

# **PRMIA Annual Atlanta Risk Leadership Conference**

**The Outlook for Enterprise Risk Management**

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# Professional Biography

## Professional

- President, James Lam & Associates (JLA)
- Founder and President, ERisk
- Partner, Oliver, Wyman & Company
- CRO, Fidelity Investments
- CRO, Capital Markets Services Inc., a GE Capital company
- VP, Glendale Federal Bank

## Industry Activities

- Author, *Enterprise Risk Management*
- Named “100 Most Influential People in Finance” (T&RM 2005, 2006, 2008)
- Named one of the world’s top risk consultants (Euromoney 2007)
- PRMIA Blue Ribbon Panel Member
- GARP Inaugural Financial Risk Manager of the Year (1997)

## Academic

- Senior Research Fellow, Beijing University
- Adjunct Professor, Babson College
- Lectured at Harvard University as the subject of a HBS case study
- MBA, UCLA School of Business
- BBA, Baruch College

## Client Solutions

- Management Consulting – ERM and risk processes
- Board Advisory – governance and oversight
- Executive Search – management and board talent



## Discussion outline

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- Business Case for ERM
- Current Trends and Practices
- Outlook on Future Requirements



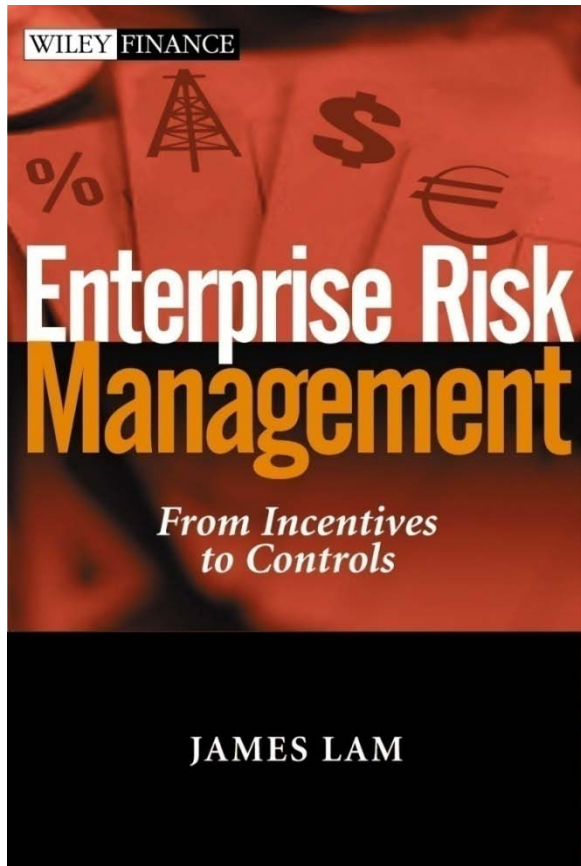
## **Integration adds value in almost every aspect of business (and life)**

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- Risk management – enterprise risk management
- Technology – integrated systems and databases
- Business management – strategy and risk
- Education – integrated learning programs
- Fitness – cross training
- Martial arts – mixed martial arts (e.g., Bruce Lee & UFC)

