



Shelter Island Risk Webinar, May 17, 2011

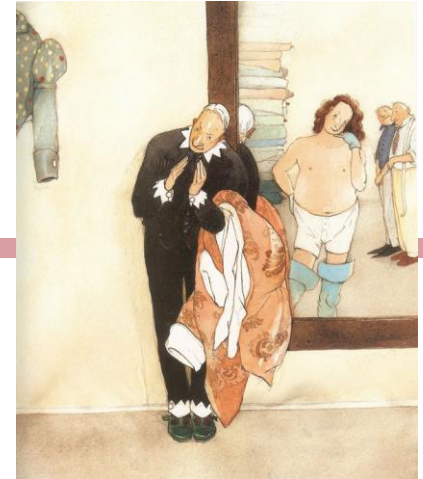
ERM: AVOIDING DETOURS TO SUCCESS

Guest Speaker: **Rick Machold**, Former Head of Enterprise Risk, Invesco

Moderator: **Rick Denning**, President, Shelter Island Risk

Introduction

- Do not fall into the “Emperor’s new clothes” trap – ***honest communication*** is essential.
- ERM should address ***the essence*** of your organization – what do you do better than anyone else?
- Avoid consultants carrying risk maps!
- ERM ***success is learned and adapted***, not bought.





**1) Given all its 'shades and nuances,
how do you define "ERM"?**

What is ERM?

Several established ERM frameworks exist, and much has been written and attempted in practice. COSO is one such framework...

In 50 words or less...:

“...a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, 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.”

Every organization must decide "what ERM is"



A Proposed Simpler Definition

In ten words or less...

“Managing the business with deliberate
and systematic attention to risk”

2) If risk taking is the essence of any organization, how does ERM deal with this reality?

ERM is No Longer “Optional”

Stakeholder expectations compel ERM practices

- Boards of Directors
- Regulators
- Stock Exchange listing standards
- Clients and business partners
- Rating agencies (e.g., Standard & Poor’s)

ERM seeks to *optimize* informed risk taking

"The unhealthiness of our world is in direct relationship to our inability to see it as a whole" – Peter Senge, The Fifth Discipline



Ideally, ERM can be "a rational response to an increasingly risky world."

-- Michael Power, "The Risk Management of Everything"



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ERM must acknowledge the boundaries and limitations of risk management

Remember where the risk management value premise starts and ends

- Risk management **can**:
 - Assess the risks faced by the firm,
 - *Communicate* these risks to those who make risk-taking decisions for the firm, and finally
 - *Manage and monitor* those risks to make sure the firm only bears the risks that its management and board of directors want it to bear

- Risk management **can't** (or shouldn't) directly:
 - Set core business strategy, a function of risk appetite
 - Execute core business strategy
 - Have primary responsibility for risk-taking decisions



ERM is not an Inoculation Against Losses

Risk management can get more than its fair share of blame when things go badly

" In summary, (enterprise) risk management does not prevent losses. With good risk management, large losses can occur when those making the risk-taking decisions conclude that taking large, well-understood risks creates value for their organizations."



3) What is the objective of an ERM program?

Understand your unique Mandate

Consider what is driving you toward ERM

- Operational surprises with direct financial impact
- Credit losses and collection problems in a down economy
- Imperative to be prepared for crisis, business interruption or natural disaster
- History of primarily organic, vertical growth and necessity to seek opportunity in riskier areas (e.g., acquisition, new geographies)
- Increasing regulatory scrutiny and compliance requirements
- Increasing expectations for transparency and quality of information about the risk profile of the business
- Client demands for greater risk management capability
- ***Focus on the short list of “value-killer” risks, i.e., those risk issues that will always be on the top risks dashboard.***



Decide on Desired Results

ERM programs are best grounded in desired business results, not activity

- Reduced earnings volatility from operational surprises
- Improved client perception and reputational integrity
- Better “Return on Management” through focus on the most critical business issues and reducing cycle time for critical decisions
- Better allocation of capital and resources
- Improved margin performance by leveraging risk insight into more risk-adjusted pricing
- Improved price/earnings ratio over time
- Lower cost of capital over time
- Others?



