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October 2013

Integration of ERM into a Corporate Environment

By Max J. Rudolph, FSA CFA CERA MAAA

This paper was submitted to the North American CRO Council 2013 Call for Papers on October 11, 2013.

Enterprise risk management can be an exercise in adding value or simply another in a long list of buzz words popular with directors, investors and rating agencies. It may even be seen as a roadblock and interventionist tool by company management. An appropriate balance must be maintained. What is the right mix of constraints versus growth, qualitative versus quantitative analysis, and short versus long time horizons? These are all questions that the successful ERM process must resolve to build transparency around all risks and build firm resilience.

Company resources are tight, and ERM is viewed by some simply as a cost. In the annual Survey of Emerging Risks that I author we continually find more being asked of risk managers, but without commensurate resources being added. Risk culture is the driver here. Where risk is embedded in a firm, both top-down and bottom-up, it is recognized that better decisions are made by considering all types of risks. Unfortunately many Risk Departments are set up to fail by focusing entirely on constraints, being able to stop a project but not being viewed as a partner who understands how risks aggregate and interact to increase returns. The prior reputation of the risk team predetermines its success, and this is driven from the top. If senior management involves the risk team early in new product development, for example, they are able to suggest adjustments that may lead to a more stable product or provide an internal hedge against a product sold in another part of the company. If the CEO (Chief Executive Officer) views the risk team as a cost center then they will not be successful.

Organizational Structure

Each company must integrate the risk team into an existing organizational chart based on the underlying risk culture. At some companies the primary risks, typically at manufacturing or service focused firms, can be covered by insurance. The Chief Risk Officer (CRO) becomes a coordinator who seeks out competitive rates and coordinates insurer expertise with in-house risk mitigation. In this situation the CRO might report to the Chief Financial Officer (CFO) or Treasurer and be a low level officer or high level manager. The position rarely gets involved in strategic planning discussions and reports to the board are generally canned and informational, covering tactical plans and recent results. Key risk indicators typically provide lagging data.

Small firms will likely add the CRO duties, and sometimes the title, to the CFO as he is the primary provider of oversight at such firms. Reports to the board are part of normal

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financial disclosures and can incorporate strategic topics. Key risk indicators provide lagging information but can incorporate leading indicators as well.

Many larger financial firms, with higher levels of financial risk relative to operational risk, have a CRO position that reports to the board, with a dotted line to someone on the senior management team. This position often focuses on data collection and board presentations designed mostly to make the board able to say they have considered risks, or they can be a key management team member that engages the board to understand how the firm's risk profile is evolving and the potential implications. Done right the focus is on leading risk indicators and brainstorming between areas. This has added benefits of oversight and succession planning.

Unfortunately, many firms rely primarily on quantitative data collected from experts in the business units rather than filling the risk team with business experts and experienced practitioners who can qualitatively question specific practices before they get out of control.

Large firms have an additional hurdle as they tend to be bureaucracies, and those who rise through the ranks have often avoided stressful challenges rather than acting as providers of useful contrarian advice. A small firm may have better risk management practices because the CRO has business experience that drives qualitative analysis rather than an overreliance on quantitative models. The largest companies tend to fall into a trap where complex models are developed and the shortcomings of those models are ignored or included in small print as a footnote. While quantitative analysis is important, everything that counts can't be counted.

Best practice org chart: firms that want to improve their decision making should segment their risk management team between data collectors, where a consistent ERM process is developed and implemented, and strategic planning. The CRO should manage the planning process, making sure that consistent assumptions and models are input to consistent models. Interactions between areas, transparency and concentration risk should be considered. This position should report directly to the CEO, and perhaps not to the board, and be the primary source of common sense oversight to the management team. This natural skeptic must be protected politically by the CEO or it won't work. Interestingly, this role could be filled externally by a consultant who provides honest feedback. Many firms will place employees with this type of expertise in senior management roles running a line or as CFO.

Incentives must be aligned throughout, starting with a firm's risk appetite and tolerance. Risk limits can then be set on a consistent basis across business units. It's not common today, but risk managers should not receive a bonus. Their base pay should be adjusted to compensate them appropriately. If not, the risk manager is incented to complete a less diligent search for previously hidden risks.

Contrarian Thought

The best decisions are made after considering all sides of an issue. Acknowledging multiple viewpoints, and filling management teams and boards with members having broad perspectives, helps to avoid groupthink and yes-men. Staffing a team where everyone is expected to agree with the CEO is short sighted. The senior management team should encourage skeptical thinking at all levels of the firm while recognizing the importance of rallying behind the final decision when interacting with outside stakeholders. At an insurer, for example, expertise could come from knowledge of products, investments, accounting and operations. Few individuals can check all these boxes so it becomes a team approach. Internal staff from another division or external consultants (or rotating consultants) can bring different backgrounds and perspectives. It is easier for an outsider to make waves than for someone who depends on a regular paycheck from a single firm. Charlie Munger, Vice-Chair of Berkshire Hathaway, is a great example of this latticework approach. When Warren Buffett presents an opportunity Munger is not afraid to tell him what he really thinks. While Munger does not have the title he clearly acts as the Berkshire CRO.

