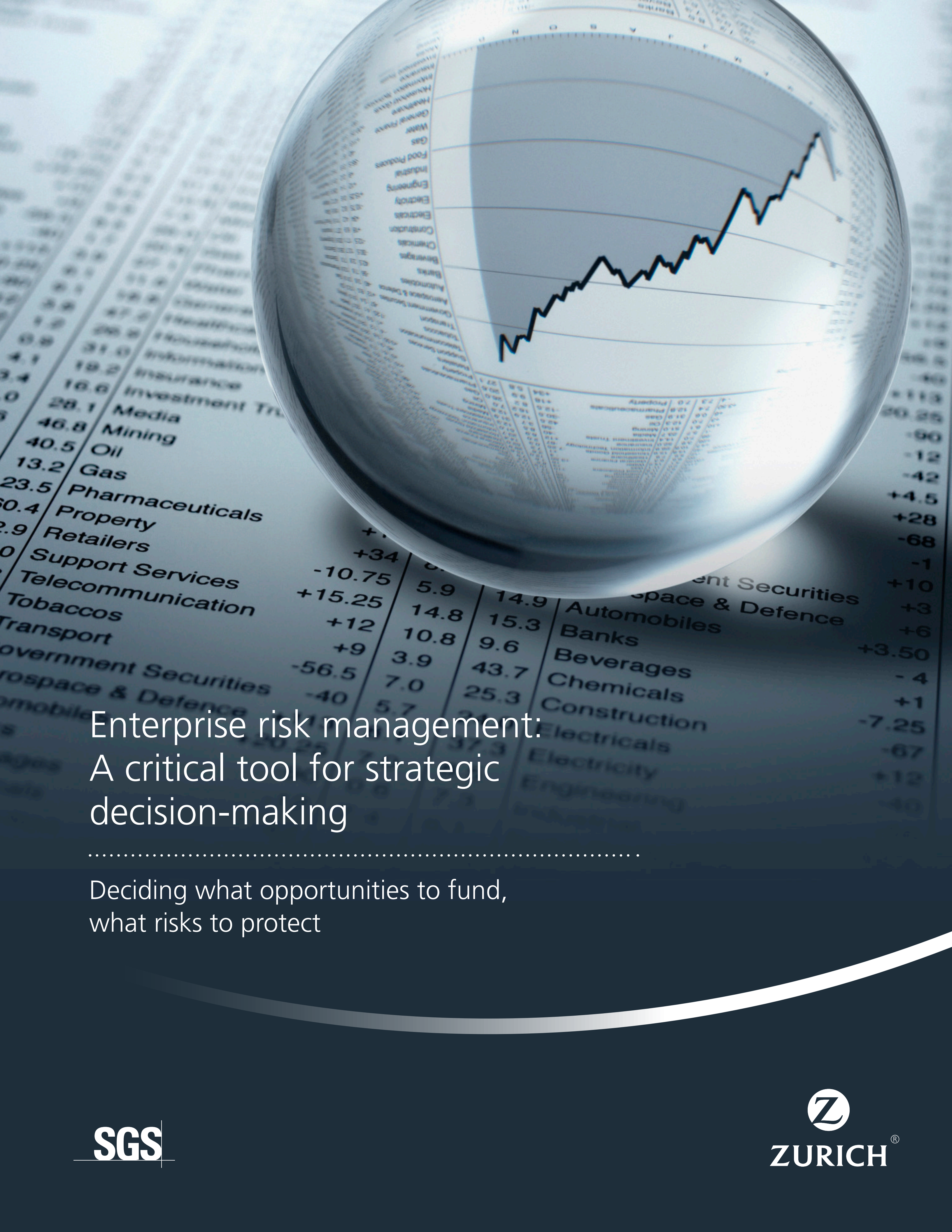

Enterprise risk management: A critical tool for strategic decision-making

Deciding what opportunities to fund, what risks to protect

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Taking risks is a necessary part of growing a business and adding stakeholder value. An organization that operates too cautiously and misses product or market opportunities can have difficulty attracting the best talent and investor capital. While the upside of risk is the ability to strategically seize business growth opportunities, today's complex world has also revealed the downside of risks. Fragile global supply chains, technology dependence, increased speed of product cycles, and complicated financial models and relationships continue to multiply the breadth and depth of risks facing organizations.

Failure to either anticipate growth opportunities or plan for negative events can have serious consequences on business operations, including loss of customers, inadequate asset protection, failure to meet regulatory requirements, lower profitability and share price. How can the senior management of an organization be more aware of their potential risks—both the upside and downside? Recently, there has been an intensifying interest in enterprise risk management, or ERM, as a tool to enable organizations to consider the potential impact of all types of risks on their processes, products, services, activities and stakeholders. In short, an effective ERM approach can help an organization make the most efficient use of its capital. By determining what growth opportunities to fund, and what potential risks need budget support, an organization can better ensure it will meet its business objectives today and into the future.

Regulatory and Legal Drivers of ERM

Enhancing an organization's growth opportunities, improving financial and operational performance, and reducing losses are some of the internal drivers that spark the development of an ERM framework within organization's today. However, there are significant external drivers—primarily regulatory and legal—that are challenging organizations to formalize their risk management processes. In short, it's just good business practice.

