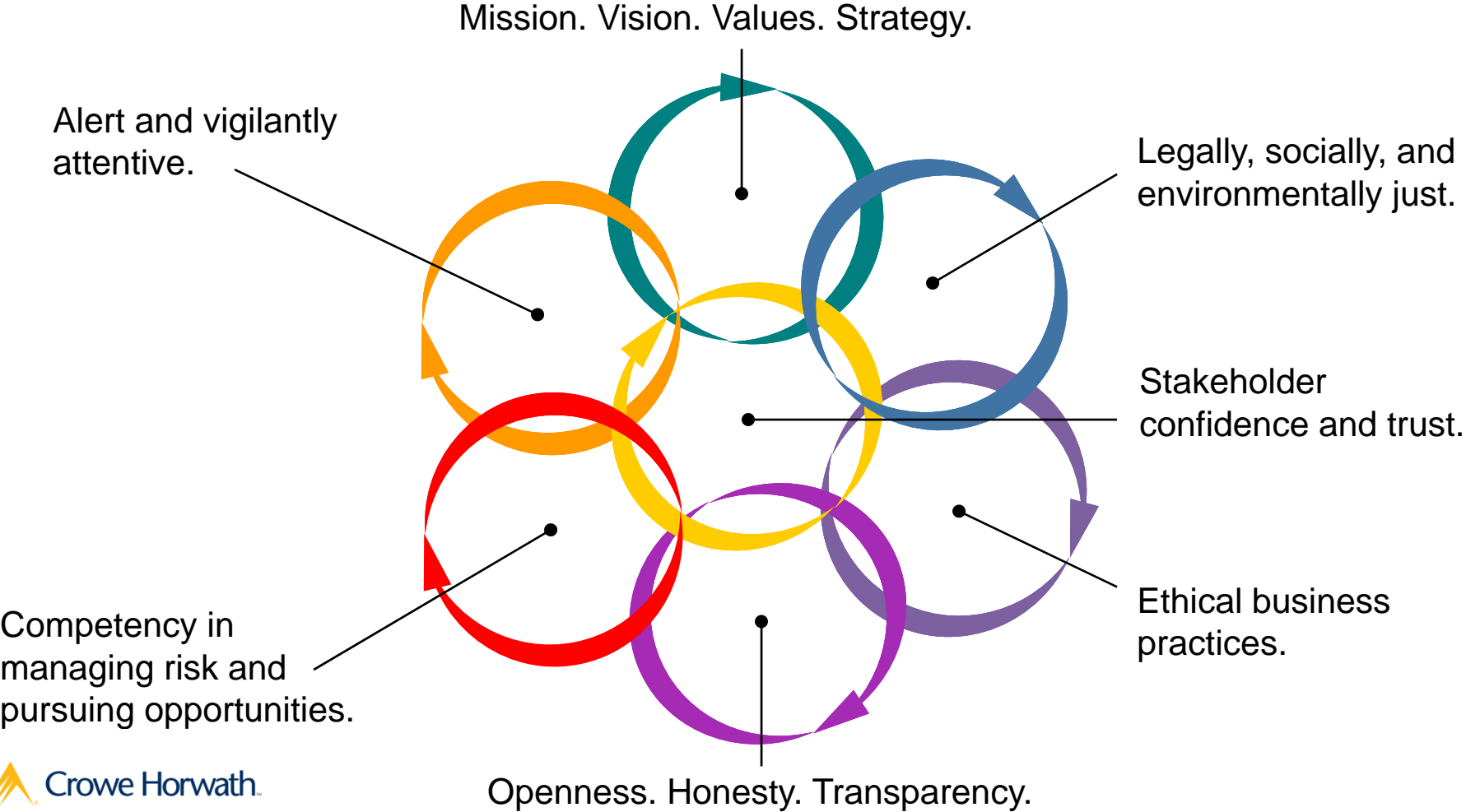
## Enterprise Risk Management

*Where and How It Fits Within the Modern Models of Corporate Governance*

February 2010



# Key Indicators of Management Quality



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# Corporate Governance

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# Dynamics of Good Corporate Governance

**Corporate governance** is the systems and processes an organization has in place to protect the interests of its diverse stakeholder groups, e.g. shareholders, employees, customers, vendors, community, etc.

## Corporate Governance Framework<sup>SM</sup>



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## DISCUSSION: Governance

- Why do you think Corporate Governance is important?



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## Why Corporate Governance?

### University of Michigan Business School

"Firms with profitable investment opportunities and with more reliance on external financing have higher quality corporate governance, and firms with higher corporate governance ratings are valued higher."

### McKinsey & Company

"An overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards. This applies to companies in every country of the world"

### Business Week

"The stocks of companies with the best boards outperformed those with the worst boards by 2 to 1. But as the economy slowed...the Best Boards companies retained much more of their value, returning 51.7%, vs. -12.9% for the Worst Board companies."

### Columbia Law Review

"... corporations with active and independent boards appear to have performed much better in the 1990's than those with passive, non-independent boards."

### Journal of Economics

"We find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions."

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## Why is It Important?

- Meet Legal Requirements and Fiduciary Responsibility to Investors
- Attract & Retain Qualified People
- Gain Community Support
- Obtain a Competitive Advantage
- Maintain/Improve Reputation
- Increase Stakeholder Return
- Fosters Trust

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## Benefits of Good Governance

- Sets tone at top
- Applies to all organizations no matter where they are located
- Applies to all individuals equally – within an organization and across organizations
- Provides a way to realize the vision of mitigating risk and optimizing performance simultaneously in today's regulatory environment
- Pays for itself through increased shareholder returns

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## Other Reasons...