## ERM should be defined as a value-added function

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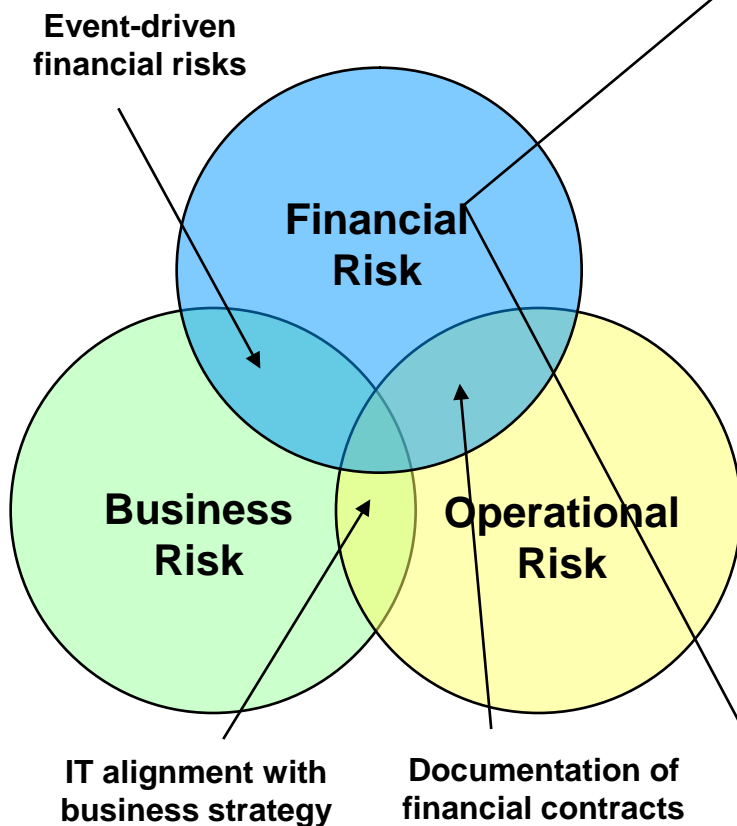


### Definition of ERM:

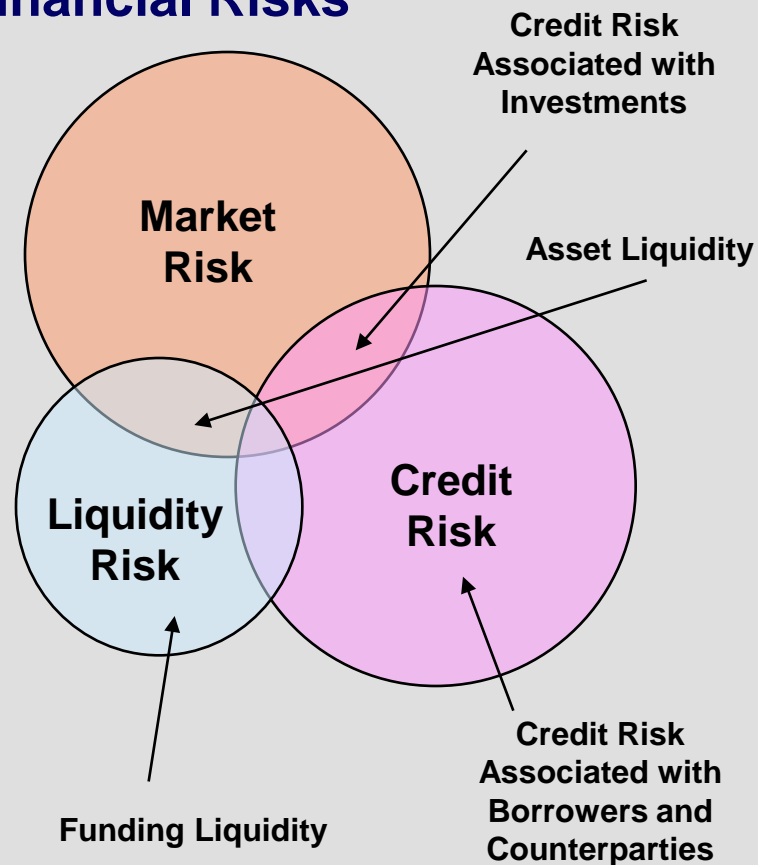
**“An integrated framework for managing credit risk, market risk, operational risk, economic capital, and risk transfer in order to maximize firm value.”**

# Risks faced by companies are highly interdependent

## Enterprise-Wide Risks



## Financial Risks





# Early adopters of ERM have reported significant and tangible benefits

<u>Benefit</u>	<u>Company</u>	<u>Actual Results</u>
Market value improvement	Top money center bank	Outperformed S&P 500 banks by 58%
Early warning of risks	Large investment bank	Global risk limits cut by 1/3 prior to Russian crisis
Loss reduction	Top asset management company	Loss-to-revenue ratio declined by 30%
Regulatory capital relief	Large commercial bank	\$1 billion regulatory capital relief
Insurance cost reduction	Large manufacturing company	20-25% reduction in insurance premium



