The role of top management and the board in ERM

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Enterprise risk management is at its most effective when it informs every aspect of the business and when the ERM framework is continually evaluated and updated. A key objective for senior management and board members should be to foster a risk-aware culture across the organization, and to actively monitor and update ERM. Among our study's Trendsetters[1]—companies that are most proficient at creating value through ERM—management and the board ensure that ERM is fully integrated into the strategic decision-making process and regularly review the ERM framework to ensure progress remains constant.

Our survey of 125 North American companies showed that no less than 94% of Trendsetters have their risk management practice embedded in the strategic planning process. Only 57% of Transitionals and 32% of Beginners were able to make that claim.

WHY TRENDSETTERS LEAD IN MANAGEMENT COMMAND

At companies with the best ERM framework, what distinguishes the management and board? One key factor is their level of awareness of risk. Says Brian Merkley, global director, corporate risk management, at Huntsman Corporation, a chemicals manufacturer: "One of the most tangible benefits" of ERM is that it has "increased the transparency of risk to our board, and helped them understand how management views the key risks and what's being done about them."

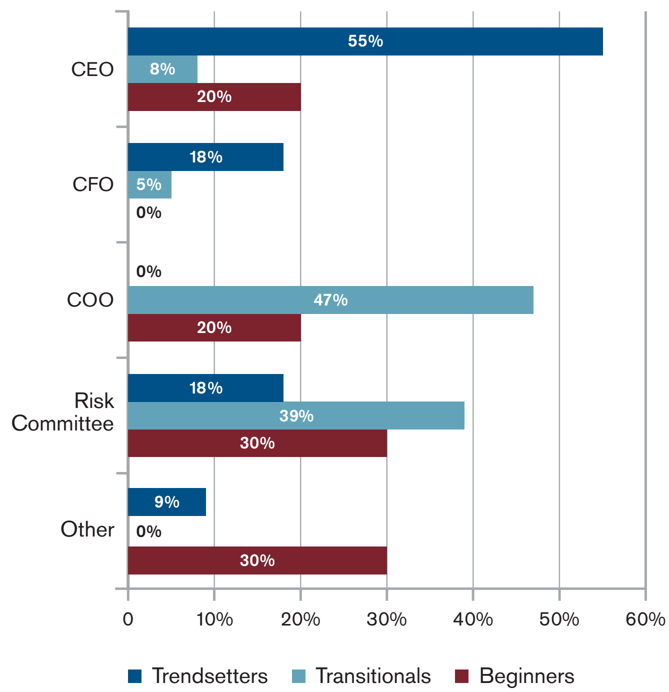
Our survey finds that Trendsetters (75%) are far more likely than Beginners or Transitionals (40% and 44%, respectively) to have a chief risk officer (CRO), and for their CRO to report directly to either the CEO or CFO (73%, vs. 13% and 20%). For almost half of Transitionals (47%), the CRO answers to the COO, adding at least one additional layer of hierarchy between the head of risk and top management; for 38%, the CRO reports to the risk committee (see Figure 1).

This suggests that at Trendsetter companies, the risk function is of sufficient stature to move management and the board to implement ERM, risk-adjusted performance metrics, and risk-stressed capital deployment. Likewise, management and the board at these companies have gone farther at making ERM a priority throughout the organization. For example:

Monitoring and auditing ERM. More than 80% of Trendsetters say management and the board regularly monitor or audit the ERM program to evaluate its effectiveness, compared with only 51%

FIGURE 1: THE CRO IS MORE LIKELY TO REPORT DIRECTLY TO TOP MANAGEMENT

To whom does the chief risk officer directly report? *Select one.*



[1] From the results of our survey of 125 North American companies, we identified three levels of proficiency at ERM value creation: At Beginners, risks are still managed in silos; at Transitionals, there is a moderate degree of collaboration and transparency across the organization; while at Trendsetters, corporate risk tolerances are aligned to business units and there is greater company-wide emphasis on reporting, regulatory compliance, and audit. See http://us.milliman.com/RiskInstituteSurvey.

of Transitionals and 32% of Beginners (see Figure 2). This is an area of attention for companies moving up the ERM value-creation curve. At Pacific Life Insurance Company, CRO Joe Celentano says the company's ERM program has never been audited, but that is likely to change soon. "Our view was that it would not add value because we already knew our shortcomings. Now I think I would be comfortable with it," he says.