Keeps CEO & CFO and others out of handcuffs



*“Former HealthSouth CFO Gets 27 Months”*  
- MSNBC, September 22, 2005

Weston L. Smith, former HealthSouth finance chief, decided to expose the company's accounting fraud after the passage of the Sarbanes-Oxley Act. (Gary Tramontina - Bloomberg News)

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*“A Guilty Verdict: The Overview; Ex-Chief of  
WorldCom is Found Guilty in \$11 Billion Fraud”  
- New York Times, March 16, 2005*

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Keeps CEO & CFO and others out of handcuffs



**“Ex-Tyco Executives Convicted”**

- Washington Post, June, 18, 2005

Tyco CEO Dennis Kozlowski leaves  
a New York courtroom after his  
conviction. *Reuters*

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## Other Reasons...

Keeps CEO & CFO and others out of handcuffs



Jeff Christiansen / Reuters

**Martha Stewart convicted of four felonies**  
- USA TODAY, March 2004

**Martha Stewart and lawyer  
Robert Morvillo leave federal  
court.**

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## Other Reasons...

- Helps Board Members, CEOs & CFO's avoid Congressional committees



# Risks

**External Risks**  
 Regulatory / Legal  
 Investor Relations  
 Competitor  
 Financial Markets  
 Catastrophic Loss  
 Sovereign / Political

**Information Risks**  
 Product / Service Pricing  
 Performance Measurement  
 Budget & Planning  
 Accounting Information  
 Financial Reporting

**Technology Risks**  
 Access  
 Availability  
 Infrastructure



**Strategic Risks**  
 Leadership  
 Alignment  
 Planning  
 Communication  
 Business Model

**Integrity Risks**  
 Authority Limit  
 Fraud  
 Unauthorized Use  
 Reputation

**Financial Risks**  
 Price  
 Liquidity  
 Credit

**Operations Risks**  
 Customer   Human Resources   Product Development  
 Supply Chain   Business Interruption   Compliance

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## Governance...a Critical Risk

- Corporate Governance is a critical risk, just ask the stakeholders of these companies...



