



Risk Management (I)

Summary

This past fall, Treasury & Risk, a magazine serving the financial community, hosted a senior -level forum focused on creating and preserving value through risk management. Conversation concentrated on three consistent themes: the importance of strong executive leadership to a healthy risk-management initiative, the need for that initiative to extend beyond litigation and operational risks to a wider range of global risks, and the role of risk management in value creation. CFOdirect sat down with PwC Partner Fred Cohen, who led a panel on Enterprise Risk Management (ERM), to discuss these latest risk management trends.

Full Article

Enterprise Risk Management (ERM) first appeared on corporate radar screens after the enactment of the Sarbanes-Oxley Act in 2002 heightened concern for effective governance. At that early stage, ERM was used by companies to identify and manage financial and litigation risks—risks that would impede production, compromise supply chains, or cut revenue—without much consideration for the bigger picture. This approach left companies largely unprepared for the consequences of market-altering, incalculable risks such as terrorist attacks, corporate scandal, and political unrest in developing countries. Now wiser, today's companies are recognizing the need for an ERM initiative that takes a more broadly strategic approach to risk management. Though many companies have achieved partial success in their risk management efforts, few have effectively embedded ERM initiatives into standard operating procedure. CFOdirect asked PricewaterhouseCoopers Partner Fred Cohen, a top advisor on state-of-the-art compliance programs, to explore the ways in which companies can attempt to bridge the gap between successful, discrete projects and embedded, integrated programs.

Executive leadership must be committed

Though effective models of ERM leadership can vary across companies and industries, one fact must remain fairly constant to ensure the initiative's success: executive management must be fully committed to and accountable for the Enterprise Risk Management program. "Recent trends show that current ERM initiatives value more than just financial returns. Now ERM is being used as a method not only for controlling damage, but also for revealing growth opportunities. CEOs and business executives, who can offer

insight into the business perspective, should be as engaged in the risk management process as CFOs and finance executives are," says Cohen.

Cohen believes that the responsibility of leading the initiative ultimately falls on the shoulders of the CEO, though this should not preclude the CFO from driving the initiative. As the financial leader of the company, the CFO is responsible for the financial aspects of ERM. In some companies, the CEO and CFO work in tandem at the strategic level, and the role of initiative leader becomes interchangeable. Regardless of what model they choose, management must set the tone for the company's attitude toward risk management. If management believes that ERM provides little value and lets it sink to the bottom of the agenda, leaders of the various business groups will rearrange their priorities accordingly. If management makes ERM a high priority and becomes heavily involved in the initiative, the business groups will follow suit. The emergence of "high- impact, low-probability" risks of various types, such as an outbreak of Avian flu and the economic growth of the BRIC countries (Brazil, Russia, India, and China), has made necessary a panoramic assessment of a company's key risks, how the risks compare to those of competitors, and what challenges the company may face in the long and short term. Implementation of such a demanding agenda will require management's oversight and interest to ensure that sufficient time is allotted to get the project off the ground. Without the support and example of executives, the ERM integration process can be significantly delayed.

Because management typically has more than enough to do, many companies elect to jump-start their ERM initiatives by appointing a Chief Risk Officer or establishing a centralized risk management group to drive risk identification. Most companies, however, abandon this oversight function early in the process, because they find that the approach offers little value to their business. "Given the complexity of large corporations today, it is unreasonable, if not impossible, to expect a designated Chief Risk Officer to have a fully comprehensive point of view regarding each and every element of the business," says Cohen. In most companies, corporate governance is comprised of separate, yet interwoven functions—internal audit, financial risk, and compliance—that may offer different or conflicting viewpoints regarding how best to handle and manage risk within the company. The risk function, which tends to focus on financial risk, is typically driven by the CFO's or treasurer's office, while the compliance function is usually driven by the Office of General Counsel or the business units. Cohen, who understands the difficulty of harmonizing the different viewpoints of these departments, offers this analysis of the issue: "While I believe that an executive, a group of

executives, or a committee needs to sit on top of these functions, I also believe that each of these areas needs to develop its own approach to governance, risk, and compliance that is consistent with the business needs of the company as a whole." He is also quick to point out that the execution of a company-wide ERM vision is most effective when handled by the individual functional groups and not by a centralized ERM unit.

Although some companies may benefit from the establishment of a Chief Risk Officer to encourage and monitor progress during the early stages of implementation, it's important for the company to begin work immediately to replace this vertical management structure with a more horizontal one. Ultimately, the processes that comprise ERM must be baked into the organizational structure, and the responsibility of business units to drive risk management must be reinforced. ERM should become a natural part of the decision-making process for all business groups, however difficult and time-consuming it may be to establish this level of integration. If the goal is to institute an ERM program that effectively identifies risks and opportunities for value creation, companies need to approach ERM not from a single point of focus but from multiple points of focus to develop a clear vision of the expected outcomes. Companies that find a centralized ERM unit indispensable should consider instituting a robust risk committee, rather than a single Chief Risk Officer, to ensure that all points of view are presented, discussed, and debated, and that consensus is built around how best to run the company.