Risk mitigation or control capital. For nearly 70% of Trendsetters, management and the board have a decision-making framework with which to deploy risk mitigation or control capital, compared with 58% of Transitionals and 40% of Beginners. Over half (56%) of Trendsetters that employ such a framework consider it to be effective versus 48% of Transitionals and just 36% of Beginners, indicating that they have embedded risk mitigation in every level of the organization. Trendsetters have also had formal risk management procedures in place longer than others, reinforcing their confidence in the framework.

Embedding a risk-aware culture. Nearly 70% of Trendsetters say management and the board implant a risk-aware culture throughout the organization, compared with only 44% of Transitionals and 20% of Beginners. At Huntsman, Mr. Merkley notes that company founder and chairman Jon Huntsman took a direct hand in instilling risk awareness throughout the company from its early days. "Part of this awareness stems from the fact that when you are manufacturing chemicals at high temperatures, you had better understand the risks, because the consequences can be catastrophic if you don't," he says.

Integrating ERM with performance management. Management and the board integrate ERM with performance management at more than half (56%) of Trendsetters, compared to 36% and 20% for Transitionals and Beginners, respectively.

BEGINNERS ARE MOVING UP QUICKLY

What matters most in determining which companies will be successful at ERM value creation in the longer term may not be the company's size or even its current level of risk maturity, but management and the board's determination to embed it deeply into every level of the organization. Aftab Saleem, vice president of enterprise and derivative risk at Miami-based World Fuel Services, says that while the company wants to create a more "in depth" enterprise risk program, "it depends on our CFO and CEO, and their appetite to go to a deeper level of detail with ERM."

While management and the board at Trendsetter companies have put more of the policies and processes in place to create a best-practice ERM framework, other companies are moving swiftly to catch up with them in most areas. Perhaps surprisingly, however, these tend to be companies at the earliest level of ERM value creation—Beginners, not Transitionals. As a result, Beginners actually have a profile that hews more closely to that of Trendsetters than of Transitionals. For example:

Larger companies. The overwhelming majority of Beginners (76%) and Trendsetters (73%) are large companies with over $2 billion in total revenues, while only a bare majority (55%) of Transitionals fall into this category.

FIGURE 2: TRENDSETTERS COMPANIES ARE AHEAD IN MOST ASPECTS OF ERM PROFICIENCY

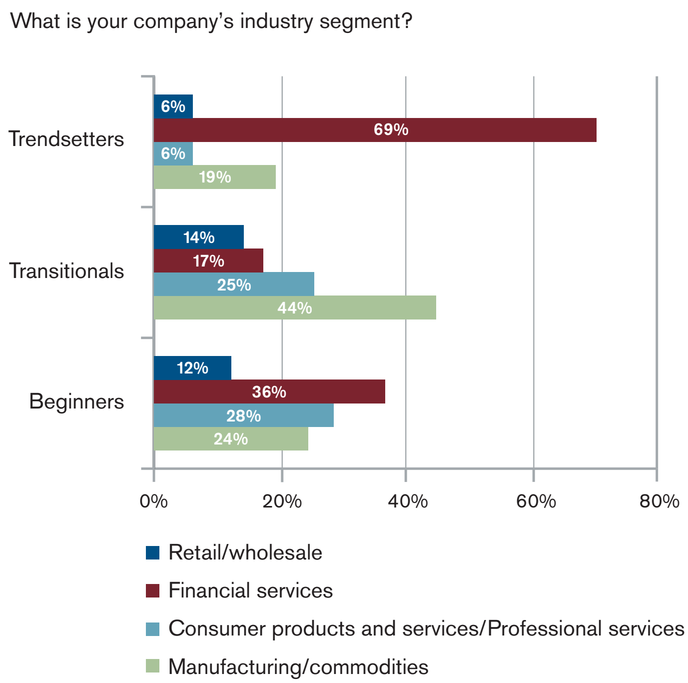
With which of the following statements about your company's management and board do you agree? *Select all that apply.*