**Adelphia**

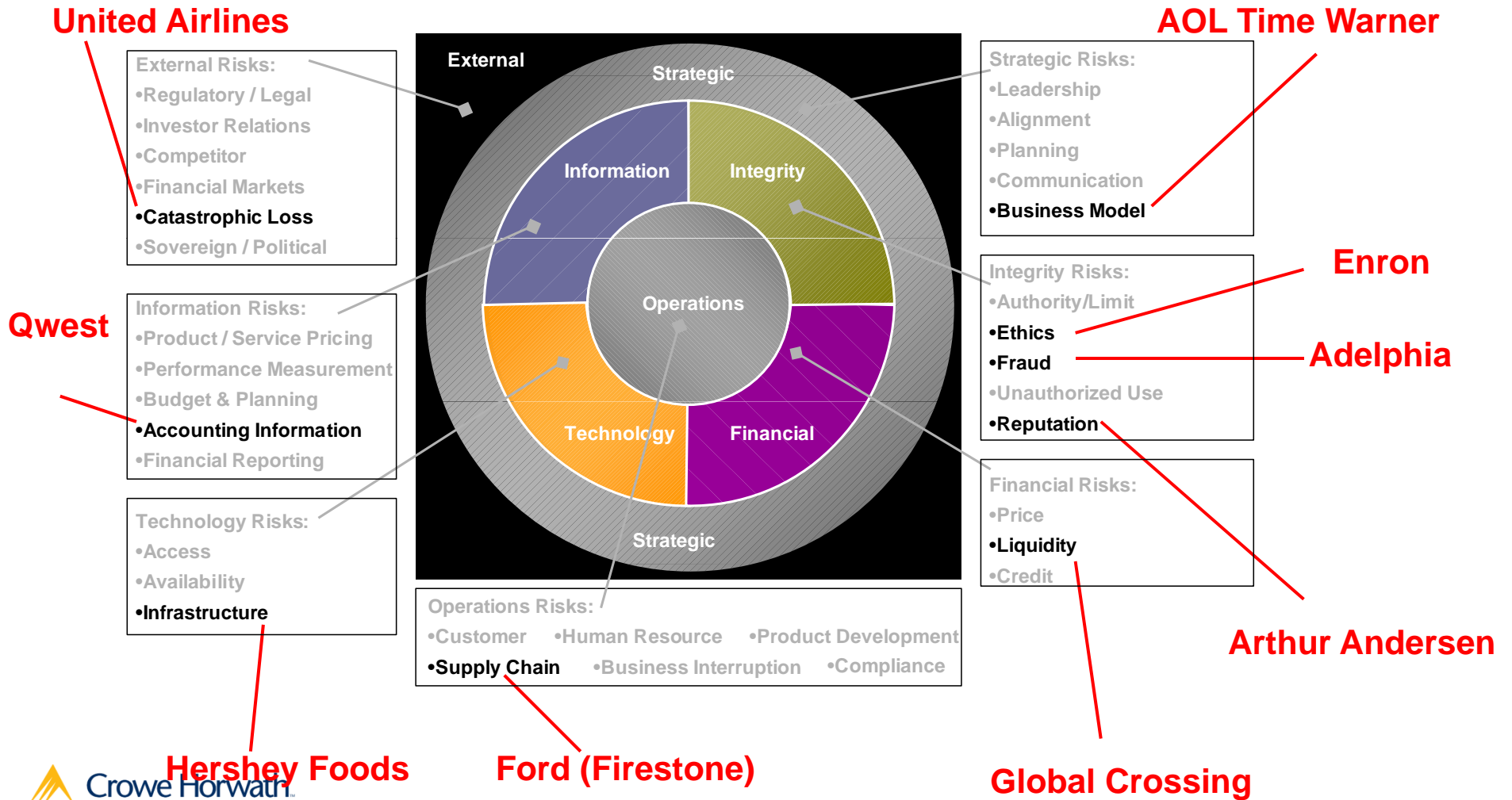
**HEALTHSOUTH**



**tyco**



# The Impact of Unmitigated Risks – “The Classics”



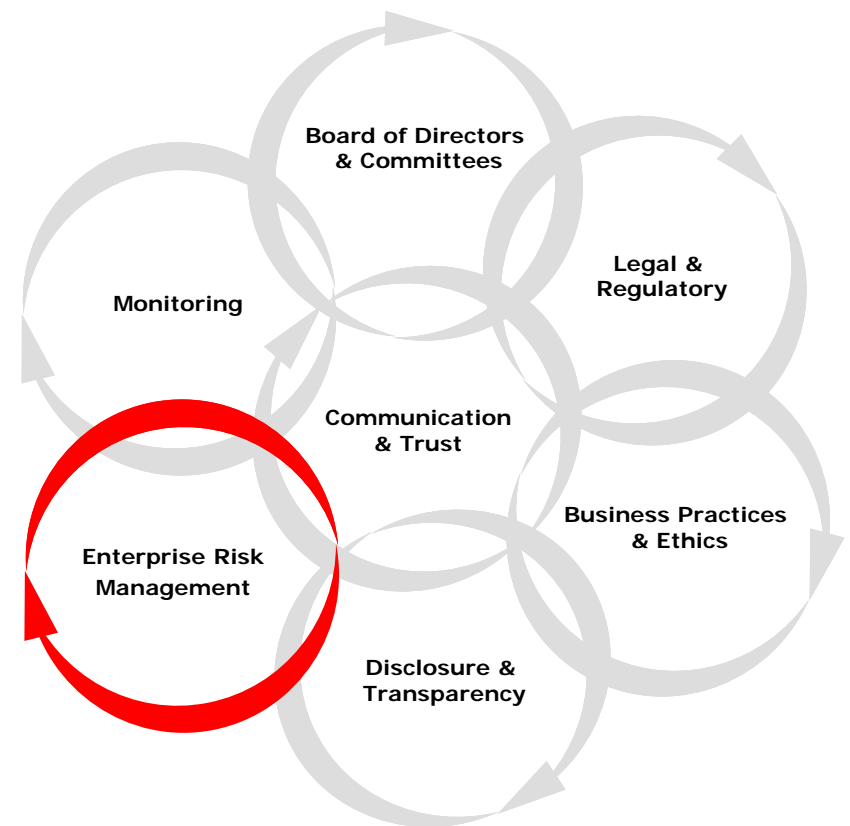
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# Enterprise Risk Management

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## ERM: An Integral Component of Corporate Governance

Enterprise Risk Management (ERM) is a process designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.



Corporate Governance Framework™

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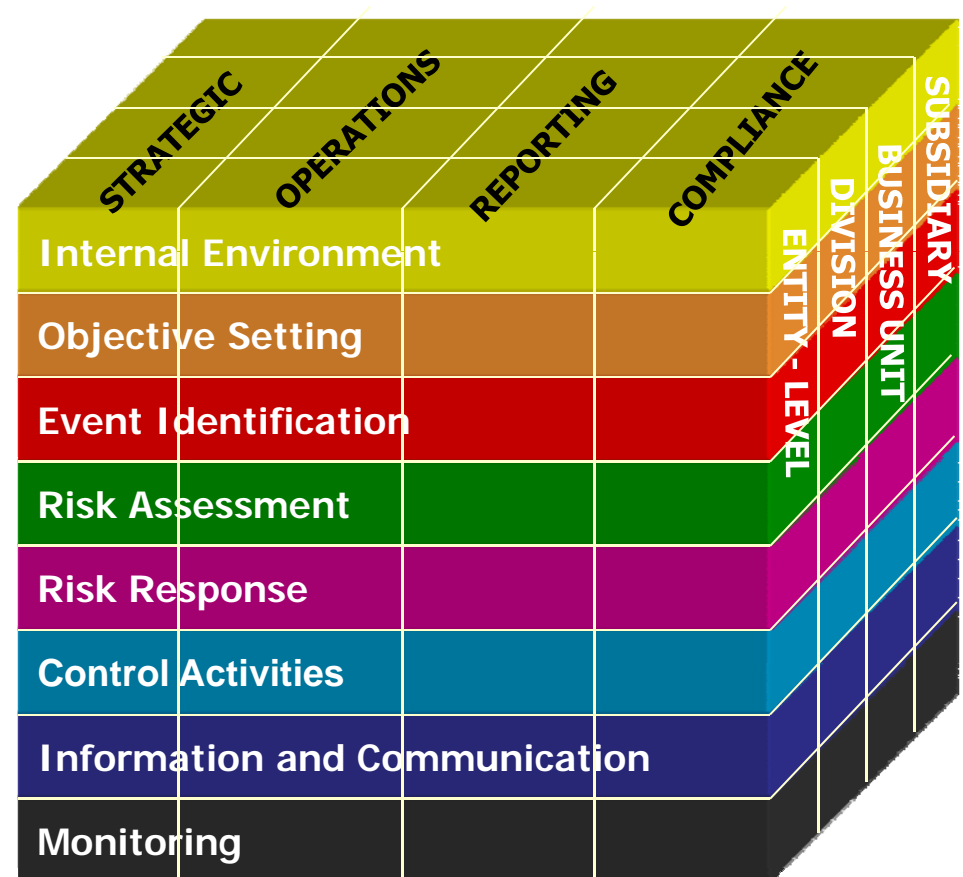
## Risk Management Defined

*Business risk is an event, action, or failure to act that may adversely affect an organization's ability to achieve its business objectives and successfully implement its strategies.*