Shifting focus from the purely financial to the global

In the wake of the Indonesian tsunami and Hurricane Katrina, companies are wondering how ERM can better prepare them for unpredictable disasters. Today, staying competitive in the marketplace means not only surviving tragedy, but also claiming a fair share of the reconstruction efforts shouldered by private enterprise. As companies complicate their operations and stretch their business across borders, they will need to structure ERM initiatives to recognize the possibility of highly unusual risks.

To assign quantitative measures to high-impact, low-probability risks, companies should identify the few elements within them that actually can be measured. They should then examine whether these risks are unique to their experience or whether they are consistent with the experiences of other companies. But numbers can reach only so far. At some point, companies will need to look beyond the calculations and rely on good business sense in

decision-making. "There's been a push to move away from the precision of traditional ERM programs and to approach risks from a more directional level," says Cohen. "This involves looking at initial risk assessments to identify how a particular risk can be measured, even if it's fairly qualitative, and then developing scenarios of potential outcomes. The same criteria can then be used to determine whether that risk is growing or shrinking."

He presents a hypothetical case. A company that manufactures beverages relies heavily on water for the manufacture of its products. Because loss of water represents a risk capable of crippling production and sales, the company must consider the impact on its operations of a water shortage. "Although a water-related problem cannot be measured, the company can tag the risk with an estimated number by considering loss of sales over 'x' number of days and multiplying that number by the typical volume of revenue for a day," reasons Cohen. "If it takes 30 days to correct the problem, the company can begin to put some measures around what that risk will mean both qualitatively and quantitatively. Here, the greater loss pertains to reputation, which will also require some measurement." Yet, while fuzzy measurements are helpful and necessary, high-impact, low-probability risks should be approached less from a financial perspective and more from a business perspective to ensure that qualitative factors such as public fear and reputation are included in risk assessments.

Here the classic example of two hotly competitive mobile phone companies comes to mind. The companies relied heavily on the same New Mexican plant's production of semiconductor chips for use in their mobile phones. When a fire destroyed the plant's entire stock of chips and shut down production, one company acted quickly to capture all of the supply in the market and, so doing, nearly forced the other out of the mobile phone industry. How was the successful company able to gain this competitive edge? It had identified the loss of its supply chain as a potential risk and evaluated that risk from a strategic perspective. The company was more ready for disaster. It chose to focus on the value that could be gained from thinking about risks in a broader context and, as a result, secured significant benefits when disaster struck. Ultimately, the end product of ERM should be value preservation *and* value creation. An effective ERM program works unequivocally toward both goals.

Technology can help

As the risks companies face grow in size, variety, and frequency, management becomes increasingly interested in understanding how technology can facilitate risk identification and assessment. Surprisingly, most ERM programs now consist of highly manual processes with minimal automation. Several software vendors are responding to this need by developing applications that can support an ERM program.

Though this movement toward technology is undeniable, companies have expressed concern about how to integrate technology without compromising their strategic focus. If a robust ERM program requires more of a strategic approach, based on recurrent discussion and debate, where does technology fit in? Cohen maintains that an effective balance can and should be struck between dialogue and technology. "When a company decides to identify risks and to measure their impact on operations, it should establish a dashboard that illustrates how those risks perform on a historical, current, and projected basis," explains Cohen. "Many risks are deeply embedded in the operation of the business. Therefore, risk management systems must be capable of capturing and integrating business performance, as well as the associated risks." Consider, for example, a US company that is launching a new product, outsourcing its supply chain to China, and maintaining some production in the US. This company should have systems, information, and technology that can track production and monitor error rates regarding products that are manufactured, shipped, and returned. The company should also ensure that a similar program exists in China. If not, technology should be developed so that the performance of Chinese manufactured goods versus US manufactured goods can be accurately compared. If technology is implemented and product failure rates increase, the decision to outsource may prove less cost-effective, and more risky, than initially anticipated. "There is a need to develop a system that allows companies to capture comparative information regarding risk so that they can adequately monitor performance. Technology can help with this."