Articulate your Guiding Principles

Fundamental statements that speak clearly to what ERM is and is not

- ERM is a process built into the business, not a separate, centralized function
- We are seeking not to eliminate risk but to understand and manage it
- ERM is woven into the fabric of strategic planning, routine management and other operating rhythms of the company
 - Guard against parallel universes, i.e., redundant risk management processes that can impede the progress of the business
- The value of ERM is in the dialogue
 - Robust ERM will help vet risk/reward decisions more thoroughly
 - ERM is fundamentally about facilitating information flow and insight, and putting that information to practical use in managing the business
- We must address not only problems to be avoided, but also opportunities that could be missed
- We must not become overly enamored with data management processes and reports, which are only a means toward risk dialogue and risk-based decisions, not ends in themselves



**4) What are some common “detours,”
and how can they be avoided/
corrected?**

Common ERM Detours

1. Preoccupation with Process
2. “Delusional Optimism”

Though other potential detours exist, we will focus today’s discussion on these two.

Detour #1. *Preoccupation with Process*

- Missing the big picture (Forest for the Trees)
 - UBS Example
- Confusing ends with means
 - We get so enamored with our process and activity (means) that we start believing it is inherently valued (ends)
 - *"I hate heat maps!"* – The heat map should be the beginning of dialogue in the risk-based decisioning process, not an end in itself

Symptoms: The rubber never meets the road, and/or we miss something big and obvious.

"...(there is an) overwhelming tendency for ERM to exacerbate process."

-- Michael Power, "The Risk Management of Everything"



Missing (or ignoring) the Big Picture

In the list of risk management failures, failure to see or act on the big picture is common

- Failure to see the big picture, “connect the dots” across the risk profile and anticipate problems
(see UBS example below)
- Failure to aggregate risk exposures across the firm
- Loss of focus on the balance sheet – leverage, liquidity, capital utilization
- Poor ability to measure and monitor credit and counterparty concentration
- Weak valuation, pricing and modeling capabilities
- Inadequate stress testing and scenario analysis



Shareholder Report on UBS's Write-Downs

6.3.5 Risk Management

UBS has identified the following contributory causes in relation to risk management by the relevant businesses generally, including:

- Failure to respond to wider industry concerns: At the level of relevant business management, there appears not to have been sufficient discussion of or actions upon concerns surrounding Subprime as an asset class until Q3 2007, even though UBS's research team issued research reports on this area. This seems to have arisen largely from the belief that deterioration in the Subprime market would not impact AAA assets. For example, in March 2007, the Rates business gave a relatively pessimistic assessment of certain aspects of the Subprime market to Group Senior Management. However, over this period, CDO Warehouse activity continued and the CDO desk proposed increases in limits.