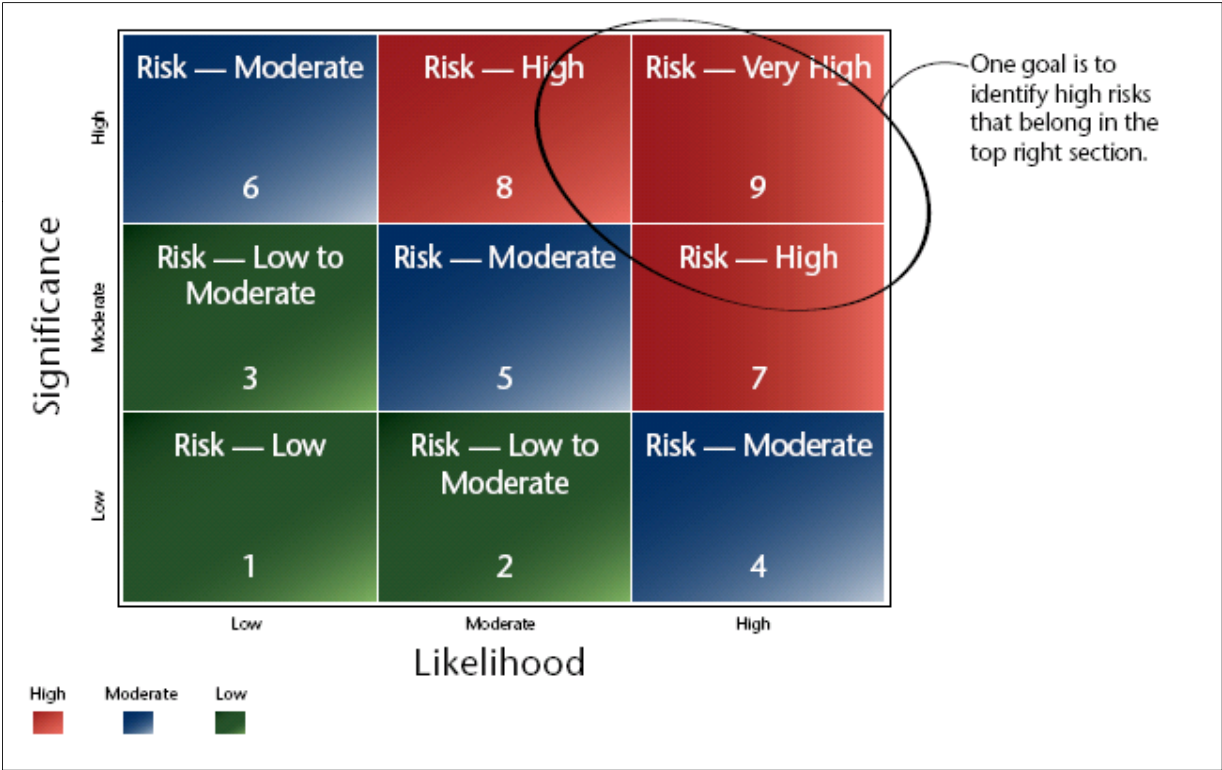
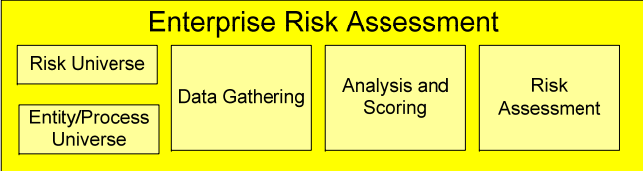
# COSO ERM Framework

Framework consists of 8 components:

- *Internal Environment*
- Objective Setting
- Event Identification
- *Risk Assessment*
- Risk Response
- *Control Activities*
- *Information and Communication*
- *Monitoring*



# Risk Assessment

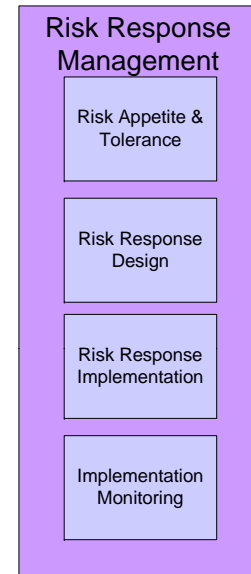


**"Risk profile"** — there is no standard definition for this term; it is commonly used in a conceptual sense to represent the entire portfolio of risks that constitute the enterprise. Some companies represent this portfolio in terms of a cumulative probability distribution (e.g., of cumulative earnings) and use it as a base from which to determine the incremental impact (e.g., on required capital) of alternative strategies or decisions.

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## Some Risk Responses

- **Avoid** (e.g. exit the business, sell unit)
- **Reduce** (procedures to reduce impact, likelihood or both)
- **Share** (e.g. insurance, pooling, hedging, outsourcing)
- **Accept** (no action taken)