For similar reasons, Cohen promotes the use of risk adjusted-return on capital (RAROC), a metric that evaluates an investment's risk level and factors that could affect its potential return. Based more on possible scenarios than strict quantifications, RAROC adds a dimension of risk (i.e., the probability of the distribution of those earnings or cash flows) to the expected return, which may be predicted using a company's budget preparations or an extrapolation of its performance over multiple time

periods. On a retrospective basis, a company can examine the risks associated with the business by using RAROC to compare its investments against one another. For example, a company may invest \$10 in a US bond and \$10 in a developing country. Because of the political risks inherent to investing in a developing country, the investment in the Treasury bond proves far less risky to the company, though potentially less profitable in the long term. "We hope that when companies recognize a risky strategy, they are able to eliminate some of the risk factors, make the percentage return more probable, and reduce the overall risk to make it more palatable." RAROC is an important element to consider in examining a company's risk profile and is best addressed through an automated operational dashboard. This ensures that different investments are compared fairly and that the methodology becomes an integrated part of the company's day-to-day operational activities.

A maintenance matrix often proves helpful for integrating RAROC and other risk measurements into a company's risk management program. "If a company starts at the strategic level and works down, it can create an automated matrix for maintenance," Cohen says. By making risk measurements and considerations such as RAROC part of management's everyday language, companies can save time and resources, which can then be invested in other important areas. "From an operational perspective, a company should be able to identify three or four critical elements of its operation, collect data for them, and effectively monitor compliance and performance within each of them. This type of maintenance dashboard can help companies solidify the beginnings of an effective risk-identification process."

From initiative to integrated program

At most organizations, ERM remains in its infancy. It is all about "initiatives," not yet about completions. However, this should not be discouraging. Most often, companies create initiatives with the intention of structuring processes that can later be embedded into corporate culture. At some point, companies must confront this methodological question: should governance, risk, and compliance be evaluated separately as elements of a larger program or should they be evaluated under the umbrella of Enterprise Risk Management? Initially, most companies place these elements of compliance and governance within the scope of ERM, but as time goes on they gradually become part of the daily management function and no longer fall under the umbrella of the initiative. This is good-it's an important first step. When

companies successfully embed compliance and governance (pieces of the ERM puzzle) in standard operating procedure, they prove more capable of assessing the magnitude and frequency of risks. Many companies on the path to ERM have successfully reached this stage. Yet, despite their ability to evaluate operational risks, they still struggle to identify global risks, which are less easily quantified and better addressed by a scenario-based approach. A company's ability to identify global risks represents the second, more challenging step toward a robust and fully embedded ERM program.

The process of moving the remaining elements of risk identification into the day-to-day performance measurement of an organization is slow, and many companies have quite a distance left to travel. Cohen suggests that, among other reasons discussed above, lack of a core program could be to blame. "Many companies have not fully adopted a fundamental program that would identify the six to twelve key risks that can create or destroy value. Thus far, most have been unable to incorporate this type of program in a performance monitoring or measurement capability—at least not in a meaningful way," Cohen explains. This represents the major work that companies must still accomplish to implement a robust ERM program that considers global risks and risk-adjusted return on capital.

"We are dealing in a dramatically complex world, and there is a definite need to develop Enterprise Risk Management programs that identify, assess, and mitigate a wide range of operational and global risks," says Cohen. "A robust ERM program enables companies to operate more efficiently and effectively with lower risk profiles and therefore allows them to remain viable in competitive international markets."

Fred Cohen is the Global Advisory Leader for PricewaterhouseCoopers' Energy, Utilities and Mining sectors. Mr. Cohen has led many of PwC's Advisory Practices including the Consumer and Industrial Products Industry Sector, the Finance, Operations, Risk and Compliance Practice and the Financial Risk Management Practice. He began his career as a treasury and finance consultant. For over thirty years, he has advised global corporations on business strategy, organizational structure, financial risk management and financial and management reporting. You may contact Mr. Cohen at 646.471.8252 or via email at fred.cohen@us.pwc.com.

Currently, Mr. Cohen is focusing his efforts on assisting companies develop a deeper understanding of their enterprise risks including the impact of geopolitical risk on the business performance of global companies. As part of

this effort, he leads an alliance between PricewaterhouseCoopers and the Eurasia Group. The alliance was formed to help multinational organizations integrate political risk management into their overall enterprise risk management framework. In his leadership role, Mr. Cohen works with chief executives and board members of large organizations to help them understand the dimensions of operational and financial risk and how to incorporate risk management into their business strategy. He also addresses the growing need for political risk management as businesses rapidly move operations into new and emerging markets around the world.

A frequent lecturer and writer on finance and risk management topics, he has recently presented at the EEI Audit Committee Training Program, the EuroFinance Treasurer's Conference in both the US and Europe and several PwC sponsored conferences and roundtables. Mr. Cohen has appeared on CNBC's Squawk Box. He has also been quoted in The Wall Street Journal, Investors Business Daily, Public Utilities Fortnightly and Electric Light & Power, among others.

Mr. Cohen received a B.A. in Political Science from Rutgers College, an M.B.A. in Finance and Accounting from Drexel University, and participated in the Executive Education, International Program at Wharton School.