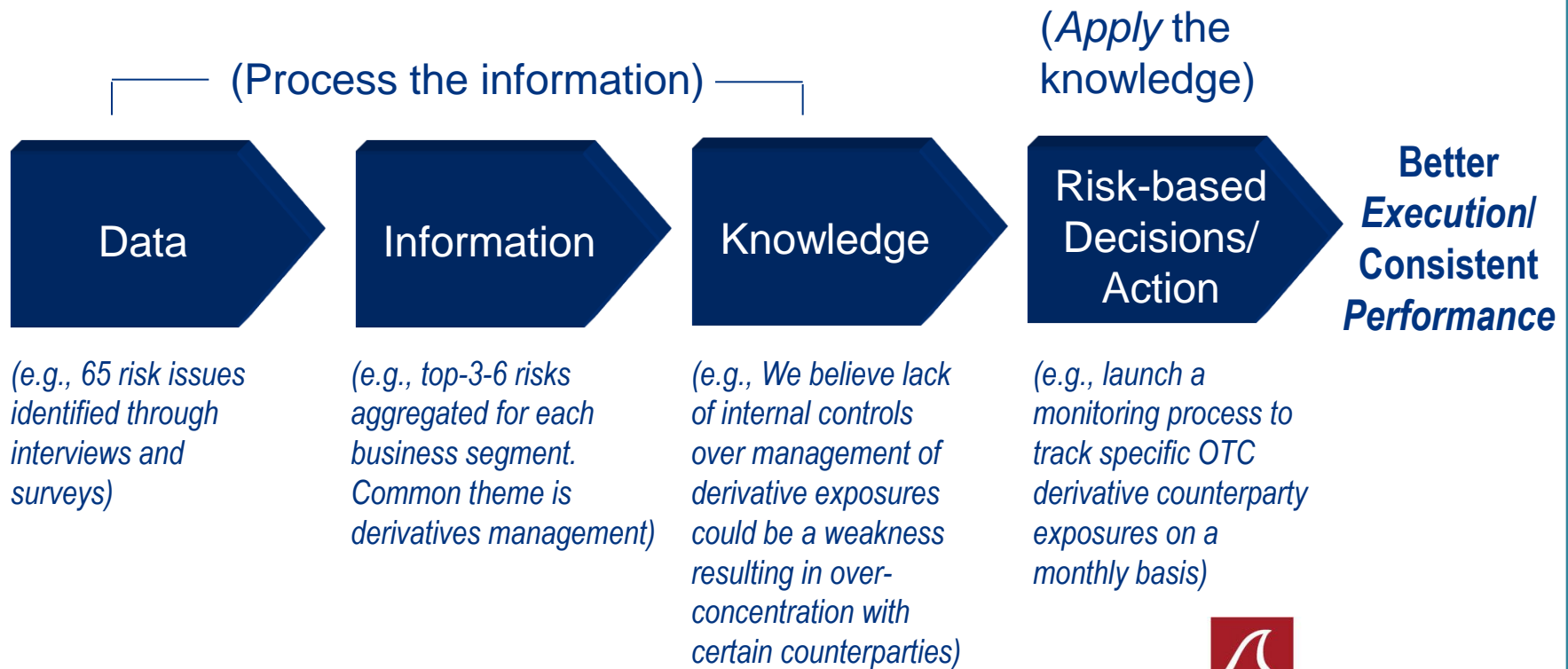
Remedial Ideas for # 1. *Preoccupation with Process*

- Re-focus on the business *results* from the effort
- Re-focus on the quality and productivity of risk dialogue - “The value’s in the dialogue”
- Stop doing things that aren’t bearing fruit

Recovery Signs: Better engagement by the business and release from the need to sell ERM so hard. Value and practical benefits of good risk dialogue become more self evident.

Focus on ERM Results: What Gets Better?

A healthy ERM process should enrich the decision-making process by ensuring that risk insight is applied routinely



5) How then is ERM performance evaluated?