In July 2009, the SEC proposed rules that would require management to increase its disclosures of information that describe the overall impact of compensation policies on risk-taking. The proposed rules would also require disclosure in a proxy statement about the board's role in the company's risk management process, and the effect that this has on the way the company has organized its leadership structure. The SEC believes that disclosure should provide information about how a company perceives the role of its board and the relationship between the board and senior management in managing the risks facing the company.

At the same time, a bill was introduced in the U.S. House of Representatives that would require corporations to establish a risk management committee comprised of independent directors. Additionally, the U.S. Treasury Department is considering requiring compensation committees of public financial institutions to disclose strategies for aligning compensation with sound risk management.

Ratings agencies and analysts have also taken a keener interest in governance efforts. In 2008, Standard and Poor's (S&P) began assessing ERM processes as part of its corporate credit ratings analysis. Clearly, the need to create a robust ERM framework is something no corporate board or senior executive team can ignore today. Risk management has moved beyond just the purview of the CFO and accounting department to become an enterprise-wide responsibility.

In addition, the International Organization for Standardization (ISO) published the ISO 31000:2009, Risk Management – Principles and Guidelines on November 15, 2009. ISO 31000 provides generic guidelines intended to promote the adoption of consistent processes so as to ensure the risk is managed effectively, efficiently and coherently across organizations.

Less about Business Continuity, more about Business Resilience

Risk management is often used as a synonym with business continuity management. While the two processes share much in common and similar methods, they are different concepts.

Business continuity management deals with factors that may cause significant business disruption or may damage the organizations' reputation. It emphasizes preparing the organization for and bringing the organization back from a threatening event. In other words, business continuity management is an application of risk management in the context of threatening risks and emphasizing a timely recovery after an incident.

Enterprise risk management, on the other hand, sets down a structured framework for the organization to identify, rank, and control all the risks concerned. The purpose of this broader assessment is to create a more resilient business—one that is better prepared to adapt to changing conditions and leverage emerging opportunities, as well as anticipate surprises and recover from disruptions. Effective enterprise risk management goes hand in hand with a business resilience process by creating a proactive infrastructure for dealing with risks systematically, holistically and successfully.

360-Degree ERM Process Supports Strategic Objectives

Effective risk management today requires an enterprise approach that views risk from all angles – a strategic, 360-degree view supported by tactical, holistic solutions. Achieving this broad view ensures business resilience, reduces total cost of risk, and protects profitability by improving a corporation's ERM framework. An organization with a broader view of risk can better uncover and manage its business challenges, including operations and procedures, management styles and strategies, industry issues, emerging risks and more.

A 360-degree ERM process can help organizations meet these strategic objectives:

- **Protect the capital base**
  An ERM review can potentially drive meaningful financial benefits including reduced cost of servicing debt, improved access to capital and cost of capital.
- **Enhance value creation and contribute to optimal risk-return profile**
  ERM can increase probability of the upside and decrease the probability of a downside.
- **Support corporate decision-making process** for senior management, ERM can demonstrate its incorporation of risk information as a decision-making process, especially for rated companies that need to score well on the S&P ERM assessment.
- **Protect reputation and brand by promoting a sound culture of risk awareness**
  ERM can increase investor confidence through proven management accountability for risk.

ERM in Action

Over the past five years, Zurich's operational risk capital efficiency has improved through a strengthening of its ERM process, which includes the introduction of an operational risk management framework. This framework provides Zurich with risk management tools to specifically identify, assess, manage and quantify operational risks. Through this framework and the wider ERM process, Zurich increases its ability to achieve efficiency and effectiveness gains. This allows Zurich to better focus on optimizing company resources and in turn decide what opportunities to fund.

For example, one business unit experienced a reduction of 21.7 percent in operational risk-based capital consumption when Zurich moved from an asset-based approach to its current, risk-based approach for operational risk quantification. The business unit management then identified areas of high-risk exposure, performed a deeper assessment and developed measures to mitigate the exposures. As a result, in the following year the unit experienced an additional reduction of 28.9 percent in operational risk capital consumption. The operational risk capital not consumed was then available to fund profitable growth for Zurich.

The Strategic Benefits of ERM

The benefits of developing a new ERM framework or improving upon an existing, more basic one include:

- Minimizing barriers to achieving objectives and maximizing strategic growth opportunities
- Reducing variability in expected business outcomes to enhance value creation advantage
- Generating superior business intelligence to enable improved strategic decision making
- Decreasing total cost of capital through optimizing the balance of risk and opportunity
- Identifying key exposures, quantifying critical activity, and solidifying value chains
- Demonstrating the benefit of increased risk transparency across your organization
- Using additional risk information to improve risk transfer and decrease negative events
- Protecting tangible and intangible assets to minimize impact on bottom line profitability

Clearly, managing risk can no longer be left to one person such as a Chief Risk Officer or siloed into one department, but demands a transparent approach to strategic decisions and daily operations. ERM can encourage resilience and help protect profitability in an ever-changing business climate. Applied robustly across all areas of an organization, a strategic ERM process will efficiently manage available capital---budgeting for potential risks while funding the appropriate growth opportunities.

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