Concentration risk

One way to reduce overall risk is to diversify, spreading out risk to limit the opportunity for a single event to materially impact the firm. This can avoid concentration around a specific risk such as product, geographic region, asset class, sales person, supplier, leverage, lack of liquidity, and decision making. The largest risk being ignored today at companies is the risk that decision making is concentrated in one person or a very small set of people. As the SOA says, Risk is Opportunity, and in this case it can be a positive or negative. If the CEO drives all decisions, and many companies choose this path, the company is more likely to outperform or underperform. The CEO hire is very important, but many boards are hesitant to make waves and do not provide the oversight assumed by other stakeholders.

Time Horizon

It is very important for a risk team to compare results across various time horizons. The natural tendency is to put out the short-term fires first, but risks that are building should not be ignored. Mitigation efforts get harder to implement and more costly as an event gets closer. Think about the current crisis surrounding federal entitlements such as Social Security. Small adjustments made a few years ago would have been sufficient, but now prior inactivity makes the challenge that much greater. Few risk managers think beyond the current tactical business plan that extends 3-5 years into the future. Sensitivity testing and scenario analysis should focus quantitative analysis on the tactical plans, with up to 10 scenarios created to test specific risk exposures. Some consistency from year to year is important but a few should be considered wild cards and change annually based on current concerns and developments.

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The best practice firms, in addition to looking at short-term and tactical time frames, will also consider longer term concerns. By spending time thinking and assessing qualitatively over longer periods, a company can develop competitive advantages with proactive development plans. While some can be quantitatively assessed over long periods, it may make more sense for many risks to look at them qualitatively. Using experienced practitioners to brainstorm a risk and how it might interact with a specific risk profile provides value without a large budgetary commitment.

Emerging Risks

Risks that could change over longer periods of time should be documented, assessed and planned for. For an insurer these could include higher/lower mortality/morbidity, an extreme earthquake, geomagnetic storms or an inflation spike. Companies should be creative in identifying emerging risks, thinking outside of their comfort zone to include such risks as climate change, regional conflicts, impact of fracking operations and regional recessions. By monitoring external emerging risk assessments as well as periodically discussing the topic at internal ERM Committee meetings the risk manager can extract differing perspectives about a risk. Combinations of these emerging risks should be considered, as it is important to differentiate between independent risks and mutually exclusive risks. More than one independent risk can happen at the same time.

Efficient Markets

Risk managers need to be the adults in the room when arguments are made that markets are always right and that higher risk projects must be undertaken to earn above average results. We have seen many instances where markets overshoot the true value of an asset, in both directions, providing an opportunity for those willing to go against the herd. Most of the time markets are very close to being efficient but being overly focused on recent results leads to anchoring and poor decision making. Sometimes we misunderstand the drivers, like yelling at bad behavior and celebrating good behavior only to have both revert to the mean during the next measurement period. Often being aware of these human frailties associated with behavioral finance help risk managers avoid common mistakes. After all, only a trade between willing buyer and seller creates the market price that becomes an example of market efficiency.

Diversification is plentiful when conditions are good, but as soon as bad things happen others follow suit and correlations increase. For hidden risks and misunderstood risks, diversification plays a key role in building resilience so a firm is able to fight through tough times.

Consistent process

It seems to be rare that firms enact consistent pricing methodologies between divisions, geographic regions and when contemplating an acquisition or divestiture. For an insurer some examples include; inconsistent tax rate, inconsistent capital charge, marginal versus stand-alone pricing, and inconsistent hurdle rate (opportunity cost). A best practice firm

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will measure itself consistently so that the capital allocator (generally the CEO) can compare opportunities.

Experience

The inexperienced risk manager thinks differently than an experienced one. Initially the focus for a young risk manager is on downside risk, then the risk manager thinks he knows enough to optimize results, and finally (generally after his "optimal" model blows up) he tries to manage the risk of not meeting corporate goals and maintaining solvency. By retirement he is starting to understand that he knows what he doesn't know, and it's still quite a bit. This is why many investors succeed well into their older years. Experience and wisdom pays dividends.

Conclusion

A risk manager's job is to assure the firm can live to fight another day. Only by holistic assessment of risks, with aggregation across business units and risk silos while considering interactions will lead to better decisions being made. Multiple perspectives, including some that are skeptical and contrarian, should be sought out and encouraged. Some of these may be best found outside the firm. The best risk team structure will vary by firm and risk profile, but reaching for longer time horizons and involvement in strategic planning will provide a competitive advantage by identifying bubbles and opportunities.

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