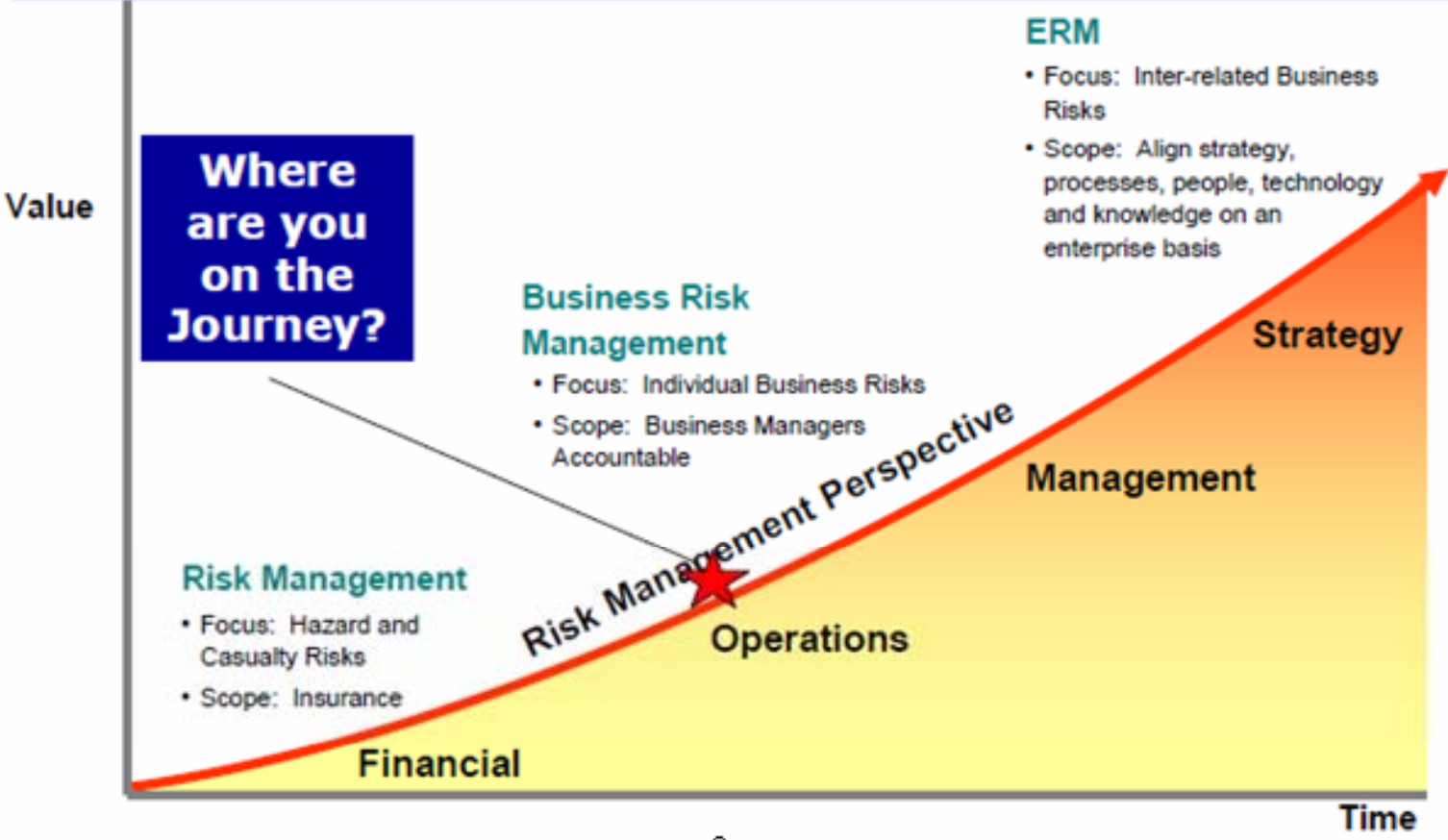
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## ERM Process

- Identify, source, assign responsibility and measure risks
- Design risk strategies
- Implement risk management strategies
- Audit and monitor strategies on an on-going basis
- Communicate results

# ERM is a Journey

Ultimately, integrating risk management functions improves performance, is more cost effective and supports business strategies



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## ERM Journey Elements

### **From:**

Informal Risk Management Activities

Risk loosely understood

Risks considered within function / BU

Ill defined risk universe

Risks are locally addressed

Reporting is haphazard and focused on easy to quantify historical data

Reporting is local and fragmented

No defined ownership of risks



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### **To:**

→ Formal Risk Management Process

→ Formal risks are understood by CEO

→ Risk considered in the context of business strategy

→ Formal risk universe is established and prioritized

→ Risks are addressed more broadly with a critical risk focus

→ Qualitative and quantitative data (financial, operational, attitudes, etc.) is analyzed to provide insight for decision making (KPIs, trending, etc.)

→ Reporting is structured within an ERM governance process

→ Clearly defined ownership of risks

→ Formal monitoring (Audit Committee review of ERM process, risks discussed with Board by CEO, internal audit review of risk management effectiveness)

## Intended Benefits of ERM

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- Promoting broader understanding of risks
- Putting in place a process to highlight the key risks, what is being done, and by whom
- Bringing to light emerging risks earlier
- Enabling organizational alignment to manage the risks and control the cost of compliance
- Allowing organizations to take on and effectively manage risks that their competitors cannot

*A successful ERM program will strengthen corporate governance, which tends to increase the confidence of stakeholders, including regulators*

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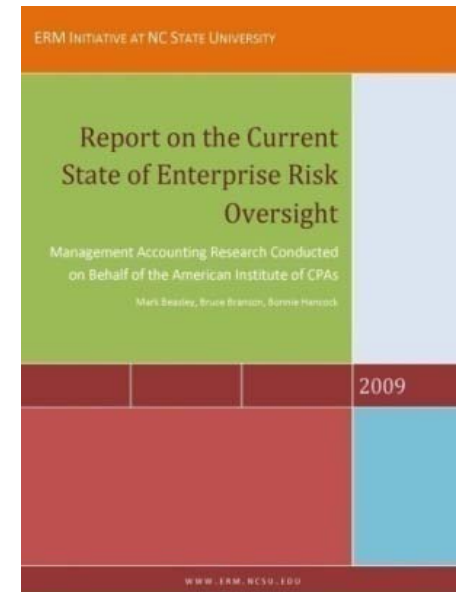
## REAL WORLD COMPANY PERSPECTIVE

“I think the point to risk management is not to try and operate your business in a risk-free environment. It’s to tip the scale to your advantage. So it becomes strategic rather than just defensive.”

– Peter Cox, CFO, United Grain Growers Ltd.