“ERM performance” is linked to business performance

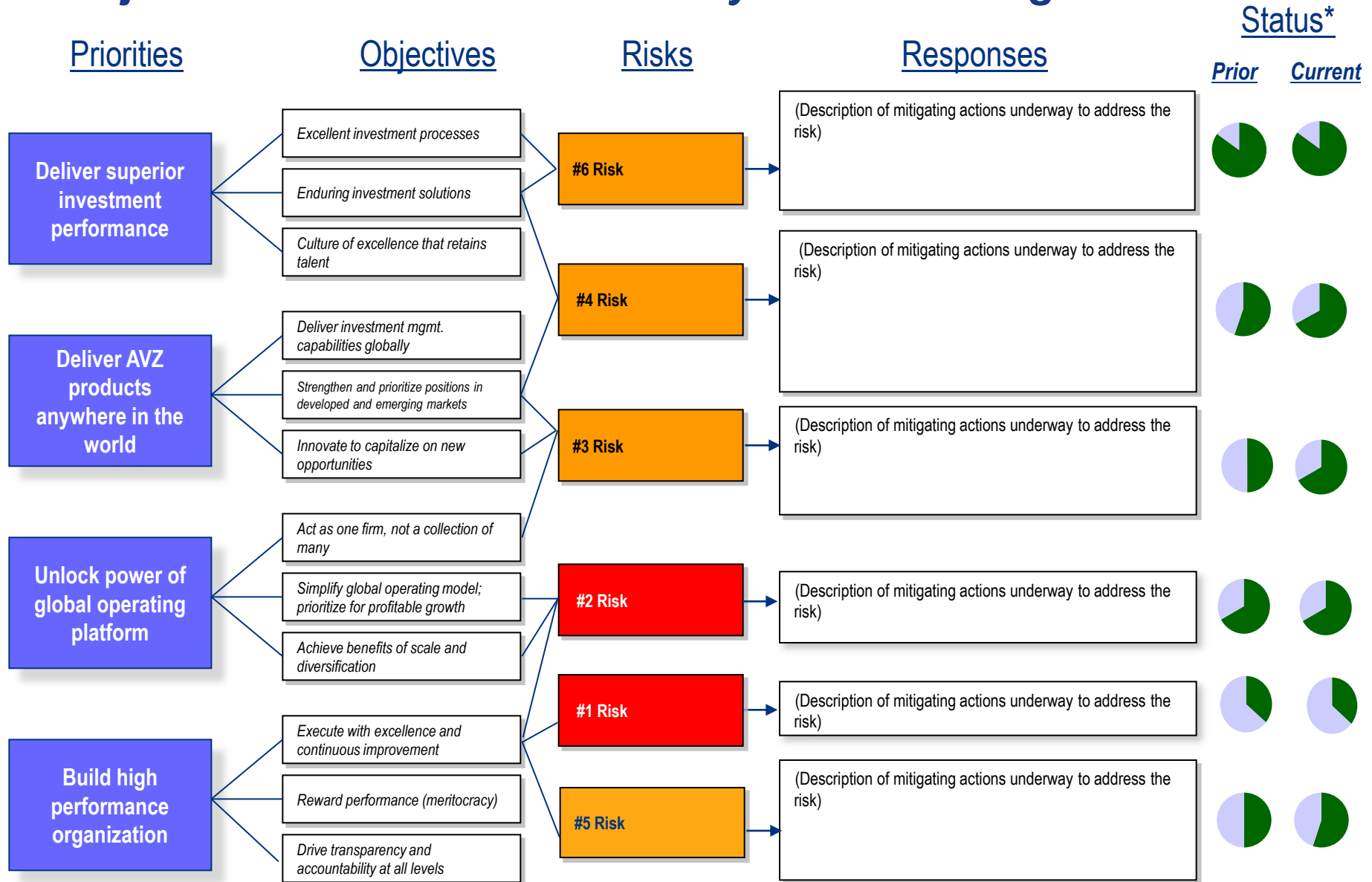
Building risk management into the business results in better and more consistent performance

- Registered Money Market Funds:
 - Avoided credit blow-ups/No exposure to AIG, Lehman, WaMu
 - Redemption requests processed without interruption
 - No capital injections or capital support/No securities purchased out of MMFs by IVZ
 - No securities downgraded below Tier 1 while held in MMFs throughout the crisis
- No involuntary fund closures
- No exposure to high profile fraud events (Madoff, Stanford)
- No securities lending losses for clients
- No significant interruption in operations from natural disasters or other events
- No significant distractions from M&A integration activities
- No major problems from counterparty relationships (e.g., collateral, custodial)
- No extraordinary adverse operational surprises in the last five years



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Subjective ERM Measure = *Quality of Risk Dialogue*



* Green denotes risk mitigation progress, moving clockwise from 12. Full green would mean residual risk has been managed to a level fully within Invesco's risk tolerance and ability to mitigate; does not mean inherent residual risk has been eliminated.

6) What internal human resources are required for ERM, and what (if any) are the best roles for outside consultants?



ERM has a few Foundational Competencies

Four Roles of an ERM Practitioner

- **Aggregator**
 - Systems thinker
 - Big picture synthesizer
- **Communicator**
 - Ruthless seeker of clarity in risk understanding
 - Visualizer of data
- **Catalyst**
 - Change agent within the culture
 - Driver and enabler of risk competency improvement
- **Diplomat**
 - “Honest Broker”
 - Source and/or legitimizer of probing questions

“They might as well just have a chief risk officer with a small support staff, but that’s because they’re not doing risk management. What they’re doing is implementing a risk management framework throughout the DNA of the firm .”