# Benefits of Effective Governance and ERM

- **McKinsey and Company (2002).** Institutional investors in North America willing to pay an premium of 12-14% for effective corporate governance
- **Gompers, Ishii, and Metrick (2003).** Investment strategy of buying firms with strong shareholder rights and shorting firms with weak shareholder rights produced excess return of 8.5%
- **Cremers and Nair (2003).** Firms with strong governance mechanisms produced excess annualized returns of 8%
- **Brown and Caylor (2004).** Firms with effective governance produce higher ROE, higher profit margin, and greater dividend payout
- **Cheng and Wu (2005).** Top decile companies in the ISS Corporate Governance Quotient ratings produced higher ROAs, higher ROEs, and higher P/E ratios
- **Hoyt and Liebenberg (2009).** ERM use among public US insurers was associated with an equity price premium of 16.5%
- **Standard & Poor's (2010).** North American and Bermudan insurers with "excellent ERM" had better stock performance in 2008 (-30% vs. -60%) and 2009 (+10% vs. -10%) when compared to those with "weak ERM"

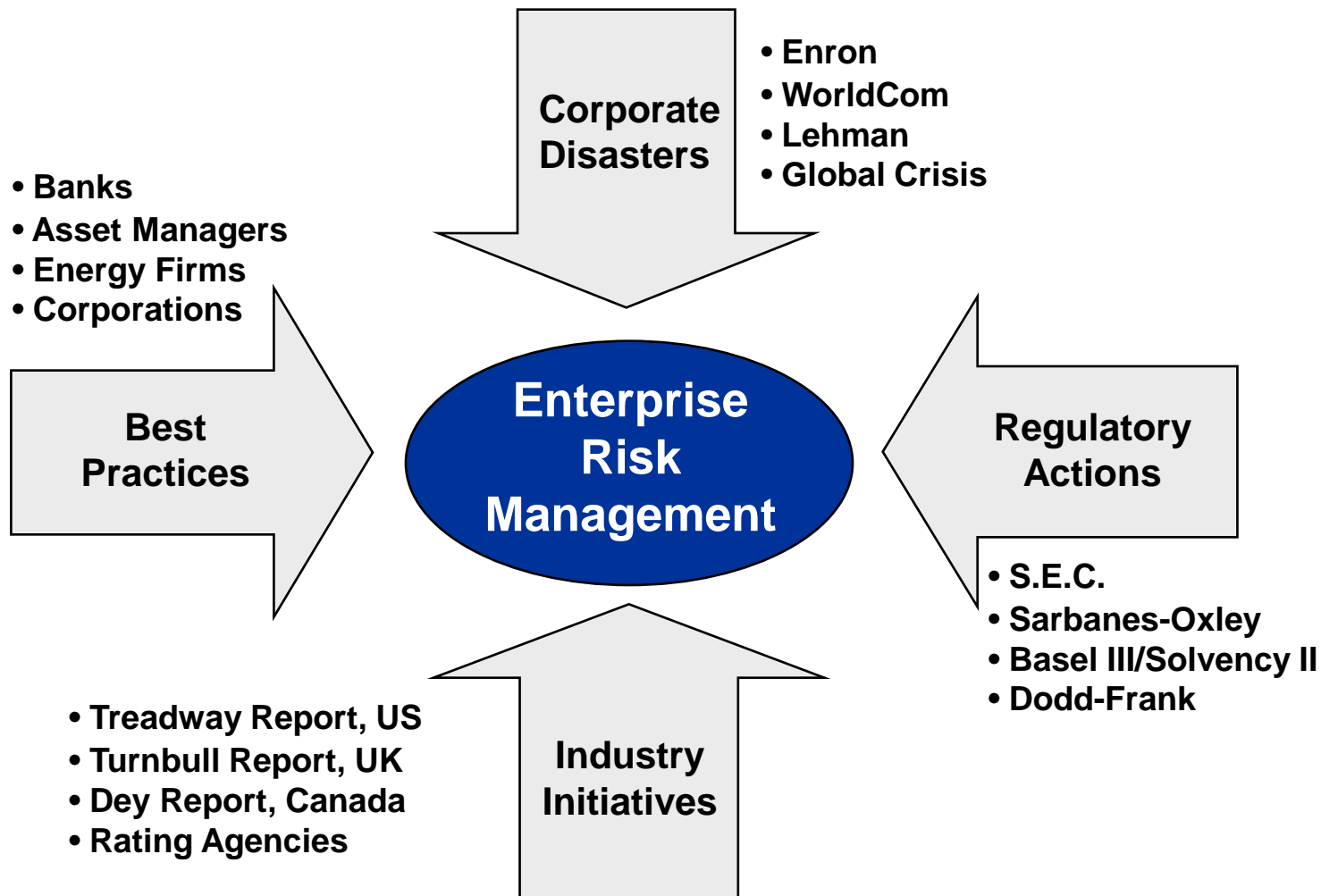


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# The growing acceptance of ERM is driven by four key forces