# ERM: EVOLUTION IN THE REAL WORLD

- Despite growing pressures for more effective risk oversight from financial crisis, level of enterprise-wide risk oversight appears to be fairly immature
- Most organizations have not fully embraced need for a top-down, enterprise-wide perspective of risk oversight
- Urgent need to evaluate existing risk management processes in light of perceived increases in volume and complexity of risks and operations surprises being experienced



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# Common Drivers for ERM Programs

- **Assess Environment After an Unexpected Event**
  - **Credit Crisis**
  - **Hurricane Katrina**
- Educate Senior Executives and Board of Directors on Risk Management Concepts and Principles
- Provide a Common Language and Framework for Identifying and Managing Risks Throughout the Organization
- Build Risk Management Concepts into Strategic Planning and Everyday Business Processes
- Encourage Intelligent Risk Taking
  - **Bottom line: All Risk Issues Lead Back to ERM**

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## Why Today?

- More organizations are reviewing their ERM approach
  - Market events
  - Competitive pressures
  - Rating Agencies
  - Regulatory scrutiny
- Board members are asking more questions about ERM process

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## Standard and Poor's Discussion Questions at Management Meetings

- What are the organization's top risks? How big are they? How often are they likely to occur? How often is the list of top risks updated?
- What is management doing about top risks?
- What is the tolerable quarterly operating or cash loss management and the board have agreed on?
- Describe staff resources responsible for risk management and their place in the organization. How do you measure risk management success?
- How would a loss from a key risk impact the planning, budgeting and the incentive and/or compensation programs of top management?
- Tell us about risk management discussions at the board level or among top management when making strategic decisions.
- How has the organization responded to a recent "surprise"? Did the "surprise" affect the organization (and others) differently?

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## Why a Governance Model for ERM?

- Most ERM initiatives begin as a project for someone within IA or finance
- Typically, a pilot effort
- It is not clear who has what responsibility
- ERM programs stall
- Internal Audit can not own ERM
- As process matures, a management structure must evolve

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## Why ERM Governance is a Challenge

- No one best practice
- No one knows how to get started and who is incharge
- Evolving process
  - In most companies, a variety of risks are being managed in diverse ways
  - No clear links to broader business strategy
  - Establishing such links can cause confusion as to roles and responsibilities

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## ERM Limitations

- Risk relates to the future – which is inherently uncertain
- ERM operates at different levels with respect to different objectives (strategic v. operations v. reporting or compliance)
- ERM can't provide absolute assurance (e.g. judgment, breakdowns, override, collusion, and cost v. benefit)

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## Link ERM to Existing Organization Processes

- Strategy
- Budgeting
- Monitoring (i.e., Compliance, Internal Audit, Environmental, etc.)
- New Business Development

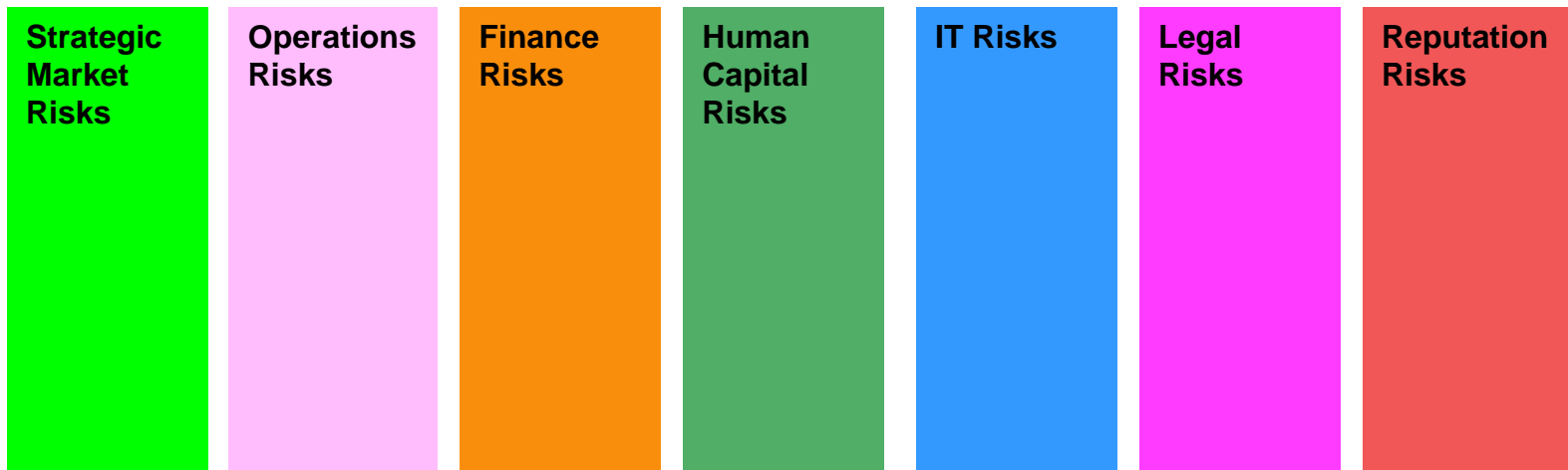
# Roles and Responsibilities

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- Everyone in organization has responsibility for ERM
  - Board/Supervisory Committee: Management is accountable to Board, which provides governance, guidance and oversight
  - Management: “Owns” system and sets tone. Chief Executive Officer is ultimately responsible
  - Risk Officer: Works with other managers in establishing and maintaining effective risk management in their areas of responsibility
  - Internal Auditors: Monitor ERM and quality of performance as part of regular duties
  - Other personnel: ERM is, to some degree, responsibility of everyone in an organization

