ERM: The Value Proposition

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Enterprise risk management (ERM) is a process of assessing and responding to all risks, including organizational and systemic risks that impact the ability of an organization to meet its objectives. The general activities in a formal ERM process include risk identification, evaluation, prioritization, treatment, monitoring, reporting, and integration into strategic decision making and key business functions. It is important to understand the challenges organizations face in implementing ERM processes before we look at the value that a sustainable and repeatable ERM process can bring.

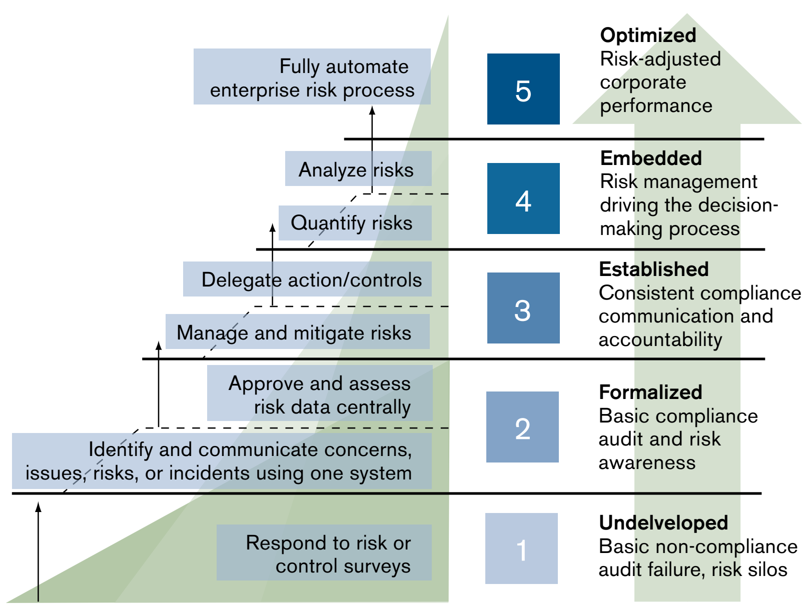
Companies have traditionally struggled with assessing the business value of ERM. Competing priorities and business line fatigue after seemingly endless rounds of assessments from Internal Audit, Compliance, and even external regulators have contributed to failed ERM initiatives. In addition, some companies have rushed through what at many times has been a board-mandated compliance effort to institutionalize ERM as one-off events rather than implementing a sustainable and repeatable ERM process.

In many cases, the efforts have been under-resourced and, for the broader risk evaluation and mitigation initiatives, have not had buy-in from executive leadership. Executive sponsorship and involvement stand at the heart of a successful ERM initiative, without which many companies have failed in their efforts to implement an effective ERM process. With so many competing priorities, companies also struggle in setting aside appropriate resources to launch and sustain an effective integrated ERM process.

An ERM process and risk management framework has to find synergy with the organization's culture and not the other way around. Too many times we see a company wanting to implement what another company is doing with regard to ERM. Although best practices are an excellent way to start thinking about ERM, this thought process should be complemented with a good understanding of a company's own unique culture, strategic objectives, structure, risk management practices, and operations. There is not one universal solution for ERM. A customized approach is crucial to finding the maturity level of an ERM solution that works for a specific company, based on best practices, extensive research, interviews, and in-depth knowledge of how an organization operates (see Figure 1). The process has to be embedded and integral to support the mission, vision, values, and objectives, and not just a snapshot from a single point in time or an annual risk assessment report.

Additional reasons for failed ERM initiatives are that a company's objectives have not been integrated into performance management and poor collaboration with other risk processes. Aligning incentives with risk management efforts can be critical to the success of an ERM initiative. Incentives reinforce the tone and culture of the organization and motivate employees to respond; this could have more positive results than a forced compliance effort. It is crucial to get buy-in from employees on the benefits of an ERM program prior to implementation, and there is no more effective way than through incentives based on actions and expected outcomes around risk-managed activities. The integration of ERM with key risk processes such as audit, compliance, and business continuity,

FIGURE 1: ERM MATURITY STAGES



for example, is also essential to realizing the value of an effective ERM process. Companies in a higher maturity level (See Figure 1) are seeing the business value in decision making as a result of the collaboration of their ERM program with other risk processes.

Milliman's Risk Advisory Services consults with organizations to develop an optimal ERM solution that matches with specialized corporate needs. Some companies have fully resourced ERM departments, while others have very restricted dedicated internal resources. Milliman can assist companies with their ERM initiatives using the following approaches:

- Review the current ERM processes and determine the steps required to raise the maturity level to the desired state.
- Design, build, and test a customized ERM process and framework and develop organizational consensus through vetting of the initial prototype.
- Adapt an outsourced ERM business process model.

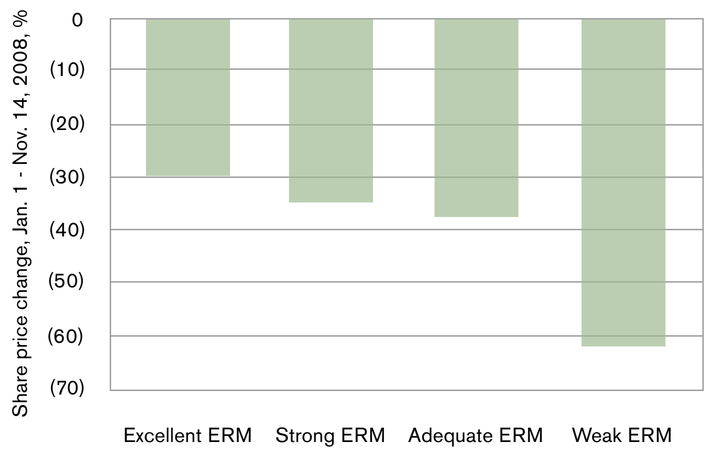
Companies wanting to protect against the downside of risks often reach for ERM as a compliance tool, but the true value of ERM is recognized when it is integrated into the organization's culture and embedded into strategic decision making and business planning. We see the following as significant benefits that organizations can achieve if they invest the time and resources to select a suitable approach to their ERM needs:

- **Performance management**: Increase certainty of achieving critical key performance indicators
- **Capital efficiency**: Align capital more accurately with the risks being taken and ensure that risks are being suitably rewarded
- **Stakeholder management**: Better alignment with expectations of key stakeholders
- **Operational excellence**: Reduce impact of surprises and boost the benefits of a well-managed portfolio of risks
- **Reduction in Total Cost of Risk (TCOR)**: Free up capital to further invest in growing the business

In February 2010, Standard and Poor's (S&P) published the report "Enterprise Risk Management Continues to Show its Value for North American and Bermudan Insurers," which links effective ERM programs to increases in share value and reduced volatility in earnings. In the report, Howard Rosen, the primary credit analyst, says in part,

> *"Although average stock prices declined among all public multiline insurers in 2008, companies with more advanced ERM programs experienced smaller stock price reductions. Those companies whose stock performance was better (i.e. those whose price declines were smaller) had received higher ERM scores. On the other hand, those companies whose stock prices had larger declines had lower ERM scores. This is consistent with Standard & Poor's view that more robust ERM programs are the most valuable in times of more pronounced stress. Looking at ERM scores relative to stock performance in 2009 reveals a different pattern" (See Figure 2).*

FIGURE 2: ERM AND SHARE PRICE CHANGE (JAN. 1-NOV. 14, 2008, %)



Excludes mortgage and title insurers. Source: Standard & Poor's.
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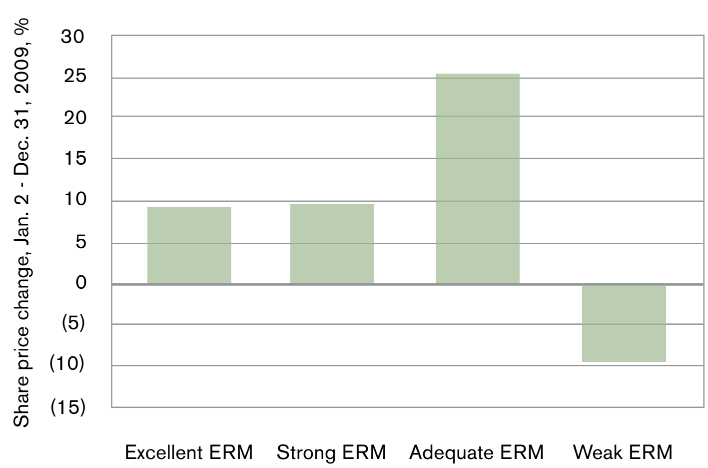
Rosen continues,

> *"Companies with Excellent and Strong ERM scores—companies whose stock prices performed better during the more stressful 2008—still improved during 2009, but didn't need to perform as well as companies with lower ERM scores to return to their pre-2008 levels of performance" (See Figure 3).*

FIGURE 3: ERM AND SHARE PRICE CHANGE (JAN. 2-DEC. 31, 2009, %)



Excludes mortgage and title insurers. Source: Standard & Poor's.
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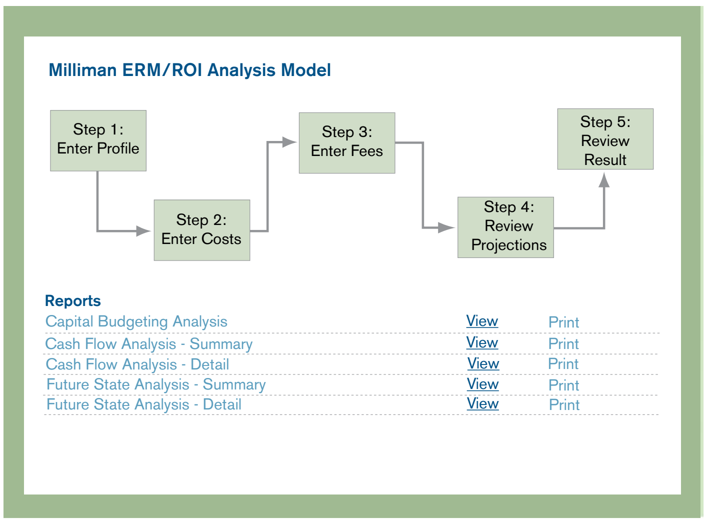
With boards of directors under more scrutiny for organizational missteps and systemic failures, a robust ERM process can help them to meet their fiduciary responsibilities. The process should also deliver tangible return on investment (see Figure 4). The decision to embed a process and/or purchase an ERM software system to support a business process should be assessed prior to any implementation.

FIGURE 4: ROI ANALYSIS FOR ERM CONSULTING SERVICE PURCHASE DECISION



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RECENT ERM MARKET DEVELOPMENTS

- Directors and officers (D&O) liability insurance provider gives a national financial institution a significant premium credit for having an ERM business process and program in place
- A leading attorney who writes a majority of the D&O forms for insurance companies has stated that an ERM program can be an effective mitigation strategy to prevent D&O claims
- Increased regulatory requirement to implement effective ERM processes

In summary, many of the resources needed to address the ERM process are likely to already exist in any organization and the process should not be a time-consuming initiative. An effective ERM program with a phased approach in mind for gradually improving the maturity level (see Figure 1) should be the primary focus for ERM directors and chief risk officers. Companies should be placing more emphasis on practical business value, which an effective ERM program can provide.

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