July 2009

Enterprise Risk Management and Consultants

By Max J. Rudolph, FSA CERA CFA MAAA

Given the importance of internal company culture to successful ERM implementation, when should a company use an external consultant? This will vary by the personnel already employed at an entity and the current status of the process.

No process in place

If a company is just starting to develop its ERM process, a consultant can help to jump start the project. Accountability should remain internal, but having someone who has gone through the process before can help to move the initial project forward by providing credibility with the board and senior management. Finding a consultant with a credential related to ERM is helpful but not required.

Developing a successful ERM framework is an iterative process that will continue to improve over time. However, it is better to treat the initial implementation as a project with deadlines and accountabilities. Support from senior management is key as many areas will need to be introduced to new concepts. A consultant can fill in around busy schedules to move things forward and help to explain concepts to key team members as well as business team leaders.

An initial project should include time with senior management and perhaps the board of directors, identification and prioritization of risks taken, accountabilities assigned for all risks, and an initial set of key risk indicators developed. A consultant's experience in this process can help to keep the process moving. There are also opportunities to leverage other projects (e.g., balanced scorecard, PBA reserves) to accomplish your ERM goals.

Initial framework in place but project stalled

Sometimes an ERM process is developed because the CEO or a board member attended a conference and the importance of ERM was stressed. An initial project is developed which is well received, but there is no momentum. Bringing in a consultant can get you back on track. In this situation, generally the initial project was treated as a one timer by participants and they go through the motions once a year in order to satisfy external stakeholders like rating agencies and regulators without realizing how much they could improve their internal decision making ability by putting more focus on balancing risk and return.

Initial framework in place and working well

Even if the ERM process is functioning well, an external fresh look can notice areas for future improvement. It will make sense to use a different consultant than was used for the initial project to get a new perspective on the risks taken. This peer review can lead to a focus on specific improvements, such as moving toward key rate indicators that drive decisions by being leading indicators rather than traditional lagging indicators.

Pricing discipline

ERM projects are often championed in the corporate area. Others participate, but often do not buy in to the new techniques offered by financial units. Pricing is a discipline that should be discussed and made consistent throughout the firm, whether it is internal growth through product pricing or external acquisitions or divestitures.

Modeling Projects

A company's iterative ERM improvements can lead to additional modeling work being done, either to improve other projections or to create a new output such as economic capital. It can be useful to have an outside consultant come in to either help with the modeling itself (many consultants are very efficient because they do this daily) or to peer review the results for reasonableness. Getting that outside perspective can improve the end result.

Scenario Planning

As firms develop their ERM framework and looking at emerging risks, the importance of scenario planning will become more apparent. An external consultant can help develop these scenarios and suggest combinations of events that could prove challenging for a firm based on their specific exposures. Other scenarios might be developed that create best case opportunities if acted on swiftly.

Skeptic

An internal employee often threatens their own career track when they challenge a previously successful unit. An external consultant has less to lose by being honest and sharing concerns about certain products or risks taken. In a firm with a strong risk culture, both internal and external skeptics are encouraged to share their views. Sometimes a little common sense can go a long way toward making better decisions. Firms may not always agree with the consultant's views, but listening and considering them lead to risks being taken with open eyes toward their downside.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!