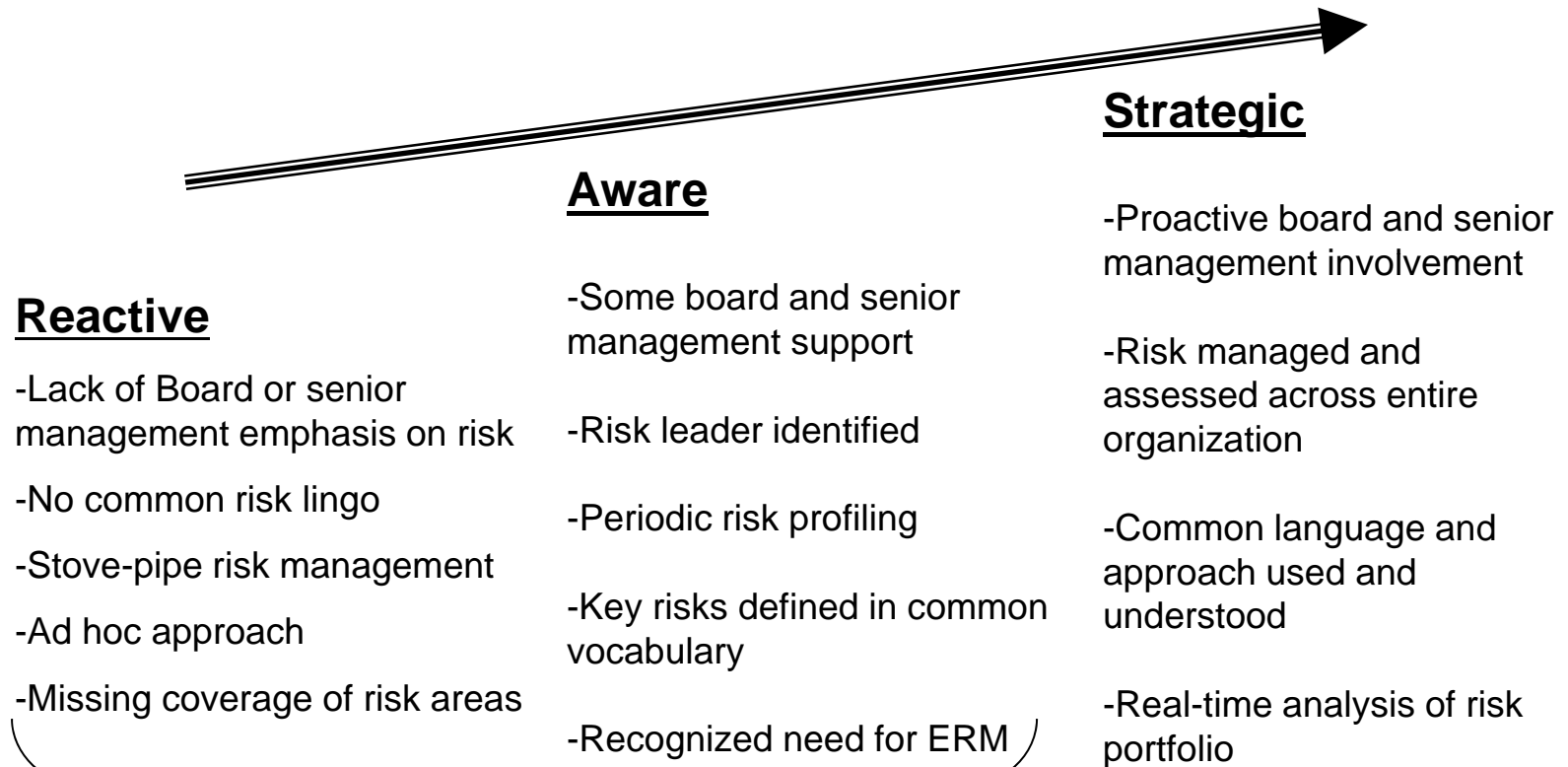
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**MANY ORGANIZATIONS STILL USE A  
TRADITIONAL  
RISK MANAGEMENT APPROACH...**