-- Economist Intelligence Unit/ACE/KPMG – “Fall Guys: Risk Management in the Front Line”

Roles of an ERM Consultant

- An ERM Consultant **can**:
 - Facilitate articulation of the ERM mandate
 - Provide an overarching framework and roadmap to get started and stay on the right course for implementation
 - Provide supplemental resources where required (facilitated assessments, training)
 - Help in “course-correcting” an ERM program that has detoured
- An ERM Consultant **can’t** (or shouldn’t):
 - “Install” an off-the shelf program or methodology – too much tailoring required
 - Be the ultimate representative to external constituencies of the ERM program
 - Assume management responsibility for the ERM process
 - “Take my watch and tell me what time it is!”



Detour #2. *Delusional Optimism*

- In pursuit of opportunity, management loses perspective of the risk context in which it is operating
 - Business environment “scanning” process slows down or ceases
 - Failure to acknowledge an “Extremistan” environment (e.g., BP Deepwater Horizon)
- Senior management stops listening to or simply rejects important risk information
 - Checks out of the risk dialogue
 - *“I hear what you’re saying, but we’re making too much money to do anything about it right now...”*

Symptoms: A “see no evil” and/or “bulletproof” mentality begins to pervade the culture, which is often very difficult to challenge effectively (if at all)

Remedial Ideas for Detour #2. *Delusional Optimism*

- Know whether you're living in "Extremistan" or "Mediocristan"
 - Focus on "emerging risks" becomes even more critical
 - *"We're living in a 3 standard deviation world right now – we ought to be talking about what might happen next week!"*
- Stay humble and teachable about ERM capabilities
 - Understand and acknowledge organizational weaknesses
 - Don't talk about what ERM is going to accomplish until you've *done it!* As with any organizational change initiative, "under-promise and over-deliver" is the best policy

Recovery Signs: A humbler and wiser senior management can increasingly speak to the value of ERM from *experiences* in which it has made a discernable value difference.

Questions

Our Next Webinar

“How to Enhance Risk Management in Your Organization” July 19, 2011 at 11am Eastern

Including Laurie Solomon
Director, Risk Management at the Coca Cola Company

Business Insurance Award Winner in 2011, Risk Manager of the Year



Suggested Resources

- Michael Power, "The Risk Management of Everything," 2004 Demos, www.demos.co.uk (there also are many excellent references in the footnotes to this rather lengthy but very rich article)
- Rene Stulz, "Risk Management Failures: What are they and when do they happen?," Ohio State University
- Rene Stulz and Brian Nocco, "Enterprise Risk Management: Theory and Practice," Journal of Applied Corporate Finance, Volume 18 No. 4
- Peter Senge, The Fifth Discipline (Chapters 5-6) on systems thinking and systems archetypes, repeating patterns in organizational functioning
- "Peter Schiff was Right" <http://www.youtube.com/watch?v=2I0QN-FYkpw&feature=related>
- Expert Viewpoint, "Where was ERM?," Chris Duncan www.irmi.com, <http://www.irmi.com/expert/articles/2008/duncan11-enterprise-risk-management-erm.aspx>
- International Risk Management Institute, The Risk Report, "Enterprise Risk Management," Rick Machold, www.irmi.com, April, 2003 issue
- UBS, "Shareholder Report on UBS's Write-Downs," April 18, 2008
- HBR, "Successful Change Programs Begin with Results," by Robert H. Schaffer, Jan-Feb, 1992
- HBR, "Delusions of Success," by Dan Lovallo, August, 2003
- HBR, "The New Religion of Risk Management," by Peter Bernstein, Mar-Apr, 1996
- "The Value Killers," Deloitte, www.deloitte.com
- Economist Intelligence Unit, "Risk 2018: Planning for an Unpredictable Decade" 2008
- Economist Intelligence Unit, "Fall Guys: Risk Management in the Front Line" 2010