	Trendsetters	Transitionals	Beginners
Have a decision-making framework for development of risk mitigation or control capital	69%	58%	40%
Have a contingency planning/crisis management process in place	88%	44%	68%
Regular monitor or audit ERM program to evaluate its effectiveness	81%	51%	32%
Have a management- or board-level risk committee	75%	32%	56%
Embed a risk-aware culture throughout the organization	69%	44%	20%
Integrate ERM with performance management	56%	36%	20%
Requires risk-adjusted budgets	19%	31%	48%
Model and understand the impact of a combination of catastrophic risk scenarios	44%	27%	36%
Require risk-adjusted capital requests	19%	29%	8%

Heavier financial services presence. Beginners are also more likely (36%) than Transitionals (17%) to be financial services firms, which have a longer tradition of managing risk according to a formal, structured approach—although Trendsetters are vastly more concentrated in this industry (69%). By contrast, Transitionals are most heavily concentrated in manufacturing and commodities (44%), which tend not to be as risk-sophisticated. It should also be noted that financial services firms are now subjected to additional regulations, which demand additional risk management efforts.

Higher-level risk committees. Transitionals are far less likely (32%) to have a management- or board-level risk committee than Beginners (56%) or Trendsetters (75%). Data from the survey suggests that sustaining progress toward greater risk management is materially aided by the support and attention of senior management.

FIGURE 3: TRENDSETTERS AND BEGINNERS ARE MORE LIKELY TO BE FINANCIAL SERVICES COMPANIES



Better contingency planning and crisis management. Almost 90% of Trendsetters and nearly 70% of Beginners have a contingency planning or crisis management process in place for the management and board, compared with only 44% of Transitionals. One firm that is moving from the Transitional to the Trendsetter level, World Fuel Services, has identified risk owners throughout the organization to monitor 15 specific risks. Says Mr. Saleem, "If the need arises we can quickly put an expert team together to deal with a previously unforeseen risk."

Quantifying the impact of catastrophic events. Modeling and understanding the impact of a combination of catastrophic risk events is a practice that management and the board at most companies have yet to adopt, regardless of their overall level of ERM proficiency. Yet Trendsetters (44%) and Beginners (36%) are significantly more likely to have done so than Transitionals (27%).

What explains the faster progress Beginners are making? It is possible that companies in the earlier stages of ERM development are attempting to reach a higher level more quickly, perhaps learning from the experience of companies already at the Trendsetter level. Beginners appear to have momentum and are anxious to maintain it. By contrast, many Transitionals may have reached a plateau and are no longer focused on attaining the stage where ERM is embedded throughout the organization and is integral to strategic decision making.

In light of their concentration in the manufacturing and commodities sectors, Transitionals may face more complex operational or process flows that make it difficult to embed the ERM framework readily throughout the organization. Even companies with relatively sophisticated ERM processes have trouble crafting a risk appetite statement, for example. At Huntsman Corporation, where this document is still a work in progress, "It's just the different perspectives that each level of the organization has, and the board has," says Mr. Merkley. "If you ask 100 people 'what's your appetite for a particular risk,' you might get 100 different answers."

For Transitionals, then, it is imperative that management and the board constantly review the ERM framework to ensure they have all the pieces in place to keep the risk management effort moving forward. At World Fuel Services, "ERM as a whole is still evolving," says Mr. Saleem. "That being the case, top-level engagement by the board is critical. Once they feel they can make better decisions, it drives our program to the next level. We have some good ideas. There are some good things we are working on. But in terms of best practice, it's management that moves it forward."

CALLS TO ACTION

At many companies, it may be up to the risk manager to create the necessary momentum at the top to develop strong ERM processes. To move the risk agenda forward, an effective risk manager must be able to educate senior executives as to the potential threats the company faces if it doesn't move proactively to address potential risks. An even more convincing argument can be made, however, when risk managers can also point to the potential opportunities for higher returns that a rigorous risk analysis can often uncover.

Once senior managers are more focused on the importance and potential benefits of this exercise, there are three critical steps to take:

1. **Create a management- or board-level risk committee:** If your company doesn't have one, this could be an effective way to get top executives to regularly consider key risks.

2. **Integrate ERM with performance management:** This induces top management to regard risk as a factor in evaluating the company's overall health, further raising its profile.

3. **Initiate or step up auditing of the ERM program:** ERM improvement should be ongoing; reporting on regular audits creates an expectation in the C-suite that further progress is needed.

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