**“SILO” OR “STOVE-PIPE” RISK MANAGEMENT...**

# ...BUT ARE SEEKING TO MOVE UP THE RISK MANAGEMENT CONTINUUM

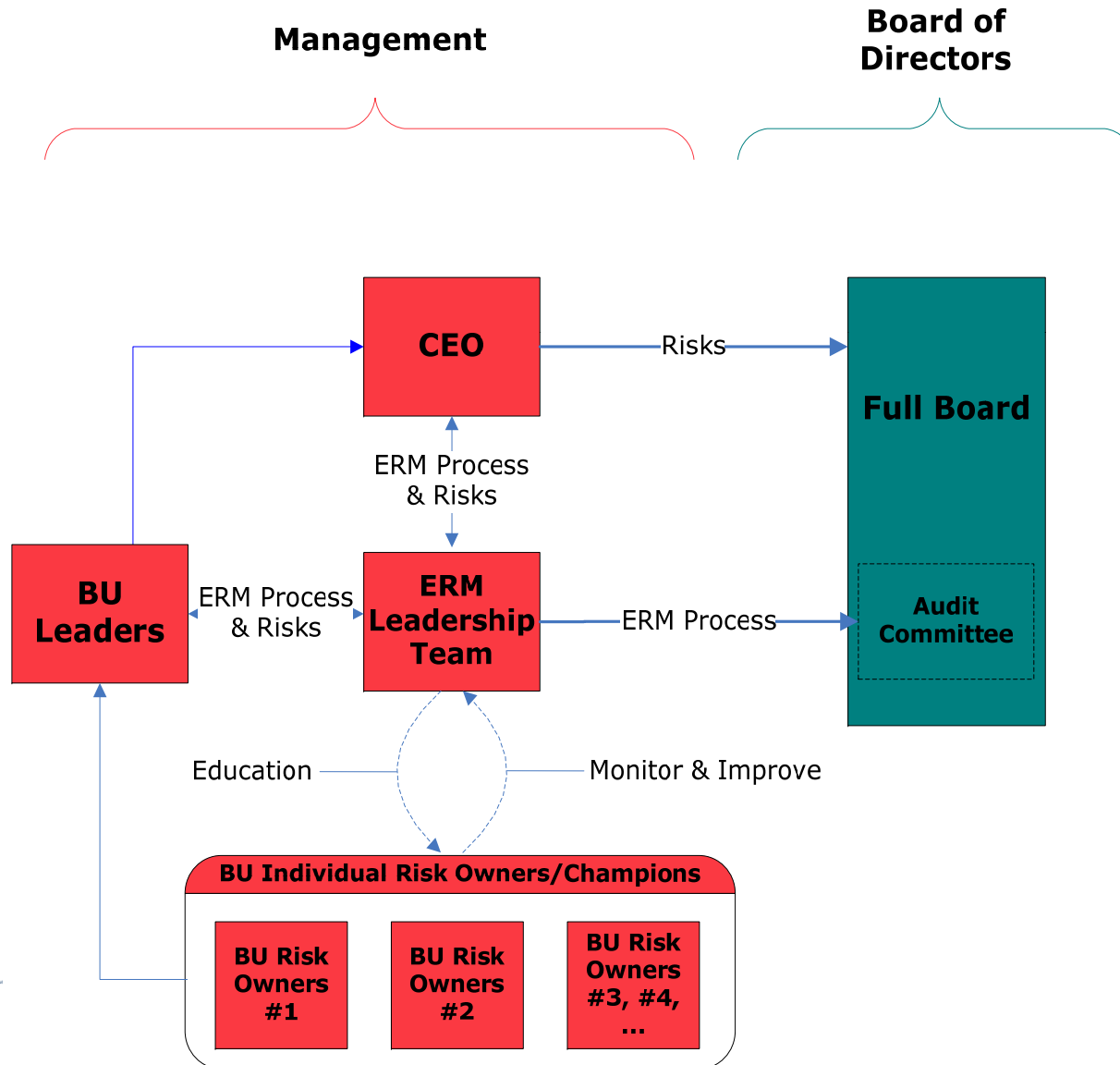


*\*Most companies straddle these two stages\**

# ERM Leadership Team Organization Structure



# ERM Governance Process - Example



# Hierarchy and Roles

<ul style="list-style-type: none"> <li>• Strategy</li> <li>• Agree to Risk Appetite</li> <li>• Approves Corporate Governance Framework</li> </ul>		<h2>Board of Directors</h2>	<ul style="list-style-type: none"> <li>• Receives report on ERM process from Audit Committee</li> <li>• Review Risks and risk management strategies</li> </ul>
<ul style="list-style-type: none"> <li>• Overall Responsibility for Risk</li> <li>• Responsible for Corp Governance Framework</li> <li>• Discusses Risk with the Board of Directors</li> </ul>		<h2>CEO</h2>	<ul style="list-style-type: none"> <li>• Establishes Ethics/Tone at the top</li> <li>• Approve risk appetite/tolerance</li> </ul>
<p style="text-align: center;"><b><u>BU Leaders</u></b></p> <ul style="list-style-type: none"> <li>• Own risk management responsibilities</li> <li>• Develop risk strategy</li> <li>• Assign individual risk owners</li> <li>• Agrees to risk management techniques</li> <li>• Take ERM process direction from Risk ERM Leadership Team</li> </ul>	<p style="text-align: center;"><b><u>ERM Leadership Team</u></b></p> <ul style="list-style-type: none"> <li>• Executive ERM Leadership</li> <li>• Provide ERM process leadership               <ul style="list-style-type: none"> <li>- risk language</li> <li>- measurement approach</li> <li>- risk strategy approach</li> <li>- monitoring requirements</li> </ul> </li> <li>• Reports to the CEO</li> <li>• Educates BU Leaders</li> <li>• Determines monitoring requirements</li> </ul>	<p style="text-align: center;"><b><u>Internal Audit</u></b></p> <ul style="list-style-type: none"> <li>• Monitoring and feedback</li> <li>• Training and support</li> <li>• Audit the ERM process</li> <li>• Reports to Audit Committee</li> </ul>	
<ul style="list-style-type: none"> <li>• Key risk owners:               <ul style="list-style-type: none"> <li>- Treasury</li> <li>- Financial</li> <li>- Operation(s)</li> <li>- HR</li> <li>- Etc.</li> </ul> </li> </ul>		<p style="text-align: center;"><b><u>Individual Risk Owners/Risk Champions</u></b></p>	<ul style="list-style-type: none"> <li>• Develops individual risk strategies</li> <li>• Assesses and monitors risk</li> <li>• Quantifies risk level</li> </ul>
<p><b>Risk is owned by everyone in the organization</b></p>			

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## Critical Success Factors

- Senior management support is critical
- Knowledge is information in action
- What gets measured is what gets done
- Process improvement, knowledge management, change management, performance management, and the like are not events
- Remember the softer side
- Don't try to boil the ocean

# BUSINESS CASE FOR ERM

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- 1. Better information about risks**
  - All entities face risks and risks constantly change – a huge information need
- 2. Opportunities to take risk**
  - Some risks create opportunities for returns
  - Other risks are over-managed
- 3. Partnering on risk responses**
  - Capture efficiencies of coordinated risk responses
- 4. Consistency in approach**
  - Work off same “score sheet”
  - Avoid offsetting risk “gains” with inefficient risk management
- 5. Strategic advantage**
  - Not all strategies bear same level of risks
  - Ensure return is commensurate with risk
  - Risk intelligence leads to competitive advantage – beat competition in response

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Questions?