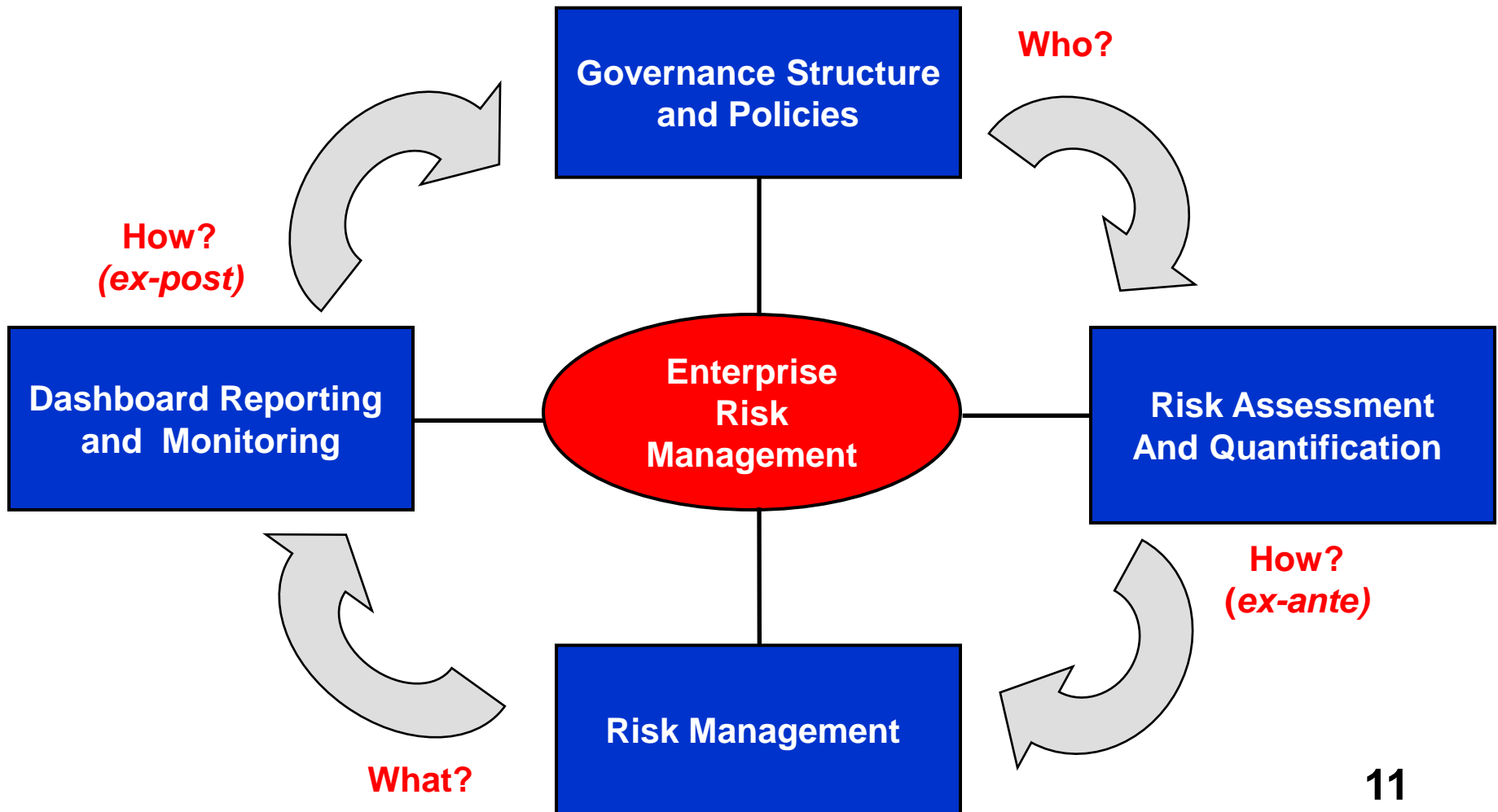




## The level of interest in ERM has never been greater

- New SEC disclosure rules and Dodd-Frank establish new requirements for board risk oversight and risk-compensation linkage
- Recent surveys indicate that risk management has replaced accounting issues as the top concern for corporate boards
- A COSO survey found only 28% of respondents described their ERM process as “systematic, robust and repeatable with regular reporting to the board.”
- A survey of 271 large companies by The Conference Board indicated that 91% are building, or planning to build, ERM. Only 11% have completely implemented ERM
- A survey of 137 global firms by the Economist Intelligence Unit (EIU) found that 45% have already appointed a CRO or equivalent, and 24% planned to appoint a CRO in the next two years
- The rating agencies, led by S&P, have established ERM criteria for financial and non-financial corporations that will be applied in their rating processes

# ERM Framework and Processes





# Risk Management Strategies

- **Risk acceptance or avoidance.** The organization can decide to increase or decrease a specific risk exposure through its core business, M&A, and financial activities.
- **Risk mitigation.** An organization can establish risk-control processes and strategies in order to manage a specific risk within a defined risk tolerance level.
- **Risk-based pricing.** All firms take risks in order to be in business, but there is only one point at which they can get compensated for the risks that they take. That is in the pricing of their products and/or services, which should fully incorporate the “cost of risk.”
- **Risk transfer.** An organization can decide to execute risk transfer strategies through the insurance or capital markets if risk exposures are excessive and/or if the cost of risk transfer is lower than the cost of risk retention.
- **Resource allocation.** An organization can allocate human and financial resources to business activities that produce the highest risk-adjusted returns in order to maximize firm value.

# WSJ Article: Airbus Officials Cite Challenges



## Key Takeaways

- Hans Peter Ring, Airbus CFO, said:

“[Airbus] must now do a better job of putting a price tag on the risks inherent in their airplane programs.”

“We are in a high-tech, complex business, and there is a lot of risk in our business. That won’t change. The question is how to price risk. Obviously, in some cases we didn’t price it right.”

- Posted over €2 billion charges for two big programs – A380 superjumbo (maximum luxury, e.g., showers and private suites, vs. production problems) and A440M military plane (fixed price contract vs. immature technology)
- Boeing also faced significant delays and cost overruns with its 787 (efficient production among large number of suppliers vs. complex outsourcing issues)

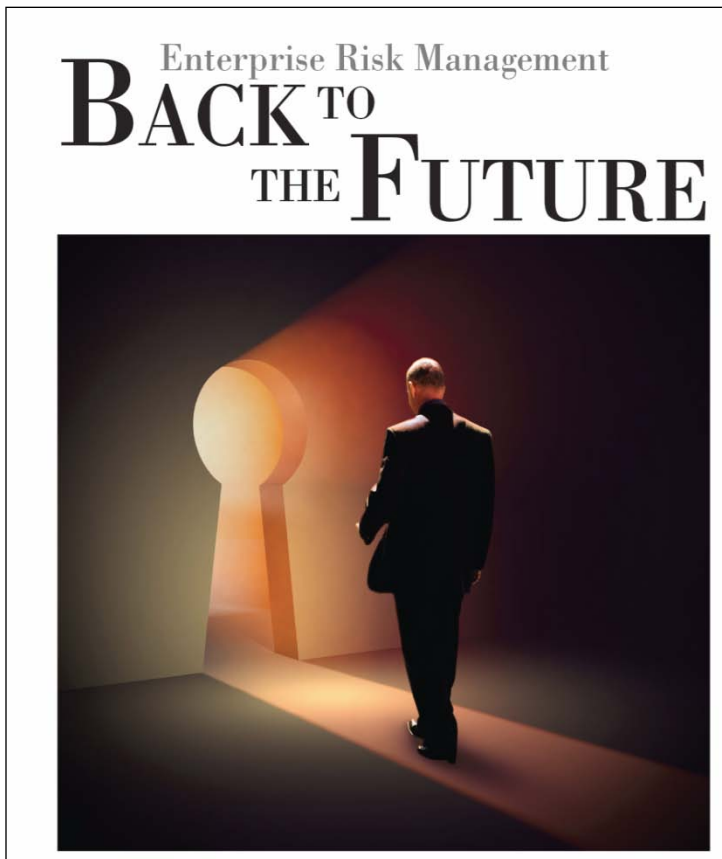


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# ERM Outlook



## Key ERM Requirements

1. Board risk governance and reporting
2. ERM policy with explicit risk-tolerance levels
3. ERM integration
4. Risk analytics and dashboards
5. Assurance and feedback loops
6. Culture and change management
7. Risk and executive compensation



## Governance, policy, and assurance (GPA) are key levers for the board

- **Governance.** Establish an effective governance structure to oversee risk. How should the board be organized to oversee ERM? What is the linkage between strategy and risk management? How can the independence of the risk management function be strengthened?
- **Policy.** Approve and monitor an ERM policy that provides explicit risk tolerance levels for key risks. Do risk management policies and risk tolerance levels effectively capture the board's overall risk appetite and ERM expectations? What is the linkage between risk policies and compensation policies?
- **Assurance.** Establish assurance processes to ensure that an effective ERM program is in place. What are the performance metrics and feedback loops for ERM? How to improve the structure and content of board reports? How should that assurance be disclosed to investors, rating agencies, and regulators?



# Executive management and board responsibilities for ERM

ERM Component	Executive Management	Board of Directors
Risk Governance	Establish management structure and roles	Establish board structure and roles
ERM Vision and Plan	Develop and implement	Support vision; track progress against plan
Risk Tolerance Levels	Establish and conform	Debate and approve
Risk Policies	Develop and implement	Approve and monitor
Business and Risk Strategies	Formulate and execute	Challenge key assumptions; monitor execution
Critical Risks	Manage and measure; optimize risk/return	Provide input and oversight
Risk Reports	Provide context, analysis, and key points	Monitor key exposures, exceptions, and feedback loops
Risk Analytics	Provide qualitative and quantitative analyses	Obtain ERM assurance; conduct board assessments



# Strategic risk identified as the major cause for financial distress

## Organization

James Lam & Associates (2004)

## Research Methodology

- S&P 500 (1982-2003)
- One-month stock price decline of 30% or greater relative to the S&P 500

## Key Findings

- 61% were exposed to strategic risks
- 30% were exposed to operational risks
- 9% were exposed to financial risks

The Corporate Executive Board (2005)

- Fortune 1000 companies (1998-2002)
- Top 20% of companies with the greatest market value declines

- 65% were exposed to strategic risks
- 20% were exposed to operational risks
- 15% were exposed to financial risks

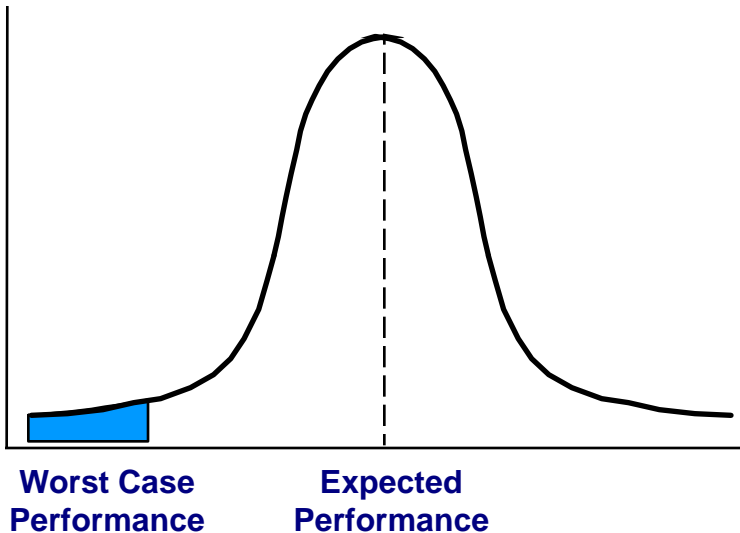
Deloitte Research (2005)

- Thomson Financial Global 1000 Companies (1994-2003)
- One-month stock price decline relative to the Morgan Stanley Financial World Index

- Among the 100 largest declines:
- 66 involved strategic risks
  - 62 involved external events
  - 61 involved operational risks
  - 37 involved financial risks

# Integrating Strategy and Risk Management Performance

## Distribution of Outcomes



## Integrating Strategy and ERM

1. Define business strategy and objectives [or functional performance targets]
2. Establish KPIs based on expected performance
3. Identify risks that can drive variability in performance (risk assessments)
4. Establish KRIs for critical risks
5. Provide integrated monitoring with respect to 1-4

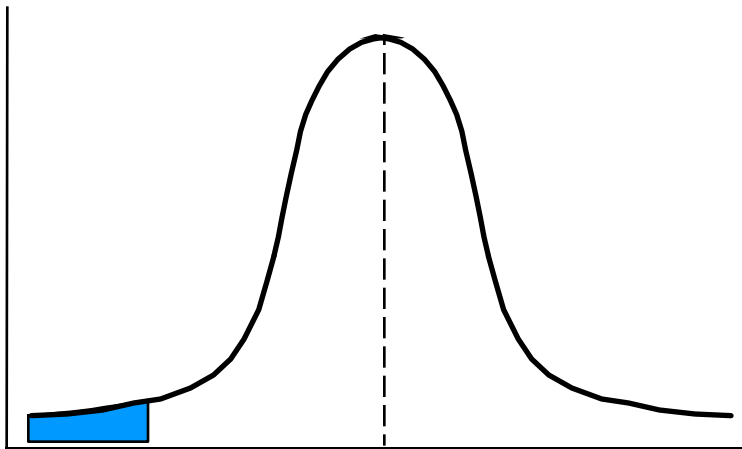
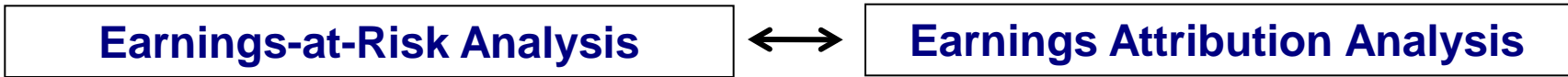


## **Key question facing corporate boards and executives today**

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**“How do you know if your risk management program is working effectively?”**

# Establishing a feedback loop on ERM



Worst Case EPS = (\$1.00)      Expected EPS = \$3.00

- 1. Business Plan: \$2.00
- 2. Interest Rates: \$1.00
- 3. Oil Price: \$0.50
- 4. Key Initiatives: \$0.30
- 5. Expense Control: \$0.20
- \$4.00**

Expected EPS :	<b>\$3.00</b>
Actual EPS:	<b><u>\$1.00</u></b>
Difference:	<b>\$2.00</b>
Business Plan:	<b>\$1.00</b>
Interest Rates:	<b>\$0.50</b>
Key Initiatives:	<b>\$0.10</b>
<b>Unforeseen Factors:</b>	<b><u>\$0.40</u></b>
	<b>\$2.00</b>

**Key Questions:**

1. Did we identify the key risk factors?
2. Were our EPS sensitivity analyses accurate?
3. Did risk management impact our risk/return positively?